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Independent Evaluation Group

# The World Bank Group Guarantee Instruments 1990–2007

## An Independent Evaluation

# THE WORLD BANK GROUP

***WORKING FOR A WORLD FREE OF POVERTY***

The World Bank Group consists of five institutions—the International Bank for Reconstruction and Development (IBRD), the International Finance Corporation (IFC), the International Development Association (IDA), the Multilateral Investment Guarantee Agency (MIGA), and the International Centre for the Settlement of Investment Disputes (ICSID). Its mission is to fight poverty for lasting results and to help people help themselves and their environment by providing resources, sharing knowledge, building capacity, and forging partnerships in the public and private sectors.

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# Abbreviations

| | |
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| ADB | Asian Development Bank |
| AfDB | African Development Bank |
| ATI | African Trade Insurance Agency |
| BOAD | Banque Ouest Africaine de Developpement |
| CAS | Country Assistance Strategy |
| CELT | Credit-enhanced lending transaction |
| EBRD | European Bank for Reconstruction and Development |
| FDI | Foreign direct investment |
| GOLF | Global Offshore Liquidity Facility (IFC) |
| GRC | Guarantee Review Committee |
| GRIP | Guaranteed Recovery of Investment Principal |
| GTFP | Global Trade Finance Program |
| IBRD | International Bank for Reconstruction and Development |
| IDA | International Development Association |
| IEG | Independent Evaluation Group |
| IFC | International Finance Corporation |
| IPRC | Implicit political risk cover |
| MIC | Middle-income country |
| MIGA | Multilateral Investment Guarantee Agency (of the World Bank) |
| MSME | Micro, small, and medium-size enterprise |
| OPIC | Overseas Private Investment Corporation (US) |
| PBG | Policy-Based Guarantee |
| PCG | Partial Credit Guarantee |
| PPP | Public-private partnership |
| PRG | Partial Risk Guarantee |
| PRI | Political risk insurance |
| PRM | Political risk mitigation |
| RRG | Rolling Reinstatable Guarantee |
| RSF | Risk-Sharing Facility |
| SIP | Small Investment Program (MIGA) |
| SME | Small- and medium-size enterprise |
| WAEMU | West African Economic and Monetary Union |
| WBG | World Bank Group |

Complex infrastructure projects that carry a higher perception of risk have been beneficiaries of WBG guarantee instruments.
Photo by Arne Hoel, World Bank Group.

# Acknowledgments

This report was prepared by a team led jointly by Asita De Silva (Independent Evaluation Group [IEG]–World Bank), Ethel Tarazona (IEG–Multilateral Investment Guarantee Agency [MIGA]) and Stoyan Tenev (IEG–International Finance Corporation [IFC]), under the supervision of Marvin Taylor-Dormond (Director, IEG–IFC). It draws on research and contributions from Abdul Akande, Unurjargal Demberel, Tanakorn Makaew, Bertrand Marchais, Carlos Nunez, Carla Pazce, Aurora Medina Siy, Victoria Viray-Mendoza, Ian Webb, and Stephan Wegner. Yvette Jarencio and Rosemarie Pena provided general administrative support to the study team. Heather Dittbrenner edited the report, and Sid Edelmann, Sona Panajyan, and Shunalini Sarkar managed its publication and dissemination.

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The overall goal of WBG guarantee instruments is to facilitate investment in high-risk projects and countries. Terraced rice paddies near a Red Zao village, outside of Sapa, Lao Cai province, in northern Vietnam. Photo by Tran Thi Hoa, courtesy of the World Bank Photo Library.

# Foreword

Foreign direct investment and private capital flows are highly concentrated geographically, with almost half of them reaching the top five destinations. These flows tend to evade many high-risk countries, with the exception of those directed to extractive industries. Regulatory and contractual risks, particularly in infrastructure, have inhibited investments in many parts of the developing world. A core objective of the World Bank Group (WBG) has been to support the flow of private investment for development; guarantees and insurance have been among the instruments that the Group has used to pursue this objective.

This evaluation assesses the effectiveness in the use of guarantee and insurance products by the WBG. It finds that these instruments have effectively advanced WBG strategic objectives, in particular facilitating the flow of private investment to high-risk sectors and countries. The diverse range of these instruments has helped to meet the demand for risk mitigation under a variety of circumstances. The Multilateral Investment Guarantee Agency, (MIGA), a relatively small institution of 100 staff, has issued $17 billion in guarantees and meets a gap in the provision of political risk insurance that private providers are unable to meet. The World Bank's partial risk guarantee has supported large and complex public-private partnership infrastructure projects in high-risk countries. Its partial credit guarantees have introduced countries to commercial markets or reintroduced them following a crisis. The International Finance Corporation's (IFC) guarantee instruments have led its entry in the market for local currency finance and have helped improve access to finance for underserved market segments.

At the same time, the evaluation finds important weaknesses in the delivery of political risk mitigation instruments that constrain their deployment. A range of policy or mandate restrictions holds back the use of the instruments in specific situations. There has been competition among WBG institutions for the same clients, imposing transaction costs on clients and reputational risks on the WBG. Weaknesses in marketing efforts for MIGA and World Bank products contribute to limiting client awareness of the products. Inadequate internal awareness of the instruments in the World Bank and IFC reduces the potential for their wider use. Inconsistent pricing of the Bank's partial risk guarantee instrument entails risks of creating market and product distortions.

The challenge for the WBG is to create an environment in which guarantee and insurance products can be deployed—alongside other WBG instruments—in a flexible and efficient manner to meet client needs. The report concludes that maintaining the status quo, particularly in the delivery of political risk mitigation products, ought not to be an option. It suggests that WBG senior management should decide whether to take a set of collective and individually tailored actions within the current institutional structure or to adopt a new organizational structure for product delivery.

*Vinod Thomas*
Director-General, Evaluation

MIGA guarantees cover projects for noncommercial risk, such as infrastructure projects that may be interrupted by a political upheaval. Photo by Suzanne Pelland, courtesy of MIGA.

# Executive Summary

Notwithstanding the dramatic growth in private financial flows to developing countries, there is significant untapped potential for greater involvement of the private sector in financing development-oriented investments. Foreign direct investment and private capital flows are highly concentrated geographically: almost half of foreign direct investment goes to the top five destinations (World Bank 2007a).

These flows bypass many high-risk countries, with the exception of some that are directed to extractive industries. Regulatory and contractual risks, particularly in infrastructure, have inhibited investment and threaten the sustainability of economic growth in large portions of the developing world. A core task of the World Bank Group (WBG) is to support the flow of private investment: guarantees have been among the instruments used to achieve this.

This evaluation reviews the WBG's experience with guarantee instruments during 1990–2007.[1] Although these instruments have been an established product line of the WBG for two decades, they have not been rigorously evaluated across the World Bank, International Finance Corporation (IFC), and Multilateral Investment Guarantee Agency (MIGA).

The study asks three main questions: (1) Should the WBG be in the guarantee business? (2) Have guarantee instruments in the three WBG institutions been used to their potential as reflected in WBG expectations and perceived demand? (3) Is the WBG appropriately organized to deliver its range of guarantee products in an effective and efficient manner?

The answer provided by the evaluation to the first question is yes. Guarantees have been effective in promoting key WBG strategic objectives, particularly in facilitating the flow of investment to high-risk sectors and countries. The additionality—or unique contribution of these guarantee instruments—has derived from the WBG's relationship with host countries, its capacity to absorb risks that the private sector is unwilling or unable to bear, and its focus on the objectives of poverty reduction and sustainable development. Guarantee instruments remain important for the WBG's priorities.

The answer to the other two questions is essentially no, especially regarding the delivery of products for political risk mitigation (PRM). The use of guarantee products in each of the three institutions has fallen short of reasonable expectations because of external and internal factors. Considering external factors, demand projections appear to have been overly optimistic. This is particularly true in infrastructure, where the rapid growth of the mid-1990s has not been sustained. In addition, the supply of risk mitigation offerings by other private sector providers in emerging markets has also grown in both products and markets.

The internal factors for the negative answers include (1) competition among institutions for the same clients and of the kind that often imposes additional transaction costs on clients and adds reputational risks to the Bank; (2) weaknesses in the marketing of WBG guarantees and PRM products that limit client awareness and choice; (3) a range of supply-driven policy and mandate restrictions that inhibit the deployment of WBG guarantee instruments in response to evolving client needs; (4) limited internal awareness, skills, or incentives in the World Bank and IFC to use guarantee instruments in relevant situations; and (5) inconsistent pricing of the Bank Group PRM products, which runs the risk of creating market distortions and product differentiation among WBG instruments based on price. These suggest opportunities to productively expand the use of guarantees.

To overcome the current limitations of the delivery system of WBG guarantees and PRM instruments and to enhance their use and development potential, the evaluation recommends that WBG senior management take a strategic approach and decide whether to maintain the existing organizational structure, while addressing some of its important problems, or to develop and propose an alternative organizational structure to the Board.

Under any scenario, WBG senior management needs to take actions to introduce greater flexibility in the use of guarantee instruments in response to dynamic country and client needs and market developments by taking several actions: (1) revising existing policies and regulations on guarantees to minimize supply-driven product restrictions and allow product differentiation on the basis of value added; (2) ensuring that adequate incentives exist for staff to offer the full array of WBG guarantees and PRM products to private sector clients; (3) establishing more systematic links between advisory services and the deployment of Bank Group PRM instruments and other products, particularly in infrastructure; (4) following a consistent approach to pricing of PRM across its guarantee instruments to avoid potential distortions; and (5) strengthening internal awareness of the guarantee instruments and the skills for their use and reducing transaction costs where possible, keeping in mind the importance of maintaining adequate processes and regulations for risk management and safeguards.

If a new organizational structure is developed and proposed, this evaluation recommends that WBG senior management consider at least three alternative perspectives for organizational realignment: the client perspective, the country perspective, and the product perspective. If the current organizational structure is maintained, the study recommends that the management of each individual WBG institution enhance the delivery of its own guarantee/insurance products by implementing specific measures designed to improve policies and procedures, eliminate disincentives, increase flexibility, and strengthen skills for the deployment of the products.

## Should the World Bank Group Be in the Guarantee Business?

**Guarantee instruments have been largely effective in supporting WBG strategic objectives.** Across the WBG, guarantees have effectively promoted private investment. Since 1990, MIGA has issued 897 guarantees for a total of $16.7 billion. Its guarantees supported investment flows across a broad range of high-risk sectors and countries and for small and medium-size investments.

The World Bank has issued 25 guarantees for $3 billion. Although limited in number, its Partial Risk Guarantees have facilitated the flow of investment in large infrastructure projects in high-risk countries, particularly by enhancing the credibility of untested regulatory regimes. The International Bank for Reconstruction and Development's Partial Credit Guarantees have been used to introduce well-performing countries to markets or to regain access following crises.

IFC has approved 196 guarantee operations for $2.8 billion, including through its Global Trade Finance Program. More than 30 percent of its guarantees have been used to support trade and investment flows in Africa. They have also enhanced access to financing for micro, small, and medium-size enterprises in low-income countries.

Guarantees account for 1.6 percent of the International Bank for Reconstruction and Development's loan portfolio and 6 percent of IFC's. That compares with 2 to 4 percent of the portfolios in other multilaterals examined in this study.

**The WBG's additionality in risk mitigation derives from its relationship with governments and its contribution to broader development objectives.** Each institution has issued a substantial proportion of its guarantees in high-risk countries: 45 percent in MIGA, 46 percent in IFC, and 48 percent in the World Bank.

The WBG's additionality in mitigating risk is largely derived from its special relationship with governments, which enables it to absorb higher risks than private sector providers can take on. MIGA remains the largest multilateral provider of traditional political risk insurance in the world and has filled a gap in the market by providing longer-term insurance in higher-risk countries. World Bank guarantees have helped further both policy reforms and the environment for private investment. IFC guarantees have supported financial innovation and capital market development by introducing new financial instruments to new classes of investors. More than half of IFC's commitments under the Global Trade Finance Program were in Africa, which has helped address a gap in the market for trade finance.

## Have WBG Guarantees Been Used to Potential as Reflected in WBG Expectations and Perceived Demand?

**Whereas guarantee instruments remain an important tool for supporting WBG strategic priorities, the use of the instruments has fallen short of WBG expectations to varying degrees.** Several factors contribute to the perception that there is significant unmet demand for WBG guarantee instruments: (1) Political risk is consistently ranked as a main constraint to the flow of foreign direct investment to developing countries; (2) regulatory and contractual risks are perceived as the main reason for the growing investment gaps in infrastructure; and (3) abundant liquidity in emerging markets calls not for external funding but for enhancements that can help deepen the market, extend maturities, lower spreads, and redirect resources to underserved market segments and new areas unfamiliar to financiers in emerging markets.

A large number of developing countries and sectors do not receive enough funding because of perceptions of high risks that the private sector is unable to mitigate. In light of significant potential demand, and given the importance of the instrument for the WBG's strategic priorities, various strategies and policies have anticipated a significant increase in the deployment of guarantees. Relative to these expectations and to perceived demand, the use of WBG guarantees has been modest.

**Some external factors explain limited deployment.** The WBG has had overly optimistic expectations, particularly in the case of public-private partnerships across a range of infrastructure sectors based on rapid growth in the mid-1990s. These have not been realized in part because of perceived high regulatory and contractual risks. Some studies indicate that 65 percent of investors self-insure rather than taking third-party insurance, suggesting a more limited effective demand. Private sector providers of risk mitigation products have expanded their coverage in terms of both products and markets. Liquid markets in the 2000s have reduced the demand for sovereign Partial Credit Guarantees.

**Internal factors have also constrained the deployment of instruments.** MIGA's Convention and Operational Regulations limit its adaptability to new market trends. MIGA has also not been sufficiently aggressive in innovating within the flexibility allowed by current policies. Internal constraints to the deployment of Bank guarantees include the application of standards designed for public sector operations to private sector projects; a depletion of skills; and lack of both internal and external promotion of the instrument. IFC has tended to apply a traditional project financier's approach to guarantee-type instruments. It has taken an overly conservative stance toward risk-sharing facilities, which has constrained their utilization.

Although some progress has been made in innovation, there has been limited replication and scaling up. Processing requirements in terms of safeguards and risk management in each of the three institutions have added value and must be maintained and strengthened. But inefficiencies that encumber processes need to be improved upon.

## Is the Bank Group Appropriately Organized to Deliver the Range of Guarantee Products?

**There is an overlap in the provision of PRM products within the WBG.** The WBG's guarantee instruments were designed to be complementary, not competitive. However, a range of both guarantee and nonguarantee products overlap in the provision of PRM for private sector clients, and this overlap has tended to expand over time.

Flexibility of policies and innovation in guarantee and nonguarantee products have expanded the scope for competition. In addition, several nonguarantee IFC products offer PRM to the market. IFC's lending and equity investments carry a degree of implicit political risk cover, and its B-loan program can mitigate transfer and convertibility risk through the umbrella of IFC's preferred creditor status. The PRM products of the three WBG institutions serve the same broad group of clients, and there is evidence that these overlaps have caused confusion among clients and internal competition of the kind that often imposes additional transaction costs on clients and adds reputational risks to the Bank.

**At the same time, each institution's products carry distinct attributes that help define market niches.** The package of services accompanying Bank/International Development Association (IDA) Partial Risk Guarantees makes them appropriate in situations of large, complex public-private partnerships in untested regulatory environments and difficult business climates. IFC's PRM can be packaged with a full set of financial services and combined with commercial risk cover. MIGA products can offer flexible, self-standing political risk coverage that is least disruptive of the project financial structuring process and that can match the need for longer-term cover and reach smaller investors. Thus relationships of both substitutability and complementarity exist among the WBG PRM instruments, which implies that there are opportunities for cooperation and a need for coordination.

The three WBG institutions have cooperated on guarantee projects in several instances, but such cooperation has often been associated with high transaction costs. In selected cases, the three WBG institutions have cooperated on the same projects, particularly large, complex projects in IDA countries. At the same time, this cooperation has often been associated with higher transaction costs, for both the institutions and the clients. In one project, the participation of the Bank, MIGA, and a third multilateral insurance provider required the project sponsor to enter into three contractual agreements, each with different structures, coverage, and mechanics.

The IDA-IFC program to enhance small and medium-size enterprise access to finance in Africa, although achieving development outcomes, has been difficult to replicate, because it has been difficult to mobilize IDA resources for first loss provisions. The need to fit these operations into existing IDA operations has also been a limitation, and different procurement and conflict of interest policies within the WBG have added to transaction costs.

The establishment of the joint IFC-Bank Subnational Finance Department has institutionalized synergies between IFC and the Bank in subnational finance. However, it has been difficult to come up with mechanisms to reward Bank staff for contributions to an IFC project. And despite attempts to resolve the pledge of shares and sharing of arbitral awards issues related to the allocation of collateral assets between lenders and insurers, they continue to hinder direct IFC-MIGA cooperation.

**Mechanisms to enhance coordination across the WBG have had varying degrees of effectiveness.** More systematic consultations between MIGA and Bank country and sector departments have helped ensure that MIGA-supported projects are consistent with the Bank

Group's strategy in a country. But the principles that govern the relationship between MIGA and IFC products have been unclear. The "hierarchy of instrument" principle—which dictates that Bank products be deployed last—has provided some guidance, but implementation has been difficult. A Group-wide Guarantee Review Committee had limited success in harmonizing approaches and added to transaction costs. Its functions have now been transferred to the Operations Committee of the Bank. In some cases, informal information sharing about business opportunities has been effective in leading to actual guarantee projects.

**There is limited coordination within the WBG in developing new products and at the business development stage.** Lack of staff incentives, inadequate skills, and poor familiarity with the products of the other institutions have prevented better exploitation of downstream synergies in marketing WBG products. Significant potential exists for more systematic links between Bank-IFC advisory services and the use of WBG risk mitigation instruments, particularly in infrastructure, keeping in mind the need to manage potential conflict of interest issues. The Bank and MIGA apply different approaches to pricing of political risk in their products for private sector clients, which limits the effectiveness of coordination through the market. Products are not offered as a single menu of options to prospective private sector clients. In sum, opportunities exist for improvement, and maintaining the status quo should not be an option.

## Recommendations

**To overcome the current limitations of the delivery system of WBG guarantees and PRM instruments and to enhance their use and development potential, the Independent Evaluation Group recommends the following to WBG senior management:**

1. **Take a strategic approach and make a decision whether to maintain the existing organizational structure while addressing some of the important problems, or develop and propose an alternative organizational structure to the Board.**

2. **Under any scenario, take action to introduce greater flexibility in the use of guarantee instruments in response to dynamic country and client needs and market developments by—**
   - Revising existing policies and regulations on guarantees to minimize supply-driven product restrictions where most needed and to allow product differentiation on the basis of value added
   - Ensuring that adequate incentives exist for staff to offer the full array of WBG guarantees and PRM products to private sector clients within a single menu of options
   - Establishing more systematic links between advisory services and the deployment of PRM instruments and other products, particularly in infrastructure
   - Following a consistent approach to pricing of PRM across its guarantee instruments to avoid potential distortions
   - Strengthening internal awareness of the guarantee instruments and the incentives and skills for their use and reducing transaction costs where possible, keeping in mind the importance of maintaining adequate processes and regulations for risk management.

3. **If a new organizational structure is developed and proposed, consider at least three alternative perspectives for organizational realignment: the client perspective, the country perspective, and the product perspective.**
   - Under the client approach, all products for private sector clients, including guarantees and PRM instruments, would be offered through a single window.
   - Under the country approach, the deployment of WBG guarantee and PRM products would be made according to country needs, under a management arrangement common for all three institutions.

- Under the product approach, the bulk of guarantee/insurance products would be managed under one institutional roof.

4. **If the current organizational structure is maintained, direct the management of each individual WBG institution to enhance the delivery of its own guarantee/insurance products by taking actions to improve policies and procedures, eliminate disincentives, increase flexibility, and strengthen skills for the deployment of the products.**

# Management Response

Management welcomes the opportunity to provide its revised response to the evaluation of the use of World Bank Group (WBG) guarantee instruments, prepared jointly by the three Independent Evaluation Group (IEG) units of the WBG: IEG–World Bank, IEG–International Finance Corporation (IFC), and IEG–Multilateral Investment Guarantee Agency (MIGA).

Management agrees with IEG's conclusions that WBG guarantee instruments have evolved over the last 17 years; they now have the ability to provide support to clients across a large and diverse spectrum of investments under a variety of institutional structures, and they have played an important role in mobilizing private capital. Management also agrees with the thrust of several of the recommendations for exploring ways to ensure that guarantees are used as effectively as possible, including improving coordination and marketing. Management notes that these improvements need to be carried out in a manner that ensures that Bank Group risk mitigation instruments complement—not supplant—private sector risk mitigation instruments and provide true additionality.

## Management Comments

Management is pleased that the IEG report reflects management's view that guarantee products have proven to be useful instruments in helping the WBG fulfill its mission. Recent experiences tell us that more could be done to optimize the use of guarantee products to meet WBG clients' demand.

### *Building on the strengths of WBG institutions*

Although management shares the report's view that there are opportunities to increase the effectiveness of the WBG guarantee products, it has concerns about the manner by which the evaluation was conducted. Management believes that in an attempt to generate overarching conclusions, the report has "oversynthesized" issues as relevant to all parts of the WBG, when most are relevant to one, sometimes two, but seldom all three institutions. As a result, management believes the report missed an opportunity to appropriately inform the WBG on how it could build on the strength in the difference in the mandates, client bases, and guarantee products of each institution.

### *Differences in mandates of MIGA, IFC, and the Bank*

Each WBG institution has a mandate that is defined under its charter. According to these mandates, each member of the group serves the needs of its clients. The International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) clients are, first and foremost, member governments. IBRD and IDA guarantees, which require a sovereign counter-guarantee, play a role that is distinctly different from that of MIGA insurance and IFC guarantees. This difference is evident in the structure and use pattern of these products: IFC guarantees do not have a sovereign counter-guarantee and are used chiefly as unfunded loans to support primarily private sector clients; MIGA provides mitigation of political risk for cross-border investments. Bank guarantees are mostly used for complex projects in high-risk situations that require government commitment, with the ongoing Bank engagement with the country and the sector as primary factors in choosing this instrument. In fact, only a small fraction of these guarantee products have a common risk mitigation function. It also points out that multilaterals that have unified structures have an equal or smaller share of guarantees in their product mix than the WBG does.

## Summary of Management Actions

Even prior to the IEG report, management has been working to identify opportunities for increasing synergies in the WBG guarantee products. Subsequent to the Committee on Development Effectiveness discussion of the IEG report in May 2008, management has been engaged in a process of further analysis and has identified two broad areas for improvement: (1) a set of issues specific to each institution and (2) more effective collaboration among the Bank, IFC, and MIGA on joint solutions in support of ultimate clients (essentially governments in the case of the Bank and private sector entities in the case of MIGA and IFC). Management is now working to put these improvements in place.

### *Institutional issues*

MIGA has embarked on a wide-ranging set of initiatives to better serve its clients. The Bank has also launched a focused effort toward realizing the full potential of IBRD and IDA guarantee products. The effort is aimed at removing constraints to the effective deployment of guarantees, looking at issues of policy, organization, and incentives.

### *More effective collaboration*

At the same time, work is under way on more effective collaboration, notably between MIGA and the Bank and between MIGA and IFC, given the very different nature of Bank and IFC clients. For MIGA and the Bank, the focus is on joint organization and underwriting of large, complex infrastructure projects. For MIGA and IFC, the focus is on working out a claims cooperation framework and on piloting cross-marketing of products and services.

## Conclusions

Again, management welcomes this evaluation and finds its analysis useful for ongoing work on improving effectiveness of the use of its guarantee and insurance tools. Management agrees with and is acting on several of IEG's recommendations. Detailed responses to IEG's recommendations are given in the Management Action Record.

## Management Action Record

| Recommendations | Management response |
|---|---|
| To overcome the current limitations of the delivery system of WBG guarantees and political risk mitigation (PRM) instruments and enhance its use and development potential, IEG recommends the following to WBG senior management: | ***Partially agreed*** with regard to incentives and staff awareness, as noted below. |
| **1. Take a strategic approach and make a decision whether to maintain the existing organizational structure while addressing some of the important problems, or develop and propose an alternative organizational structure to the Board.** | As noted in the Management Response, the WBG institutions have complementary but differing mandates that are defined under their respective charters. Under these mandates, each member of the group has developed different products serving the different needs of its clients. Management therefore believes that current institutional arrangements are adequate, and issues of coordination and marketing can be addressed without a change in institutional structure. |
| **2. Under any scenario, take action to introduce greater flexibility in the use of guarantee instruments in response to dynamic country and client needs and market developments by—** | |
| • Revising existing policies and regulations on guarantees to minimize supply-driven product restrictions where most needed and to allow product differentiation on the basis of value added. | • The specific characteristics of each entity's products are governed by the entity's respective charters and policies, based on the clients it serves. Each institution continues to work to eliminate unnecessary restrictions, if any, in the use of its products. Management does not agree that an across-the-board revision covering very different guarantee products offered by the WBG members is needed. More effective coordination would better address these concerns (see below). Management would also like to point out that IFC has no specific policies restricting the offering of partial risk guarantees within its institutional boundaries and calls on MIGA to provide political risk insurance as needed. In accordance with its internal guidelines, IFC does not offer guarantee products that replicate the offerings of MIGA. |
| • Ensuring that adequate incentives exist for staff to offer the full array of WBG guarantees and PRM products to private sector clients within a single menu of options. | • Management will assess the feasibility of increased staff incentives in the context of potential benefits.<br>IFC is prepared to work with MIGA and the Bank with regard to marketing the various PRM products through IFC's channels with clients. For example, there could be scope to leverage IFC's industry departments' relationships with key global private sector players to offer PRM instruments along with other financing options as appropriate. As the report notes, the newly established Client Relationship Management System could also be a vehicle for coordinated marketing efforts. The incentives for MIGA or Bank staff to utilize these channels could be considered. |
| • Establishing more systematic links between advisory services and the deployment of WBG PRM instruments and other products, particularly in infrastructure. | • The World Bank and MIGA will explore ways to establish more systematic links between advisory services and their PRM instruments. For MIGA, as solely a provider of political risk insurance and with no commercial interest, close collaboration with Bank policy advice is possible and indeed encouraged, as there is full alignment of interests between sound policy advice and such guarantees.<br>The infrastructure area is in fact a good example of WBG coordination on advisory and financing services. IFC's investment team, which is separate from the advisory team, can offer a financing package to the winning bidder subject to satisfactory due diligence. Such a package could include WBG guarantee |

**Management Action Record** ***(continued)***

| Recommendations | Management response |
|---|---|
| | products as appropriate. Advisory teams working with government clients will, as a matter of course, need to advise a government on the best options for ensuring a successful and competitive bid, for a concession, build-operate-transfer, or other structure. Those options may lead to recommendations that either indications of interest from potential financiers (IFC or others) or of availability of political risk reduction mechanisms (WBG or others) be included in bidding information packages to increase the prospects of the government achieving its objectives. Governments are of course always free to reject such recommendations. Given the possible appearance of conflicts of interest, potential conflicts arising from such recommendations are fully disclosed to clients and mitigating measures as per WBG Conflict of Interest policies are put into effect if the governments choose to follow such recommendations. WBG units may not be able to offer financing or guarantee products if the winning bidder does not turn out to be acceptable to them. |
| • Following a consistent approach to pricing of PRM across its guarantee instruments to avoid potential distortions. | • Each of the Bank group institutions uses pricing methodology that reflects the unique characteristics of it charter and its clients. Management will provide guidance to staff to ensure the consistency of Bank advice to governments with regard to the "hierarchy of instruments" principle and the fee charged by governments to the private sector to offset the costs associated with issuing a counter-guarantee. Such a fee will be considered the default option and application of the guidance will be monitored through the Finance, Economics, and Urban Development Department (the Sustainable Development Network department that supports the Regions' guarantee work). |
| • Strengthening internal awareness of the guarantee instruments and the incentives and skills for their use and reducing transaction costs where possible, keeping in mind the importance of maintaining adequate processes and regulations for risk management. | • Efforts to increase awareness and ensure adequate skills in different specializations are ongoing. MIGA and the Bank will review their procedures to address any specific issues identified in the report that lead to higher transaction costs.<br>IFC is prepared to provide training to staff on MIGA and/or Bank guarantee products it may be asked to promote. Within IFC guarantee products, IFC's Investment Guidelines and Practices provide a detailed description of each product with a note to inform IFC Treasury as soon as is practical of plans to offer a guarantee product. Within the Finance/Treasury Vice Presidential Unit, the Structured and Securitized Products Department is the center of knowledge and practice on guarantee products in IFC, providing structuring guidance to investment staff as needed. IFC will continue to cover guarantee products in relevant training modules for staff. IFC is also mainstreaming a range of innovative financing techniques to investment departments to the degree possible. |
| **3 If a new organizational structure is developed and proposed, consider at least three alternative perspectives for organizational realignment: the client perspective, the country perspective, and the product perspective.**<br>• Under the client approach, all products for private sector clients, including guarantees and PRM instruments, would be offered through a single window. | No changes to the current institutional structure are envisioned. |

**Management Action Record**

| Recommendations | Management response |
|---|---|
| • Under the country approach, the deployment of WBG guarantee and PRM products would be made according to country needs, under a management arrangement common for all the three institutions.<br>• Under the product approach, the bulk of guarantee/insurance products would be managed under one institutional roof. | |
| **4. If the current organizational structure is maintained, direct management of each individual WBG institution to improve the delivery of its own guarantee/insurance products by—** | |
| **MIGA management** | |
| • Proposing to MIGA's shareholders amendments to its Convention to remain relevant and meet its market potential. | • MIGA ***agrees*** on the desirability of amending the Convention to provide greater flexibility in political risk insurance coverage that MIGA would be permitted to provide. However, this would be a major undertaking and would require a strong consensus among shareholders on such amendments, and MIGA would proceed to a formal proposal only with such a consensus. |
| • Considering, in the meantime, alleviating several constraints derived from its operational regulations and policies. | • ***Agreed.*** An in-depth review is under way to examine what changes might be warranted in the Operational Regulations and Policies but that would still be consistent with the requirements of the MIGA Convention. |
| • Increasing its responsiveness to market demand by addressing internal weaknesses that reduce efficiency and slow responsiveness without lowering MIGA's financial, social, or environmental standards. | • ***Agreed.*** A Business Process Review is under way to examine what measures can be taken to improve operational efficiency and responsiveness. |
| • Improving its client relationship management, including aftercare, to enhance the value MIGA adds and increase its client retention. | • ***Agreed.*** The Business Process Review noted above is also addressing client relationship management. |
| **Bank management** | |
| • Maintaining and promoting the partial credit guarantee instrument as a potential effective countercyclical tool to leverage government access to commercial funds and extending such access to IDA countries. | • ***Partially agreed at this time.*** Extending access of the Partial Credit Guarantee instrument to IDA countries would be an option that will be discussed under the IDA Guarantees Review to be presented to the Board by December 2008. |
| • Creating awareness among Bank staff of the potential use and benefits of partial risk guarantees and building necessary skills. | • ***Agreed.*** Banking and Debt Management currently provides training on the political risk guarantee and other IBRD/IDA guarantee instruments for operational staff, and also includes a discussion of the guarantees in its general training for task team leaders. The Finance, Economic, and Urban Department (the Sustainable Development Network department that supports the Regions' guarantee work) will continue to maintain adequate capacity to respond to demand from task teams for specialized guarantee expertise. |

**Management Action Record** ***(continued)***

| Recommendations | Management response |
|---|---|
| • Developing a marketing strategy that encompasses both governments and the private sector to better identify situations in which the role of a partial risk guarantee can make a difference. | • ***Partially agreed.*** The potential use of guarantees is most usefully discussed as a part of Country Assistance Strategy preparation, thus making the governments fully aware of the availability of guarantees. Management will work to ensure that the potential use of guarantees is discussed as part of the preparatory Country Assistance Strategy discussions for all countries. In addition, as part of outreach programs for IBRD financial products, Banking and Debt Management routinely includes material on the availability and potential for IBRD guarantees. Management plans to undertake a similar outreach program for IDA guarantees and is exploring various institutional options. |
| • Streamlining processing steps to reduce both internal disincentives to working on partial risk guarantees and transaction costs for private sector clients while ensuring that crucial measures for social and environmental safeguards and risk management are maintained. | • ***Partially agreed.*** Management is exploring ways to streamline the processing of guarantees but will not commit before identifying specific measures. Compliance with Bank policies pertaining to environment and social safeguards would not be affected by any changes in policies related to guarantees. |
| **IFC management** | |
| • Mainstreaming its guarantee products through its operations departments in the same manner that its equity and loan products are deployed. | • ***Already the practice.*** IFC guarantees are essentially unfunded loans, enabling IFC to extend credit to a client, but without the associated funding inherent in a loan. The basics of the appraisal and processing are identical between the two products; however, there are differences in structuring and documentation. Therefore, a member of the Structured and Securitized Products Department joins the investment team to assist with these functions for structured guarantee transactions. IFC has the same relationship with the client whether offering a guarantee or loan, with the same investment staff in IFC involved, regardless of the product offered. In both cases, staff from IFC's Investment Operations do a thorough due diligence up front and perform a monitoring function throughout. The representations, warranties, covenants, and so forth contained in the documents are similar. Therefore, there is not an overall issue regarding the processing of guarantees versus loans.<br>However, there are some broader, related issues with respect to improving processing of innovative financial products at IFC that are important and that management is addressing. IFC has been developing many innovative financial products in recent years, including various types of structured finance, RSFs, local currency facilities, securitizations, and other structures, using many guarantees. An important challenge is to mainstream the use of these products to investment departments as they become established, to reduce processing times and improve efficiency, and to allow groups such as the Structured and Securitized Products Department to remain focused on innovation and product development. This mainstreaming requires training investment department staff and developing replicable financial models and documentation. Management is undertaking this process now, including implementing a new organizational structure for the Structured and Securitized Products Department in which product development is centralized and business development decentralized. This is expected to better facilitate ongoing development of innovative products by a core staff in headquarters, with a focus on mainstreaming these products to field-based investment staff as the products mature. |

## Management Action Record

| Recommendations | Management response |
|---|---|
| • Assessing the extent to which it can bring its guarantee products closer to meeting Basel II and regulatory requirements in general, so that the guarantee beneficiaries can use IFC products more effectively for capital, provisioning, and exposure relief. | • ***Not agreed.*** Because guarantees are simply unfunded loans, to the degree that loans are Basel II efficient, so are guarantees. As there is no underlying discussion in this report on what issues specific to IFC guarantee products pertain to Basel II, IFC cannot assess this recommendation. |
| • Revisiting its approach to RSFs to increase flexibility and improve the attractiveness of the product. | • ***Agreed with respect to simplifying the process.*** IFC's position with respect to first loss in risk-sharing facilities (RSFs) is not about willingness to take risk but about the appropriateness of the project structure. It is well understood in the market at this time that the decoupling of origination and risk is what led to the subprime crisis. Fortunately, IFC understood this risk early on and has insisted that clients who originate loans retain a first-loss position in the portfolio to ensure an alignment of interest. Whether an off-balance sheet securitization or an on-balance sheet RSF, the approach to portfolio risk is the same.<br>However, there are some broader issues with respect to the implementation and replication of RSFs in a timely and efficient manner that management is addressing. As management develops more of these structures, it is becoming more efficient with respect to processing and documentation, and management is now working to simplify and standardize these structures to the degree possible. IFC currently has more than 20 RSFs in the pipeline with a medium to high probability of closing, many in IDA countries. In addition, management continues to work with counterparties such as IDA to share in the first loss alongside clients in instances in which such participation enables a deal to happen that otherwise would not. |
| • Scaling up successful models in energy efficiency, education, and capital market development based on the use of guarantee structures. | • ***Agreed on scaling up in these sectors; not agreed on limiting scope to guarantee products.*** Management agrees that IFC continues to scale up successful models in these areas. However, guarantees are just a subset of the full range of financial products IFC offers, and scaling up is not necessarily dependent on the use of guarantees. As discussed in a recent planning document, IFC is pursing programmatic approaches as a way to increase the development impact and additionality of operations by extending IFC activities beyond the individual project into a program of projects and advice. A key approach to this is through wholesaling, where IFC is combining its financial sector and industry expertise to enable the wholesaling of IFC financial products for specific industries through local banks. This will allow IFC to reach smaller clients in smaller, harder-to-reach countries, in many cases IDA countries. The education sector is one of the major areas in which this is being done. In energy efficiency, IFC has been a leader in the development of financing programs through financial intermediaries designed to deliver environmental benefits, including clean energy. Management expects to scale up in this area. Finally, a number of capital market projects that include guarantees are being explored that would address such needs as access to housing finance, trade finance, and agribusiness, and which will be facilitated using short-term finance, local currency financing, and risk-sharing products. |

MIGA's guarantees supported the development of Mozambique's Temane and Pande gas fields and the construction of an 865-km cross-border gas pipeline in Mozambique and South Africa. Photo courtesy of Sasol, a project guaranteed by MIGA and the first cross-border initiative in Sub-Saharan Africa.

# Chairperson's Summary: Committee on Development Effectiveness (CODE)

On May 7, 2008, the Committee considered *The World Bank Group Guarantee Instruments 1990–2007: An Independent Evaluation* and the draft management response. Comments by the external reviewers were circulated to the Committee as background information.

## Background

The Board of Executive Directors considered several management reports on the World Bank Group's (WBG) guarantee activities including reviews in 1997 and 2000 and technical briefings in 2005 and 2007. This Independent Evaluation Group (IEG) report is the first independent evaluation of the WBG guarantee instruments, undertaken at the request of the Board.

## IEG's Main Findings and Recommendations

The report assesses the effectiveness in the use of the WBG guarantee instruments and the delivery system of guarantee products within the WBG. The Director-General, Evaluations, highlighted three key findings from the report in his opening statement. First, guarantees have been effective in promoting key WBG strategic objectives, particularly in facilitating the flow of investment to high-risk sectors. Second, several weaknesses are evident in the political risk mitigation activities, including (1) competition among the WBG institutions that imposes additional transactional costs on clients and reputational risks to the WBG; (2) weaknesses in marketing; (3) supply-driven policies and restrictions placed by the mandates of WBG institutions; (4) limited staff awareness and skills, as well as incentive issues in the World Bank and IFC with respect to guarantees; and (5) inconsistent pricing of the WBG political risk mitigation products. Third, the use of guarantee products of each WBG institution has fallen short of expectations because of these weaknesses.

The IEG report's main recommendation is for WBG senior management to "take a strategic approach and make a decision whether to maintain the existing organizational structure while addressing some of the important problems, or develop and propose an alternative organizational structure to the Board." The Director-General, Evaluations, highlighted this recommendation for the Board's attention and emphasized that maintaining the status quo, particularly in the delivery of political risk mitigation products, is not a tenable option and changes need to be made with or without organizational adjustment. The IEG report recommends that if a new organizational structure is proposed, management should consider at least three distinct perspectives: client, country, and product. Regardless of any organizational change, the IEG report recommended that WBG senior management take action to introduce greater flexibility in the use of guarantee instruments in response to dynamic country and client needs and market developments.

## Draft Management Response

A joint Bank, International Finance Corporation (IFC), and Multilateral Investment Guarantee Agency (MIGA) response was presented, which noted that the IEG report provides analysis and recommendations that may be drawn on to enhance the effective use of WBG guarantees and insurance products. Management agreed with the general thrust of several IEG recommendations, such as the need to improve coordination and marketing. However, it noted that in attempting to synthesize the issues and recommendations, the report may have "oversynthesized" the findings at the WBG level, when most issues are not relevant across the board. Management also opined that a greater focus on the differences in mandates of MIGA, IFC, and the Bank (International Bank for Reconstruction and Development [IBRD] and International Development Association [IDA]) and on the WBG's client-focused approach could have offered a different perspective to the IEG evaluation. In her opening statement, the MIGA Executive Vice President representing WBG management summarized the distinct mandates and clients served by each WBG institution. MIGA's mandate is to foster development through the provision of political risk insurance for productive foreign investment and to mitigate risks for cross-border investments. IFC promotes private sector development, and its guarantees are used chiefly as unfunded loans to private investors. IBRD and IDA serve client governments, and these guarantees require sovereign counter-guarantees. The IBRD and IDA guarantees are more complicated instruments than the Bank's loans, credits, or grants and are demanded mainly for complex projects in high-risk situations. Management emphasized that the WBG as a whole can bring a rich diversity of instruments, which should be used in a complementary fashion to support specific development objectives and client needs.

## Overall Conclusions

The Committee welcomed the timely discussion of the high quality and comprehensive IEG evaluation of the WBG guarantee instruments. There was broad interest in this evaluation, and the need for more strategic thinking by senior management about the WBG approach to guarantee business in the longer term was emphasized. In this regard, there were diverse views on IEG's recommendation for the WBG senior management to "make a decision whether to maintain the existing organizational structure while addressing some of the important problems, or develop and propose an alternative organizational structure to the Board." The Committee remained neutral on the issue, neither recommending nor precluding organizational change, which is a long-term matter to be considered by management. Members stressed the need for a more in-depth analysis by management to determine the most appropriate way to address the market challenges and the weaknesses identified in the IEG report, and for the effective delivery and use of WBG guarantees.

Several speakers underlined that maintaining the status quo was not an option and suggested that the Management Response could be deepened to include a review of the three perspectives for organizational realignment suggested by IEG. On the other hand, some members noted the difficulties posed in organizational change, including impact on staff morale and legal implications. Regarding the possibility of amending the MIGA Convention, the Committee reiterated the understanding of the April 30 CODE meeting that it is looking forward to the management's assessment of the constraints of the MIGA Convention before it could make any judgment on this issue.

Speakers stressed the importance of responding to market changes, being client oriented, and promoting the full array of WBG guarantee products. In this regard, they noted a need for a higher level of collaboration among the WBG institutions, improved marketing, greater staff awareness of the guarantee instruments, and appropriate staff incentives. Comments were also made on the overlap and competition of political risk products as raised by IEG and on the need to adjust and streamline internal policies and procedures, to consider the consistency of pricing policies across the WBG, and to think about a "single window" for guarantee products.

## Next Steps

The Committee supported the request made by some Executive Directors for a full Board discussion of this IEG report, together with the Management Response. The date of the Board discussion will be determined by the Corporate Secretariat after requisite consultation.

Management was asked to revise its response to the IEG report for the Board discussion, taking into consideration the comments raised at the meeting. A WBG legal opinion on the feasibility of a "single window" for guarantees, as well as any other legal questions that may arise during the forthcoming Board discussion related to the WBG delivery of guarantees, should be prepared in due course. The Committee Chairperson concluded that, in accordance with the approved IEG Disclosure Policy Statement, this evaluation report will be made publicly available following the Board discussion, unless the Executive Directors decide not to disclose.

The following main issues were raised at the meeting:

### *Organizational change*

Members considered the IEG report a good basis for considering longer-term improvements in the effective use of WBG guarantees in a changing market context, beyond the short- to medium-term focus of MIGA Operations Directions. In this context, IEG's main recommendation calling on the WBG senior management to decide whether to maintain or suggest changes to the existing organizational structure elicited a range of comments. Members and speakers noted the need for management to analyze and propose concrete solutions, including a timetable, to address the issues raised by IEG (for example, overlaps, competition, and pricing) and to streamline the delivery of WBG guarantees, increase competitiveness of guarantee products, and introduce more flexibility to adapt to client needs. Several speakers noted that the effective use and delivery of WBG guarantees may be enhanced to a certain extent through organizational adjustments within each WBG institution (for example, internal policy changes or updating the Operations Regulations of MIGA) but also said that management should not rule out the option for organizational change. A few of them observed that changing the organizational structure will likely be even more difficult than amending the MIGA Convention and should be considered as a last resort.

Other speakers emphasized that maintaining the status quo is not an option and urged management to quickly review different alternatives. Likewise, they requested management to revise and deepen its response to the IEG report with more analysis on the issue of organizational change, including the three options suggested by IEG (for example, client, country, or product approach). A few of them also remarked that IEG could have been more specific in its recommendation for organizational change. A member questioned the appropriateness of the IEG recommendation and noted that it was not clear from the IEG report whether IEG found any fundamental deficiencies that could only be addressed through a change in organizational structure. In this regard, some members clarified that this IEG report should be considered a fact-finding paper as requested by the Executive Directors and that the idea of an organizational change for the WBG guarantee business had been actually raised by the management itself in past meetings. The negative impact on staff morale in raising the issue of organizational change was also noted by a few members.

*Management noted that multilateral development banks that have unified structures but no specialized guarantee institution do not have a larger share of guarantees in their product mix than the WBG, and the use of guarantees is not necessarily greater at these other multilateral development banks. Furthermore, none of the other multilateral development banks has had the same success in extending political risk insurance as MIGA. Accordingly, management was not recommending a restructuring of the organization but was focusing on strengthening WBG collaboration. At the same time, management welcomed a Board discussion on guarantees, underlining that the issue of changing the organizational structure required the involvement of the President, senior management of WBG, and* *the Board. The MIGA General Counsel added that any changes in organizational structure will probably necessitate an amendment to the MIGA Convention. Such an amendment would require the affirmative vote of 60 percent of the Governors exercising 80 percent of the total voting power of the institution. Noting that the IEG report is expected to be disclosed, management commented on the need for a good communication strategy by the Board, particularly because the Committee discussions focused on organizational issues. It cautioned that the external public may have different views on the matter, which may affect the options available to management and the Board.*

*Management concurred that much could be done to strengthen the delivery of guarantees, which are part of a portfolio of services offered to clients. It committed to consulting senior management on how to deepen the Management Response. IEG reiterated that its evaluation findings indicate that substantial business opportunities are missed with the status quo, and so a more in-depth review discussion on the options for strengthening the delivery and use of guarantee products in a rapidly changing market situation were merited.*

### Client-focused approach

In considering the options for enhancing the effective use and delivery of WBG guarantees, several speakers urged WBG management to consider the client perspective option. They also encouraged WBG management to seriously consider the possibility of a "single window" for guarantees. A member stressed that the issue was not whether guarantee products were marginalized, but whether WBG clients' need for different products (for example, loans, equity, guarantees) is being met. A speaker understood that if guarantees are underutilized, it also meant that clients are underserved. *In their opening statement, IEG staff clarified that its recommendations do not advocate that guarantee products should take precedence over various WBG instruments or propose a target level in use of WBG guarantee products.* Referring specifically to MIGA, another member expressed support for introducing greater flexibility in its products by overcoming some of the constraints through the revision of its current Operational Regulations.

### Cooperation within the WBG

Several speakers stressed the need for greater collaboration among the three institutions based on their comparative advantages, and strengthening the coherence of the products offered, including their pricing. Some members echoed IEG's remark that overlaps and competition did not necessarily imply redundancies, but required better WBG coordination. One speaker noted that there was sufficient external market competition and that competition within the WBG should be minimized. They and others called for more coordinated WBG efforts for marketing, increased staff knowledge of the guarantee products, and appropriate staff incentives.

A speaker urged management of IFC and the Bank to make better use of staff knowledge and skills available at MIGA. Regarding IFC's readiness to work with MIGA and the Bank to market various political risk mitigation products, one member cautioned about the need for staff expertise in these products and the risk of conflict of interest. Another member suggested the possibility of placing MIGA under the umbrella of IFC, because IFC has a more extensive network for marketing and MIGA guarantees can complement IFC products. In this context, he also requested clarification about the issue of conflict of interest. Still another member cautioned against this idea. There was a question raised about the limited number of joint Country Assistance Strategies that included MIGA.

*Management agreed on the need for more WBG coordination. MIGA management noted that political risk insurance requires specialized skills, which are available in MIGA, but integration of MIGA work with IFC can lead to conflicts of interest, especially when there are claims that MIGA needs to mediate. The MIGA General Counsel noted that MIGA has a strict fiduciary duty embodied in its Convention that does not allow staff to take into consideration other interests outside the institution in the discharge of their duties.*

*The IFC Acting General Counsel pointed out that the overall objective of increased WBG coordination is probably less problematic from IFC's perspective, and the IFC Articles of Agreement (especially Article I , Purpose) are more flexible in the sense that they expressly recognize that IFC's role is to complement the activities of the Bank. Bank management briefly described how guarantees were incorporated into its outreach efforts to offer customized financial solutions focusing on IBRD countries, as well as training of both clients and Bank staff on the different financial products.*

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*Jiayi Zou, Chairperson*

Vietnamese woman riding a bike. Photo by Suzanne Pelland, courtesy of MIGA.

# Definitions

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| **Acceleration** | Making payments due immediately in specified circumstances. |
| **Assignment** | The complete transfer of the rights under a contract to one party in that contract. |
| **Credit-default swap** | A financial contract under which an agent buys protection against credit risk for a periodic fee in return for a payment should there be a credit-default event. |
| **Credit insurance** | A form of guarantee against loss from default by debtors. |
| **Credit-Linked Guarantee** | Credit guarantee conditional on an event not occurring. |
| **Derivatives** | Financial contracts whose value derives from underlying securities prices, interest rates, foreign exchange rates, market indexes, or commodity prices. |
| **Direct debt substitute** | Credit enhancement guarantee that covers some or all principal and interest payments and that may be applied to, among other instruments, loans, bond issues, commercial paper facilities, note issuance facilities, revolving credits, and portfolios of credit. Direct Debt Substitute Guarantees are general guarantees of financial indebtedness and function as a debt substitute. The most common example is the financial guarantee of indebtedness to domestic banks. |
| **Double default** | Both the obligor and the guarantor failing to meet their obligations. |
| **Financial guarantee** | A form of coverage in which the insurer guarantees the payment of interest and/or principal in connection with debt instruments issued by the insured. |
| **First-loss tranche** | A class of securities that ranks last in priority of payments. It is generally structured as the most junior claim on the borrower or collateral assets, absorbing losses in a manner similar to equity capital. |
| **Fortuitous event** | Any occurrence or failure to occur that is or is assumed by the parties to be to a substantial extent beyond the control of either party. |

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| **Full Credit Guarantee** | Unconditional guarantee of 100 percent of the principal in present value terms (with the coupon rate used as the discount factor) for all categories of risk. This is economically equivalent to a guarantee of all principal and interest payments on their due dates. |
| **Guarantee** | The agreement by a guarantor to assume the responsibility for the performance of an action or obligation of another person or entity and to compensate the beneficiary in the event of nonperformance. |
| **Guarantee for Commercial Operations** | Credit enhancement guarantee in a nonlending situation, where the objective is to back up a client's performance in a commercial transaction involving the provision of goods and services, such as guarantees of bid or performance bonds (called standby letters of credit in the United States); a guarantee that facilitates commercial transactions between the associated parties. |
| **Insurance** | A practice or arrangement by which a company provides a guarantee of compensation for specified loss in return for payment of a premium. |
| **Nonhonoring of sovereign guarantees** | Failure of sovereign or subsovereign entities and some state-owned enterprises to satisfy direct debt obligations or guarantees. |
| **Novation** | Term used in contract and business law to describe the act of either replacing an obligation to perform with a new obligation or replacing a party to an agreement with a new party. In contrast to an **assignment,** all parties to the original agreement must agree on a novation. |
| **Partial Credit Guarantee** | An unconditional guarantee of a portion of the principal and/or interest in present value terms for all categories of risks. |
| **Partial Risk Guarantee** | Conditional guarantee of 100 percent of principal in present value terms for specific categories of risk (such as devaluation, breach of off-take agreements, labor unrest, and technology failure). |
| **Partial Credit and Partial Risk Guarantee** | Conditional guarantee of a portion of the principal and/or interest in present value terms for specific categories of risks (for example, devaluation, off-take agreements, labor unrest, and technology failure). |
| **Performance Bond Guarantee** | Guarantee of a bond issued by the client to guarantee satisfactory completion of a project by a contractor. |
| **Reinstatable guarantee** | A guarantee (coverage) that can be restored after the client has failed to perform and the guarantee has been called if the client repays the guarantor within a specified number of days, or after the client has repaid the guarantor. |

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| **Risk-sharing facility** | A facility that allows a client to sell a portion of the risk associated with a pool of assets. In this case, the assets typically remain on the client's balance sheet and the risk transfer comes from a partial guarantee provided by the guarantor. In general, the guarantee is available for new assets to be originated by the client using agreed-upon underwriting criteria, but in certain situations it may also be used for assets that have already been originated. |
| **Rolling guarantees** | Guarantee of debt service payment(s) that moves or "rolls" to cover new debt service payment(s) on the client's timely payment of the previously guaranteed debt service payment(s). |
| **Securitization** | A form of financing that involves the pooling and true sale of financial assets and issuance of securities that are repaid from the cash flows generated by such assets. |
| **Structured finance** | A broad term used to describe a sector of finance that was created to help transfer risk using complex legal and corporate entities; includes securitization. |
| **Subrogation** | An accepted principle in insurance law that provides for the assignment of an existing claim from the guaranteed investor to the insurer. The insurer, as the subrogee, acquires the same rights the investors had. |
| **Subrogation in local currency** | The guarantor's recovery of the claim from the client in local currency after the guarantee has been called and the guarantor has disbursed the loan. |
| **Transfer restriction and currency inconvertibility** | An action taken by a government to prevent conversion of local currency to some form of foreign exchange. |
| **Underwriting** | The process of selecting risks and classifying these risks according to their degrees of insurability so that the appropriate rates may be assigned; includes rejecting risks that do not qualify. |

# Chapter 1

WBG support through guarantees aims to boost investor confidence and catalyze investment in complex infrastructure projects, such as this Bujagali hydropower project in Uganda, which was guaranteed by MIGA and the World Bank and financed by IFC. Photo courtesy of MIGA.

# World Bank Group Guarantee Instruments

World Bank Group (WBG) guarantee instruments have the potential to mobilize private sector financing for development. Since the 1980s, the WBG has been expanding the menu of guarantee instruments, and it currently offers a range of products to member governments and the private sector.

## Patterns in Private Investments and the Need for Risk Mitigation

**Private capital flows to developing countries have increased dramatically, but access remains uneven.** Private capital flows to developing countries increased from $165 billion in 2001 to $647 billion in 2006, but these flows have been highly concentrated in a few large middle-income countries (MICs). Almost half of the foreign direct investment (FDI) and bank flows have gone to the top five destinations. Although developing countries' access to international financial markets has improved since the 1980s, it remains uneven. Sixty percent of all developing countries (79 of 135) did not access the external bond market between 1980 and 2006, and only eight did so frequently. Most low-income countries lack ready access to private debt markets, and many continue to depend very heavily on concessional loans and grants to meet their financing needs (World Bank 2007a).

**In many emerging markets, domestic liquidity has increased in recent years.** Driven in part by the commodity boom, current account surpluses in developing countries reached a record 3.1 percent of gross domestic product in 2006. Since 2000, developing countries as a group have been a consistent net exporter of capital, and current account surpluses have contributed to abundant liquidity in the domestic financial markets of many of those countries.

**Despite the growth in private finance to developing countries, the consensus in the development community is that there is significant untapped potential for greater private sector involvement in meeting the need for development-oriented investments.** In 2006, the United Nations Millennium Project estimated the financing gap for the Millennium Development Goals at $73 billion a year for low-income countries and $10 billion a year for MICs. Needs are particularly large in infrastructure—estimated at about 5.5 percent of the annual gross domestic product of developing countries to maintain projected gross domestic product growth levels, compared with about 3.7 percent of gross domestic product actually invested (World Economic Forum 2006). Abundant liquidity in many emerging markets is accompanied by a paucity of long-term capital and poor access to financial services for large segments of the business community. Access to finance is consistently ranked among the top constraints to doing business in developing countries, particularly low-income countries. This constraint is especially strong for micro and for small and medium-size enterprises (SMEs).

**Risk perceptions are a significant factor in explaining patterns of private investment.** A recent survey of more than 600 executives of multinational companies conducted by the *Economist* Intelligence Unit revealed that political risk is “the main investment constraint” in emerging markets. The survey also found that all forms of political risk in emerging markets are seen as increasing over the next five years.

Regulatory and contractual risks are particularly high in sectors such as infrastructure and oil, gas, and mining. Political risk is a major constraint for domestic investors as well. Political uncertainty and unpredictability of economic policies are consistently viewed by entrepreneurs in developing countries as a major constraint and contribute to the reluctance of financiers in these countries to extend long-term financing to private borrowers. Risks perceptions are also a factor in explaining the limited flows of financing to micro and SMEs and to new sectors of the economy.

**Guarantees and other risk-mitigating products are viewed as particularly well suited to unlocking the potential of private investment to contribute further to development.** It is estimated that in 2006, between $225 and $439 billion FDI and debt to developing countries was covered by some type of political risk mitigation (PRM) instrument. The market for political risk insurance (PRI) has grown rapidly in recent years—PRI exposures of Berne Union members grew by 47 percent between 2001 and 2005. Analysis of market data indicates that about a third of loans to developing countries were guaranteed in 2005 and that there are significant fluctuations in the share of guarantee loans from year to year. Many governments in developing and developed countries alike have established credit guarantee schemes to support bank lending to micro and SMEs (Levitsky 1997).

**The WBG has a critical role to play as a catalytic agent to stimulate investment in developing countries, and guarantees are an important tool in its arsenal of instruments to support private investments.** Given its status and special relationship with world governments, the WBG has a comparative advantage in mitigating certain political risks, particularly regulatory and contractual risks. The WBG is expected to act not merely as a supplier of capital, but also as a catalytic agent in stimulating investment in developing countries. Its policies mandate that, in working with the private sector, it needs to limit its own participation to the minimum required to secure satisfactory financing from private risk-taking sources. In this context, guarantee instruments are an important tool in the Bank Group’s arsenal of instruments for the pursuit of its development objectives.

## The Nature of the Instrument

**A guarantee is a financial instrument for the transfer of risks.** A guarantee is the agreement of a guarantor to assume the responsibility for the performance of an action or obligation of another person or entity. The guarantor agrees to compensate the beneficiary in the event of nonperformance. Guarantees fall into the broad category of risk-transfer instruments such as collateral, insurance, and derivatives. They are unfunded transactions and thereby distinct from some funded transactions such as direct loans or loan syndications that may also serve to transfer risk. One way to characterize the instrument is to pinpoint some of its similarities and differences with these other mechanisms for risk transfer. (See Definitions on page xxxi for further related definitions.)

**Notwithstanding technical differences between insurance and guarantees, for the purposes of this study the terms are used interchangeably, because they perform essentially the same functions.** With respect to collateral, a guarantee provides *third-party security* against a failure to perform a duty and is often referred to as external *collateral.*[1] Like *insurance*, a guarantee provides protection against possible eventualities. It typically refers to compensation for *nonperformance*, whereas insurance refers to compensation for *specified loss*.[2]

When the loss arises from nonperformance of contractual obligations, the two terms are often used interchangeably, as in the case of financial guarantees and credit insurance (Ernst and Young

2005). Unlike guarantees, insurance is typically a bilateral rather than a three-party contractual relationship. Insurance also tends to work through the asset rather than the liability side of the underlying relationship, although there are exceptions and the two are economically equivalent.

Insurance agreements tend to be more standardized than guarantee contracts and typically are part of pools of contracts big enough to allow the law of large numbers to operate (except for investment insurance, where this is generally not possible). There may also be differences in how much control the parties involved have over the event that triggers the loss.[3] Despite these technical differences, *insurance* and *guarantees* share the same functions and are treated interchangeably in this report.[4]

**A guarantee, like most financial instruments, can be viewed as a form of derivative.** The "easiest and most traditional form of a credit derivative is a guarantee," where the guarantor (seller of protection) provides protection to the beneficiary (buyer of protection) with respect to the performance of a third (reference) party or obligor (Kothari 2007).

There are key distinctions between a guarantee and a derivative contract: First, a loss may not be required for payment to be made from the seller to the buyer of protection under a derivative contract; second, the relationship between the seller of protection and the obligor (reference party) is typically more remote under a derivative (the reference party may not even know about the existence of the derivative contract). Derivatives, unlike guarantees, are typically concluded under standardized master agreements and are tradable.

**Guarantee instruments can bring social gains.** Guarantee instruments help to complete markets by allowing participants to isolate and trade certain risks as distinct from other types of risks. This creates markets that lead to better allocation of risks in line with the preferences and comparative advantages of the different market players in assessing, managing, and bearing these risks. By providing asset protection, guarantees stimulate the creation of more of the underlying assets, which translates into more investments and trade.

Guarantees, if appropriately structured, could reduce expected loss from certain transactions by lowering the probability of default, the severity of loss, or both (see Fitch Ratings 2005). For example, guarantees can provide liquidity or absorb a certain level of loss on the underlying assets, thus reducing the probability of default. Guarantees could reduce credit risks by helping avoid currency or maturity mismatches. They could lower the risk profile of investments by making the expected loss dependent on the joint probability of default of two independent credits (the credit of the borrower and of the guarantor in the case of a bank loan, for example), assuming the guarantor and the issuer are not overly correlated. This is referred to in the literature as the double-default effect (Heitfield and Barger 2003).

Some experts have argued (Heitfield and Barger 2003) that double-default effects argue for lower capital requirements for such transactions. However, recognizing that although the use of guarantees and other risk management techniques reduces or transfers credit risk, it may simultaneously increase other risks (see BIS 2006, paragraph 115), Basel II takes a conservative approach and instructs against taking double-default effects into account, opting instead for the substitution approach. Under that approach, the lower risk of the guarantor (protection provider) is substituted for the exposure to the guaranteed entity (BIS 2006).

**The use of guarantees also entails certain social costs.** The involvement of a third party implies potentially higher transaction costs. Other things being equal, the presence of a guarantor tends to increase complexity and add to the fragmentation of financing. It may also increase the social cost of investment by adding the guarantor's risk to those of the entrepreneur and the lender (Keynes 1936, p. 145), unless the guarantor is sufficiently strong to offer an exceptional margin of security.

In addition, guarantees may exacerbate inefficiencies created by information asymmetries and influence the severity of the adverse selection problem. For example, a lender may have less or no incentive to screen and/or monitor a borrower because the lender will not bear the full consequences of his action or inaction in the presence of a guarantee. But if the guarantor conducts its own screening before agreeing to sell protection on an exposure, and if it has the same access to information and screening technologies as the lender does, then the problem of weakened lender incentives to screen may not arise.

Finally, a guarantee may introduce new incentive problems by adding the moral hazard of the guarantor and the guarantee beneficiaries (see Kiff, Michaud, and Mitchell 2002). Many of the standard features of guarantee contracts have emerged as attempts to address such issues. The guarantee instrument is therefore no magic bullet against market imperfections.

**Public sector institutions continue to have a role in mitigating risks through guarantee instruments.** The outcome from private actor transfer of risks could be suboptimal when there are market failures, economic/social/political externalities, or public goods. In such circumstances, there is a role for public sector institutions to step in. Guarantees are one tool that can be deployed to correct for market failures and promote the realization of positive economic/social/political externalities or the supply of public goods.

In this context, there are at least four areas in which WBG guarantee instruments can fill gaps that the private sector cannot overcome on its own: (1) Where there are failures in making credible commitments, honoring pledges, enforcing contracts. Here the deterrent effect of WBG involvement, and the halo or comfort that this gives to investors and lenders, could provide the underlying rationale for these kinds of WBG guarantees. (2) Where there is a need for provision of public goods in governance, transparency, and social and environmental performance. Here the presence of WBG guarantee instruments could ensure observance of international standards on the part of private sector actors, with consequent economic/political/social externalities in the countries involved. (3) Where there are information asymmetries and problems of moral hazard. Many private sector activities—particularly some financial sector activities—are rife with information asymmetries and problems of moral hazard, which WBG guarantee instruments can help repair. (4) Where a demonstration effect is needed after a breakdown in public order. In countries recovering from civil strife and/or humanitarian crises, WBG guarantee instruments can play a key role in turning conditions around so that private markets are able to function once again.

It is important to note, however, that public institutions, including the WBG, have their own weaknesses, and their interventions may at times exacerbate rather than alleviate market imperfections.

## Evolution of WBG Guarantee Instruments

Tapping private initiative to promote growth, reduce poverty, and help people improve their quality of life has always been at the center of WBG activities. The three WBG institutions share this objective, and all three use guarantee instruments in pursuit of these goals.

### *Multilateral Investment Guarantee Agency*

**The Multilateral Investment Guarantee Agency (MIGA) was conceptualized in 1948, but it was not established until 1988.** MIGA's origins go back to 1948, when Bank staff realized that to achieve the objective of promoting private foreign investment, guarantees were needed against noncommercial risks. There were suggestions in the early days of the Bank that private investments could be stimulated if the Bank adopted measures that included "the investment of a certain percentage of its earnings in an 'insurance fund' to guarantee foreign investments against risks such as nationalization without compensation, war, and restrictions on the conversion of currencies" (Shihata 1998, p. 41; for details of MIGA's establishment, see Shihata 1988).

It took nearly 40 years—from the 1948 confidential report on the proposed plan for guaranteeing investment against transfer risk and certain other risks through numerous reports, memos, studies, draft articles of agreement, and work to overcome the skepticism of World Bank Board members, management, and staff—for MIGA's Convention to be opened for signature on October 11, 1985. Finally, in April 1988, all requirements for member states to join were completed, and MIGA started business. The first contract was issued in 1990.

**Low foreign private investment flows and political risks had underpinned the establishment of MIGA.** After a period of diminished interest, discussions of MIGA's establishment were revived in the early 1980s. FDI had remained at very low levels compared with official development assistance, averaging $19 billion annually in the first half of the 1980s. Moreover, although cases had declined in frequency since the 1970s, there were 42 expropriations and nationalizations in Asia, Africa, and Latin America during 1978–83.

The early 1980s also saw the twin debt crises that strengthened the resolve of MIGA's founding governments that heavily indebted countries must rely on the private sector and foreign private investment to avoid the debt trap (MIGA 1994, p. 1). In the mid-1980s, there were few private political risk insurers, the types of coverage were limited, and coverage was mostly short term. Whereas the Bank's Articles of Agreement allowed it to make guarantees directly for private loans against any type of risk, guarantees for equity investments were overlooked.

**MIGA's objective was to encourage the flow of private resources among members for productive purposes.** MIGA's instruments comprised both the issuance of guarantees against noncommercial risks and the carrying out of other activities (mediation services and technical assistance) needed to allow developing countries to attract increased FDI. The MIGA Convention gave the agency a specific mandate to use its facilities to encourage the amicable settlement of disputes between investors and member countries. Mediation was chosen as the most current amicable settlement technique, as opposed and complementary to formal means of dispute resolution, arbitration, and conciliation provided by the International Centre for Settlement of Investment Disputes. It was also envisioned that MIGA's guarantee products and technical and legal services would help strengthen international standards of fair treatment of the rights of investors.

**MIGA's Convention was set up to complement, not compete with, national investment insurance programs and private insurers of political risk.** National insurance agencies tended to "act as an agent of the countries sponsoring investments of their nationals abroad" and to exclude certain investors, countries, and projects from their eligibility criteria (Shihata 1988, p. 18). Private insurers offered limited coverage, short-term duration, and few players.

It was envisioned that MIGA would fill the gaps in the market, particularly for investments in host countries that were ineligible for coverage by other programs and for investors in projects that made them ineligible because of ownership, residence, or sources of procurement. Moreover, Article 21 of the MIGA Convention called for cooperation with other insurers to encourage them to provide coverage of noncommercial risks in developing member countries on conditions similar to those applied by MIGA.

In 1997 MIGA launched two mechanisms for coinsurance and reinsurance: the Cooperative Underwriting Program, designed to encourage private insurers to cover projects in developing countries whose risks they might otherwise be reluctant to assume, and a quota share treaty or whole portfolio reinsurance agreement to expand MIGA's per project coverage and country coverage limits.

**MIGA's shareholder composition of both developed and developing member countries was intended to make it an honest broker** that could guide "all concerned parties toward a common definition of fairness and equitable treatment . . . and help avert disputes . . . or provide a channel for impartial mediation and amicable settlement when they did arise" (MIGA 1998, p. 6). MIGA is the only WBG institution with a special mandate to mediate disputes—including those unrelated to a MIGA contract. In disputes unrelated to a MIGA contract, the host government must express its consent to participate in the mediation, and the investor pays MIGA's out-of-pocket expenses for the mission.

**MIGA was to also have a deterrence effect.** MIGA's shareholder structure and its status as a member of the WBG allowed it to be "particularly effective in pursuing salvage" and thus to have a deterrent effect, which was deemed highly valuable to investors in projects that were vulnerable to changes in host government actions and policies.[5]

Its membership in the WBG gives MIGA leverage over host countries that may be sufficiently concerned about their current and future guarantee and lending programs to maintain appropriate host country policies toward foreign investment. MIGA's participation would potentially deter any abrogation of promises entered into by the host country. This deterrence role would likely survive the transition from one host government to another and strengthen MIGA's role in mediation and in claims recovery.

**MIGA's insurance products have been limited by what is allowed under its Convention, but changes can be made within the current authorizing environment.** A change in the Convention would require action by its Council of Governors and ratification by the member states.[6] However, in the short and medium term, there are policy changes that MIGA could propose that would remain within the authorizing environment of the Convention. A special majority vote by the Board is required for such changes.

In the past, amendments to Schedules A and B (membership and subscriptions and election of officers) have been made in accordance with Article 59(b) of the Convention, with Board approval. The amendments have been effected to include new states in the schedules or when Category II countries have requested a change in status to Category I and vice versa.

### *International Bank for Reconstruction and Development/International Development Association*

**Formal World Bank guarantees were not used until the early 1990s.** The provision of guarantees has been part of the Bank's mandate since its incorporation. Article I of the 1945 Articles of Agreement states, "The purposes of the Bank are . . . to promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors." Until the early 1990s, however, formal guarantees were not utilized as a means to encourage commercial finance to member countries. Instead, several cofinancing programs were implemented. Efforts through the early 1980s encouraged commercial banks to cofinance Bank-funded projects but did not specifically enhance the credit terms available to governments. Instead, cofinancing of Bank-funded projects was seen as giving commercial lenders an assurance that loan proceeds were being used for priority purposes, enabling them to develop broader and longer-term perspectives on member countries.

In 1983, to increase the volume of cofinanced operations as well as to enhance commercial borrowing terms for governments, the Bank established its B-loan program. Under this program, the Bank would either guarantee or participate directly in commercial bank loans for public investment projects that it was also financing directly. Direct Bank participation in B-loans was subsequently dropped, however, following a 1988 review that raised concerns that the Bank would dilute its preferred creditor status. Instead, under the Expanded Co-financing Operations Program of 1989, the guarantee aspects of the program were to be enhanced.

**The coverage of guarantee operations was eventually expanded to include borrowing by the private sector in both International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA) countries.** In 1991 the Expanded Co-financing Operations Program was broadened to include guarantees to support private commercial financing for private sector projects. In 1994 the Expanded Co-financing Operations Program was then replaced by the "mainstreamed" guarantee program, which divided guarantees into Partial Risk Guarantees (PRGs) to support private sector investment in member countries by mitigating political risk, and Partial Credit Guarantees (PCGs) to support government commercial borrowing by enhancing credit terms.

Initially, only IBRD and blend countries were eligible for both products. To broaden the eligibility for guarantee instruments, in 1997 the Bank introduced an IBRD PRG "enclave" program, which made export-earning projects in IDA-only countries eligible for IBRD PRGs. Shortly thereafter, the Bank introduced a pilot program of IDA PRGs for use in IDA-only countries, with an initial exposure cap of $300 million (subsequently increased to $500 million). In 1999 a further instrument was added—the IBRD Policy-Based Guarantee (PBG)—that extended the Bank's existing PCG instrument beyond projects to include sovereign commercial borrowing in support of structural and social policy reforms.

### International Finance Corporation

**The International Finance Corporation (IFC) began providing guarantees in 1982 in response to demand for local currency financing.** IFC's first guarantees were issued in response to client needs to have access to long-term local currency funding. During the next five years, IFC approved a limited number of guarantee transactions, mostly for debt, but also for some trade obligations and equity-related instruments. An IFC guarantee instrument in the 1980s was the equity-related guarantee, which was discontinued in the late 1980s.[7] In 1988, the year MIGA was established, IFC developed its first guarantee policy in response to the perceived growing demand for guarantees. The policy recognized that guarantees were special purpose instruments that give IFC the flexibility to respond to a broad range of specific client needs and to fulfill its development objectives in ways that could not be met through direct lending. The policy emphasized the importance of guarantees in promoting the development of local capital markets. It made a choice in favor of IFC providing full-risk coverage instead of PRGs.

**In response to the limited use of guarantees, IFC revised its guarantee policy in 1997.** The revision recognized that in the nine years since the policy had been adopted, and in contrast with the rapid growth experienced by IFC's direct investments, IFC's use of guarantees—although successful in individual cases—had been very limited in aggregate volume. The document addressed two reasons for the limited use of the instrument: the inherent disadvantages of full-risk guarantees versus direct lending, resulting in higher all-in-cost for the client, and the policy requirement that, in the event of a call, the guarantee be converted into a loan denominated in one of IFC's standard lending currencies.

The revised policy allowed for flexibility in front-end fees but kept commitment fees unchanged. It also amended the policy to allow for greater flexibility for IFC's subrogation in the local currency in the event of a call on a local currency guarantee. The changes were not expected to lead to a quantum increase in the volume of IFC's full-risk guarantee business, but improved applicability was expected in projects with access to funding in local currency.

**Although there have been no major policy changes in guarantees since 1997, product innovation to meet client needs has led to expansion in the range of IFC's guarantee instruments.** The major shift in the use of guarantees has been from single-credit guarantees to guarantees on portfolios of credits, such as the Risk-Sharing Facilities (RSFs).

IFC currently offers a variety of guarantee products. Its nomenclature of products includes different forms of direct debt substitutes, trade facilities, commercial operations, and the Global Trade Finance Program (GTFP). IFC has also introduced some partial-risk products, such as the Guaranteed Offshore Liquidity Facility (GOLF)

**Box 1.1: WBG Guarantee Products**

**MIGA PRI.** MIGA offers PRI coverage to foreign direct investors for any combination of the following political risks: transfer restriction, expropriation, war and civil disturbance, and breach of contract. MIGA can insure direct equity, quasi-equity, nonequity direct, and other investments. To insure debt, however, it must have an equity link. MIGA guarantees cover new foreign-currency-denominated investments, including "new" investments to existing investments, investments by private for-profit and nonprofit organizations, and publicly owned investors and organizations that operate on a commercial basis. MIGA can cover any freely usable currency, which may include local currency investments/loans. Under certain circumstances, MIGA can cover investments by local investors.

**World Bank PCGs.** PCGs support government borrowing from commercial lenders or government bond issues to finance public investment projects. They provide comprehensive cover against all risks. PBGs are a type of PCG that are not associated with specific public investment projects, and instead support agreed policy reforms. Both PCGs and PBGs are available only to IBRD countries and require a government counter-guarantee.

**World Bank PRGs.** PRGs cover commercial lenders for a private sector project against default arising from a government-owned entity failing to perform its obligations. PRGs can cover changes in law, failure to meet contractual payment obligations, expropriation and nationalization, currency transfer and convertibility, nonpayment of a termination amount, failure to issue licenses in a timely manner, other risks to the extent they are covered by a contractual obligation of a government entity, and noncompliance with an agreed dispute resolution clause. PRGs can be provided in both IBRD and IDA countries and require a government counter-guarantee.

**IFC Direct Debt Substitutes.** IFC PCGs are a credit-enhancement mechanism for debt instruments (bonds and loans). It is an irrevocable promise by IFC to pay principal and/or interest up to a predetermined amount, irrespective of the cause of the payment default. It can be applied to a single credit or to a portfolio of credits.

**IFC Commercial Operation.** This provides credit enhancement guarantee in a nonlending situation where the objective is to back up a client's performance of its obligation in a commercial transaction that involves the provision of goods and services, such as guarantees of bid or performance bonds (called standby letters of credit in the United States).

**IFC GTFP.** The GTFP supports trade transactions by offering confirming banks partial or full guarantees that cover payment risk on issuing banks in emerging markets. Guarantees issued under the GTFP cover import and export transactions and extend to both political and commercial payment risks.

**IFC GOLF.** IFC's GOLF provides single risk coverage for transfer and convertibility risk.

*Source:* WBG.

and Credit-Linked Guarantees. IFC and IBRD have established a joint Subnational Finance Department that can offer IFC guarantees to subnational entities and parastatals.[8]

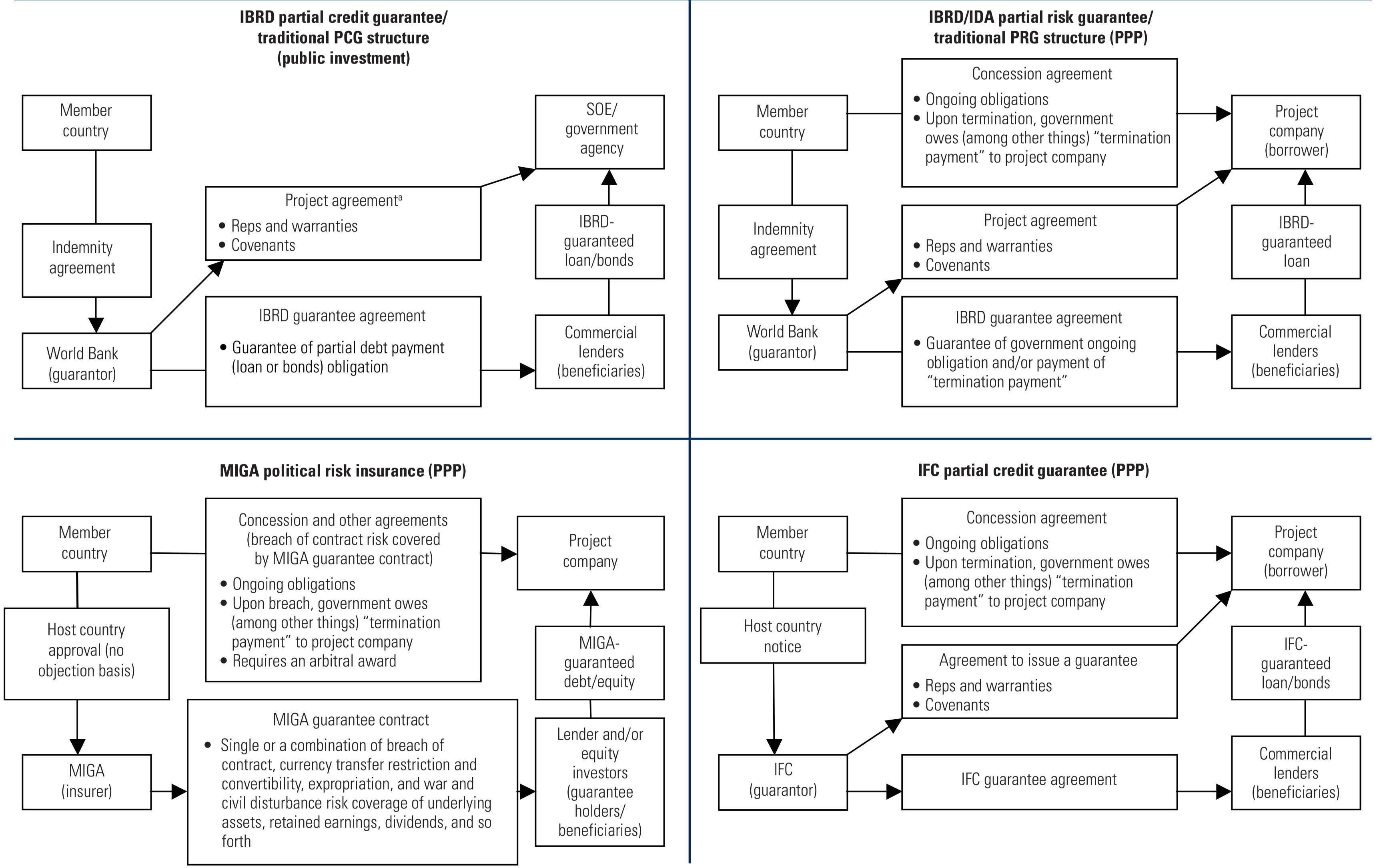
## Mapping of WBG Guarantee Instruments

**The WBG offers a wide range of guarantee instruments.** MIGA offers PRI against the specific risks of transfer and convertibility, expropriation, war and civil disturbance, and breach of contract. IBRD offers PCGs that support sovereign borrowing, and both IBRD and IDA offer PRGs that provide PRI for breach of contract as well as traditional political risks. IFC offers credit guarantees of performance of private borrowers. Its traditional range of PCG instruments for single credits and portfolios has been augmented with some PRGs in recent years. Box 1.1 presents a more detailed list of products, and Figure 1.1 illustrates the contractual framework under each of the WBG's instruments, using a public-private-partnership (PPP) project as an example.

**Guarantee transactions have a number of common elements.** The basic structure of guarantee transactions includes the following elements:

- **Guarantor (or insurer)—**The entity that provides the guarantee; equivalent to the "insurer" in MIGA's terminology

**Figure 1.1: Structure of IBRD/IDA, IFC, and MIGA Contractual Framework (using PPP as example)**




*Source:* World Bank and IEG adaptations.

*Note:* IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; IFC = International Finance Corporation; MIGA = Multilateral Investment Guarantee Agency; PCG = partial credit guarantee; PPP = public-private partnership; PRG = partial-risk guarantee; SOE = state-owned enterprise.

a. If there is no implementing agency involved, the respective project agreement provisions are included in the indemnity agreement with the member country.

- **Beneficiary (or guarantee holder)—**The entity in whose favor the guarantee is issued, such as a bank in the case of a debt obligation
- **Obligor—**The party that undertakes to perform an obligation, typically through a contract; that is, a borrower in the case of a debt obligation
- **Guaranteed asset/obligation—**The underlying obligation that is the subject of the guarantee, such as a loan in the case of a loan guarantee; equivalent to a "guaranteed investment" for MIGA
- **Events covered by the guarantee—**Events that may cause the obligor to fail to perform the obligation and that can trigger a call on the guarantee; also referred to as risks
- **Guarantee percentage/extent of coverage/percentage of cover—**Percentage of the underlying asset/liability being guaranteed/insured; in MIGA, this refers to the portion of the loss to be paid by the agency to the guarantee holder in the event of a claim
- **Calls and claims mechanism—**The steps the beneficiary must follow to be able to call the guarantee.

### *Guarantors*

**Each of the three WBG institutions can be a guarantor.** Each WBG institution may provide a guarantee as a sole participant or may coguarantee a transaction with other guarantors. MIGA and IFC can also syndicate (or reinsure) guarantees with other guarantors to leverage underwriting capacity and diversify risk.

### *Eligible beneficiaries*

**The beneficiaries of WBG guarantees are typically private entities, although there are provisions for public institutions.** The beneficiaries of guarantees issued by the WBG are typically private institutions, most often financial institutions, but also commercial firms (as in the case of IFC's commercial operations or MIGA's equity insurance) or institutional and individual investors, as in bond enhancements.

In certain situations IFC can issue guarantees to government-owned financial institutions if the result would give a significant financial advantage to the client. MIGA and the Bank can also insure public corporations that operate on a commercial basis and issue guarantees to nonprofit organizations (MIGA Operational Regulations 2007b, §1.19). MIGA beneficiaries must be foreign investors (in certain cases, local investors) from a MIGA member country, and the project must be located in a Part II country. IFC and IDA/IBRD can issue guarantees to foreign as well as local investors without restriction.[9]

### *Eligible obligors*

**WBG guarantees can have both private and public entities as obligors.** In the case of World Bank and IFC transactions, the third party on whose balance sheet the guaranteed obligation appears as a liability is the obligor or "client." MIGA does not typically have a direct contractual relationship with the obligor, unlike IFC and World Bank guarantee transactions.

WBG guarantee clients are private institutions in the case of IFC PCGs, IBRD/IDA PRGs, and MIGA PRI, and public institutions in the case of IBRD PCGs and the PCGs issued by the IFC–World Bank Subnational Finance Unit and MIGA PRI (public institutions operating on a commercial basis). Public institution clients can be national and subnational entities as well as parastatals and state-owned enterprises. The World Bank adopts the approach that the government is the primary client for both PRGs and PCGs. In the case of PRGs, however, as it is the private company that typically pays the guarantee fee and in whose name the guarantee is issued, this evaluation considers the client for a Bank PRG to be the private company on whose behalf the guarantee is issued.

### *Eligible underlying obligation/assets*

**The menu of WBG guarantees can cover almost any asset or liability.** The guarantee instruments have established eligibility criteria according to several characteristics of the underlying assets. These include the identity of the assets as defined by whether they are debt, equity, or quasi-equity; are a single asset or a portfolio of assets; are in local or foreign currency; originate locally or from foreign sources; are existing or new items; are of short-, medium-, or long-term maturity; or are a financial obligation or a nonfinancial contractual obligation (such as to deliver goods or services or a management contract arrangement).

**IFC can offer guarantees on a broad range of asset and liability classes, with the exception of straight equity.** IFC guarantees can be provided for senior or subordinated loans; senior or subordinated bonds; senior, mezzanine, or first-loss securitization tranches; and a single credit or a portfolio of credits. IFC can also guarantee long-, medium-, or short-term instruments, such as bills of exchange, promissory notes, or contractual obligations, including bid or performance bonds, delivery of carbon emission credits, and so on.

Since its Guaranteed Recovery of Investment Principal (GRIP) program was discontinued in the late 1980s, IFC has not provided guarantees for straight equity or equity-like instruments, but it can provide enhancement to first-loss securitization tranches, for example. In terms of currency, IFC can guarantee both foreign and local currency instruments. It can also provide guarantees for greenfield, existing investments, and restructurings.

**IDA/IBRD guarantees are restricted to debt obligations, although policy flexibility allows for effective coverage of equity as well.** IBRD PCGs can guarantee commercial loans to governments as well as government bond issues. PRGs can be used to guarantee commercial loans to private investors but not equity investments. In one case, however, IDA was able to effectively guarantee an equity investor by stipulating that if the government failed to make a termination payment to the project company, the company would be deemed to have made a loan to the government and it would be this loan that would be guaranteed by the Bank PRG. The case illustrates the potential flexibility of the PRG instrument in accommodating different types of assets and obligations by transforming them into a loan equivalent following a government failure to fulfill an obligation. The Bank can guarantee local currency–denominated loans to support local lenders to a project, and the guarantees are available up to the maximum maturity for Bank loans for particular countries, which may be up to 20 years.

**Eligible investments for MIGA coverage include direct equity investments, equity-type loans, nonequity direct investments, and debt linked to equity.** Eligible investments[10] for a MIGA guarantee include the following: (1) equity investments,[11] (2) equity-type loans and guarantees (for example, shareholder loans or loan guarantees), (3) nonequity direct investments,[12] and (4) other kinds of investments.[13] MIGA guarantees equity investments, long-term loans and guarantees made by equity holders in the project enterprise, and loans made by institutions with no equity involvement, provided MIGA also insures participation by equity holders.

In general, MIGA guarantees nonequity direct type interests where the returns to the investor depend on the production, revenues, or profit of the enterprise.[14] Other investments can be covered, "provided that the Board so approves by a special majority [and] . . . may be eligible only if they are related to a specific investment covered or to be covered by the Agency" (MIGA 2007b, p. 5). Eligible investments may be in monetary form, or they may be any tangible or intangible assets that have a monetary value, such as machinery, patents, processes, techniques, technical services, managerial know-how, and trademarks.[15] Examples of this practice include coverage of the management agreement of a major hotel for its investments in Peru and Costa Rica and of an oil production–sharing agreement in Equatorial Guinea.

**MIGA can offer a guarantee in any currency that at the time of the decision on the issuance of the guarantee is freely usable.** This implies that a guarantee in the host country's currency is allowed if this currency is freely usable.

MIGA can guarantee a single investment, but its guarantees are restricted to investments that will be implemented after the registration of the application for the guarantee (with the exception of expansions, restructurings, or privatizations).

MIGA can guarantee investments with terms from 3 to 15 years, although some flexibility exists to underwrite longer- (up to 20 years) or shorter-term guarantee contracts (MIGA 2007b, §2.04).

### *Events covered by guarantees*

**IFC traditional guarantee instruments offer comprehensive full-risk protection.** Full-risk guarantees provide cover against all risks, and in this sense they are unconditional guarantees. IFC's traditional guarantees are unconditional: they cover nonperformance for any reason, whether commercial or political, by an IFC client or by a portfolio of assets.[16]

IFC has occasionally provided PRGs, as in the case of credit-linked guarantees, where certain credit events are excluded from IFC's cover. Because these have typically been very low probability events (such as defaults by the sovereign on its local currency obligations), credit-linked guarantees have been a way for IFC to provide as close a substitute for full credit guarantees as possible without violating the Treasury's policy against provision of such guarantees (see below). Another example of a PRG offered by IFC is the GOLF, which covers transfer and convertibility risks only.

**Bank PCGs cover all risks, and PRGs cover traditional political risk and breach of contract risks, which in some cases include commercial and natural force majeure risks.** IBRD PCGs are also unconditional: they guarantee government repayment of a commercial loan or bond regardless of the cause of default. IBRD/IDA PRGs are triggered when a covered event causes a debt service default. Coverage can include war and civil disturbance; expropriation and nationalization; foreign currency transferability, availability, and convertibility; failure to meet contractual payment obligations; nonpayment of a termination amount or an arbitration award following a covered default; obstruction of an arbitration process; failure to issue licenses, approvals, and consents in a timely manner; and changes in laws.

Guarantees that cover government contractual payment obligations (such as a purchase agreement) can also cover other risks, including devaluations, market risk, or corporate mismanagement. That is, any risk can be covered if it is reflected in a contractual obligation of a government entity (Delmon 2007). As such, PRGs have also covered natural hazards that are otherwise uninsurable.

**MIGA's guarantees cover traditional PRI and breach of contract.** MIGA can guarantee a single risk or any combination of specific political risks. These include transfer restrictions and nonconvertibility, expropriation and similar measures, war and civil disturbance, and breach of contract. Article 11(a)(iii) of the Convention allows MIGA to provide breach of contract coverage when (1) the holder does not have a recourse to a judicial or arbitral forum to determine the claim; (2) such decision is not rendered within a reasonable amount of time; or (3) such decision cannot be enforced. At present, only the third condition is authorized by the Board, which requires an arbitral award or a court decision. MIGA's Convention allows other types of specific noncommercial risks to be covered if the Board so approves. The Convention specifically excludes devaluation or depreciation risks from MIGA's coverage.

### *Extent of coverage*

**A common feature of WBG guarantees is the intent to limit the extent of coverage to the minimum amount necessary "to achieve a successful transaction."** Guarantees can cover either part or all of an asset's value. Full credit guarantees provide complete coverage of all principal and interest due on a financial obligation, or the entire amount of investment plus some specified return in the case of equity investment. Full (or comprehensive) risk guarantees cover all risks, both commercial and political. IFC initially offered full credit guarantees, but moved over the years to provide either full coverage for PRGs or partial credit for full-risk guarantees. It does not now, as a rule, provide full credit comprehensive guarantees.

This policy decision was intended to enhance the catalytic effect of guarantees, align incentives, and avoid the creation of a surrogate for IFC's risk in the market. However, there are no strong theoretical or practical reasons for an absolute rule against full credit guarantees,[17] and in several instances IFC has provided or has moved close to providing full credit guarantees, as in the case of some credit-linked guarantees.

IFC's GTFP offers full credit unconditional guarantees on trade instruments. The same stance against the provision of full credit guarantees is seen in IBRD/IDA guarantees. IFC and World Bank PCGs can cover a percentage of the principal and/or interest or apply to only a specified period of the loan maturity. Under late maturity guarantees, IFC and the Bank cover payments in the later stages of the life of the instrument—say, between years 10 and 15 in the event of a debt service default on a loan with a final maturity of 15 years. Any default before that time would be the lender's risk. MIGA can cover amounts of up to 99 percent for loans and 95 percent for all other types of investments for political risk only.

**Bank and IFC PCGs can be rolling and reinstatable.** Both IFC and IBRD have used rolling and reinstatable PCGs. Rolling guarantees are PCGs of debt service payments that move, or "roll," to cover new debt service payments on the client's timely provision of the guaranteed debt service payment. The rolling period can cover all or part of the obligation. In reinstatable guarantees, after the client has failed to perform and the guarantee has been called, it can be reinstated (that is, coverage can be restored) if the client repays the guarantor within a specified amount of time. IFC has offered rolling reinstatable guarantees. The IBRD has used the instrument in Argentina, Thailand, and Colombia, although policy guidelines now restrict the use of reinstatable guarantees, as discussed below.

### *Calls and claims procedures*

**When paying a claim, IFC and MIGA get the investors' rights through assignment, novation, or subrogation as main vehicles for recovery.** All guarantees specify conditions under which the guarantee may be called. Such conditions may include a minimum number of days of nonpayment by the obligor, actions of notice, evidence of efforts by the beneficiary to remedy the situation, or arbitration award in the case of disputes between the beneficiary and the obligor. By paying the claim, the guarantor generally acquires the rights of the guarantee holder in the form of a novated or subrogated loan or claim.

An important concern for IFC is to ensure that the loan or claim obtained in this fashion enjoys preferred creditor status. Such a concern creates a preference in IFC toward novation, or the use of standby loans, instead of a straightforward guarantee as far as documentation is concerned.

In MIGA's case, the guarantee holder assigns an existing claim against the host government to MIGA, which is subrogated to the rights of the investor upon payment of compensation. As a subrogee, MIGA acquires the same right that the investor had. MIGA can—and does—negotiate before paying compensation, which is one of the reasons for the waiting period. If the government refuses to negotiate and subrogation fails, MIGA has direct recovery rights and a system to activate them under the MIGA Convention.

Until 1997, IFC did not allow subrogation in the local currency if there was a call on a local currency guarantee. Flexibility was introduced in the 1997 amendment of the guarantee policy, with restrictions on exposure to countries with underdeveloped derivative markets. A guarantee is accelerable if payments due under the underlying obligation can be made to fall due immediately in specified circumstances. In virtually all cases, IFC retains the right to accelerate the guarantee (acceleration is defined as a full, immediate payout). IBRD enclave guarantees and IDA guarantees are generally not accelerable.

**Although the Bank subrogates investors' rights, it also acquires a claim on the government through a counter-guarantee.** For all guarantees, the Bank enters into an indemnity agreement with the member country in which the project is located. Under this agreement, the Bank is counter-guaranteed by the member country. Once the Bank has paid out the amount owed under the guarantee, it has the right to demand immediate repayment of that amount from the member country or schedule normal IBRD/IDA repayments terms.

Unlike the IBRD, IDA's Articles do not require that it obtain a government guarantee. But as a business practice, Bank policies require IDA to obtain a counter-guarantee from the host government. As with IFC and MIGA, the Bank is also subrogated to the rights of the beneficiary of its guarantee following a payment on a claim, which can provide recourse if the government fails to discharge its obligation under the indemnity agreement.

## Summary of Similarities and Differences

**The WBG offers a diverse set of guarantee products** (table 1.1). All guarantees enable the sharing of risk through unfunded transactions. Private entities can benefit from all WBG guarantee products and—with the exception of IBRD's PCGs and the subnational finance PCGs—all WBG institutions have private entities as clients (or obligors). IFC PCGs and IBRD PCGs are full-risk guarantees, and as such they cover defaults caused by all political and commercial risks. All the other WBG guarantees are PRGs.

By type of underlying assets, all three institutions can guarantee debt, although MIGA has some restrictions for nonshareholder loans. With minor exceptions, such as IFC's Sovereign-Linked Credit Guarantee, which can specifically exclude certain types of sovereign/political risks, all WBG guarantees provide PRM (this is further examined in chapter 3).

**The unique features of IBRD/IDA guarantees are that governments are clients in the case of PCGs and that sovereign counter-guarantees are required for all Bank guarantees.** A sovereign counter-guarantee is required for all IBRD guarantees by the IBRD Articles of Agreement, and IDA has adopted the practice as a principle of business prudence. Clients may value the presence of a counter-guarantee as a further signal of the government's commitment or as indication of the Bank's ability to influence the government or deter adverse government actions. The ease of obtaining a government counter-guarantee for private transactions can vary, depending on the government's relationship with the Bank, the strategic importance of the project, and the extent to which the counter-guarantee may make explicit some implied government obligations embedded in its contract with the private firm. MIGA requires host country approval for both the issuance of MIGA's guarantee and the risks to be covered. Host country approval is sought at two levels: first, whether the proposed investment conforms to the host country government's laws, regulations, and declared development objectives, and second, approval of MIGA's issuance of the guarantee against the risk designated for coverage. Should the host country limit its approval to a certain type of risk, MIGA will have to reflect that limitation in its contract of guarantee.

**MIGA, the only WBG institution established to cover political risk, has the most unbundled and narrowly defined product space of all WBG institutions.** Because MIGA was the last of the WBG institutions to be established, and given the prevailing economic environment of the time, as well as a desire among the founders to ensure complementarity and avoid overlaps with national insurers, MIGA was given a specific role and a narrowly defined product. As a result, MIGA's PRI product is subject to the most eligibility limitations among the guarantee instruments of the WBG and can guarantee against four defined types of political risks.

MIGA's Convention does not allow it to cover commercial risks because it was designed to "provide guarantee services to investors in projects of acute vulnerability to changes in host government policies or commitments" to avoid competition with national export credit agencies. It is generally unable to guarantee against breach of contract by state-owned enterprises that operate on a commercial basis because of its inability to hold the governing authority liable for the obligations of the enterprise. MIGA's most distinctive feature is its ability to insure equity, quasi-equity, and other forms of nondirect investments, although the Bank has synthetically replicated

**Table 1.1: WBG Guarantee Instruments**

| Product attributes | IFC PCG | IFC SCLG | IFC GOLF | IFC RSF | IFC/Bank SNF PCG | IFC COP* | IBRD PCG | IBRD PRG | IDA PRG | MIGA PRI |
|---|---|---|---|---|---|---|---|---|---|---|
| **Risks covered** | | | | | | | | | | |
| Comprehensive risk | + | | | + | + | + | + | | | |
| Commercial risks only | + | + | | + | + | + | + | | | |
| Political risks | + | | | + | + | + | + | | | |
| Transfer and convertibility | + | + | + | + | + | + | + | + | + | + |
| Breach of contract | + | + | | + | + | + | + | + | + | + |
| Expropriation | + | + | | + | + | + | + | + | + | + |
| Political violence | + | + | | + | + | + | + | + | + | + |
| Conventional terrorism | + | + | | + | + | + | + | + | | +[b] |
| Non-honoring of sovereign guarantee | + | + | | + | + | + | + | + | | |
| Non-honoring of arbitration award | + | + | | + | + | + | + | + | | + |
| Wrongful calling of guarantee | + | + | | + | + | + | + | + | | + |
| License cancellations | + | + | | + | + | + | + | + | + | + |
| Sovereign default | + | **+** | | + | + | + | + | + | | |
| **Beneficiary type** | | | | | | | | | | |
| Privately owned | + | + | + | + | + | + | + | + | + | + |
| Government owned | + | | | + | + | + | + | + | + | + |
| **Client type** | | | | | | | | | | |
| Privately owned | + | + | + | + | + | | + | + | + | + |
| Government | | | | | | | | | | |
| National | | | | | | | + | + | + | +** |
| Subnational | | | | | + | | + | + | + | +** |
| Parastatal | | | | | + | | + | + | + | +** |
| Non-profit organization | | | | | + | | + | + | + | +*** |
| **Underlying assets/obligations** | | | | | | | | | | |
| Equity | | | | | | | | | | **+** |
| Portfolio equity | | | | | | | | | | **+** |
| Quasi-equity | + | + | | + | | | | + | + | + |
| Subordinated loan | + | + | | + | | | | + | + | + |
| Senior loan | + | + | | + | | | + | + | + | + |
| Bonds | + | + | | + | | | + | + | + | + |
| First loss tranche | + | + | | + | | | + | | | |
| Mezzanine tranche | + | + | | + | | | | | | + |
| Delivery of goods and services | | | | | | **+** | | | | |
| Security/enhancement | | | **+** | | | | | | | |
| Short-term instruments | + | + | | + | | | | + | | |
| Trade credit | + | + | | + | | | | + | | |
| Portfolio of assets | + | | | **+** | | | | | | |
| Production sharing contracts | + | | | | | | | + | + | + |
| Profit-sharing contracts | + | | | | | | | + | + | + |
| Management contracts | + | | | | | | | + | + | + |
| Franchising agreements | + | | | | | | | + | + | + |
| Licensing agreements | + | | | | | | | + | + | + |
| Turn-key contracts | + | | | | | | | + | + | + |
| Operating leasing agreements | + | | | | | | | + | + | + |
| Subordinated bonds | + | | | | | | | + | + | + |
| Guarantees or securities | + | | | | | | | + | + | + |
| **Guaranteed percentage** | | | | | | | | | | |
| Full | | + | | | | | | + | + | |
| Partial | + | | + | + | | + | + | | | +[c] |
| **Others** | | | | | | | | | | |
| Government counter-guarantee | | | | | **+** | | **+** | **+** | **+** | |
| In kind contribution[a] | | | | | | | | | | + |
| Local currency | + | + | | + | | | + | + | + | + |

*Note:* *COP can be conditional or unconditional. **Provided that the government-owned investor operate on a commercial basis. ***Provided that the specific investment for which the coverage is being sought will be carried out on a commercial basis. Shaded cells are distinctive features to the referenced guarantee instrument. COP = Community of Practice; IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; IFC = International Finance Corporation; GOLF = Global Offshore Liquidity Facility; MIGA = Multilateral Investment Guarantee Agency; PCG = Partial Credit Guarantee; PRG = Partial Risk Guarantee; PRI = political risk insurance; RSF = Risk-Sharing Facility; SCLG = single-currency loan guarantee; SNF = subnational finance.

a. Tangible or intangible assets that have monetary value such as machinery, patents, processes, techniques, managerial know-how, trademarks, and marketing channels.

b. Covered under war and civil disturbance.

c. The portion of loss to be paid by MIGA in the event of a claim shall not exceed 99% for loans and 95% for all other instruments.

the political risk coverage of equity in one infrastructure project in Africa. Whereas its scope of operations is limited by the Convention, it was also envisaged that the provisions could be elaborated, as the need arose, in the regulations, policies, and rules put forward by MIGA's Board of Directors, which would allow room for innovation and flexibility.

## Conclusion

**The guarantee instruments of the three WBG institutions have both clearly defined, distinctive features and overlaps in terms of types of risks covered, underlying assets, and beneficiaries.** The product comparison is based on the authorizing environment for the deployment of the instrument as specified by their charter, internal policies, and regulations. WBG guarantee instruments as a group can guarantee a broad range of assets, including debt and equity or quasi-equity; a single asset or a portfolio of assets; local or foreign currency; local or foreign funding; existing or new investments; of short-, medium-, or long-term maturity; and financial obligations or nonfinancial contractual obligations.

Virtually all types of commercial entities—public or private, profit or nonprofit, domestic or foreign—could access WBG guarantees. Risk coverage ranges from a single risk to comprehensive political and commercial risks. The instruments of the three institutions also have clearly defined, distinctive features determined by their policies and regulations. In addition to policies, however, other factors influence the actual deployment of the instruments. These include market demand, strategic priorities, and internal incentives.

# Chapter 2

The gas pipeline between Mozambique and South Africa was the first cross-border pipeline in Sub-Saharan Africa. The project was guaranteed by MIGA and the World Bank to mitigate political risks. Photo courtesy of Sasol.

# Review of the WBG's Experience with Guarantees

In chapter 1 we presented the range of WBG guarantee instruments. We now turn our attention to the way these instruments have been deployed in practice by the three WBG institutions.

## MIGA Guarantees

### *Patterns of use*

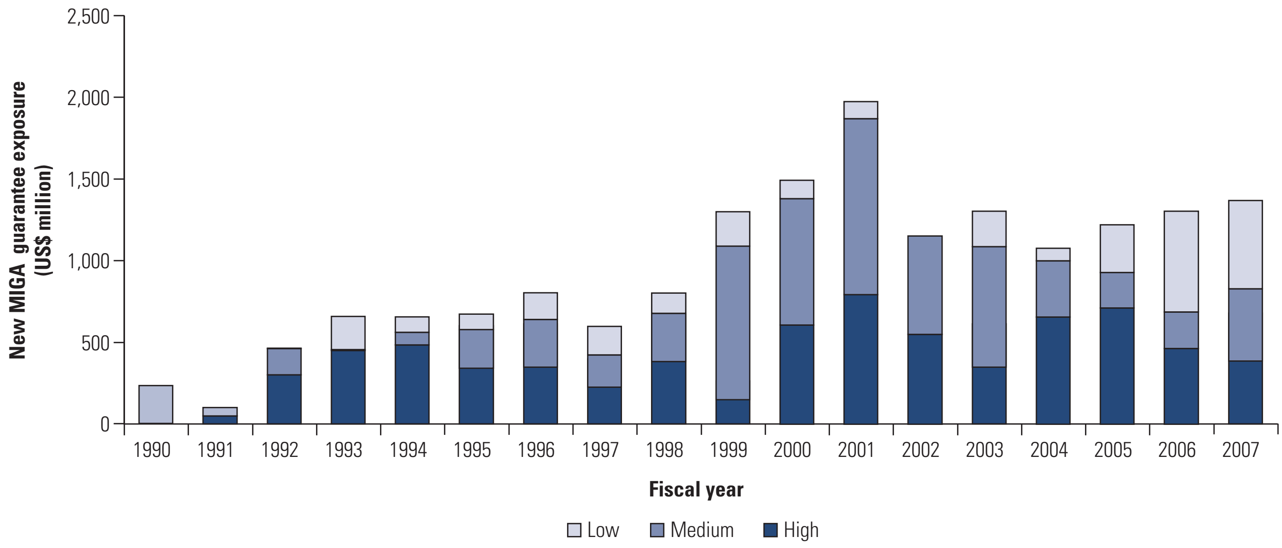
**Within the limits imposed by its Convention, MIGA has made substantial strides in fulfilling its mandate, expanding its operations and client base, and diversifying its portfolio.** MIGA has channeled an estimated $56 billion of investments in high- and medium-risk countries through its PRI products. Using the Institutional Investor Country Credit Rating index, it can be determined that 45 percent of MIGA guarantee projects are located in high-risk countries and 31 percent in moderate-risk countries; about one-sixth of MIGA projects are located in low-risk countries (figure 2.1).

MIGA's gross and net exposures follow the same trend. Frontier countries (high-risk and/or low-income countries/markets) were also the recipients of 56 percent of all MIGA guarantee contracts issued, corresponding to $7 billion in gross exposure. PRI exposure to IDA countries represented 18 percent of its overall portfolio, although the level of exposure to MICs accounts for a higher percentage (76 percent). This figure reflects investor interest in emerging markets. Most of the guarantee projects were located in developing countries that did not receive large FDI inflows, indicating demand for MIGA PRI in places that were largely ignored by international investors.

Its client base also expanded—from three clients in fiscal 1990 to 371 in fiscal 2007. MIGA's client retention has also improved: 56 percent of its gross exposure is associated with repeat clients, mainly for projects in the financial and infrastructure sectors. Most of MIGA's clients come from Part I countries, although MIGA has also focused on promoting South-South investments, which represent nearly 14 percent of the total amount of guarantees issued since fiscal 1990. MIGA has also achieved portfolio diversification in its Regional and sectoral distribution. Ex post evaluations of a sample of 21 MIGA guarantee projects during fiscal 1996–2002 show that about half (48 percent) of the projects attained satisfactory or better development outcomes and made a positive contribution to the achievement of MIGA's development mandate. These projects provided extensive benefits to the host countries and communities.

**MIGA's PRI business expanded rapidly, especially in the second half of the 1990s but was negatively affected by post-2001 events.** It has now started to recover. Between fiscal 1990 and 2007, MIGA issued $16.7 billion in guarantee coverage for 897 guarantee contracts in support of 556 projects in 96 countries. Latin America

**Figure 2.1: MIGA's Gross Exposure, by Country Risk Classification, Fiscal 1990–2007**




*Source:* MIGA.
*Note:* Based on Institutional Investor Country Credit Rating. MIGA = Multilateral Investment Guarantee Agency.

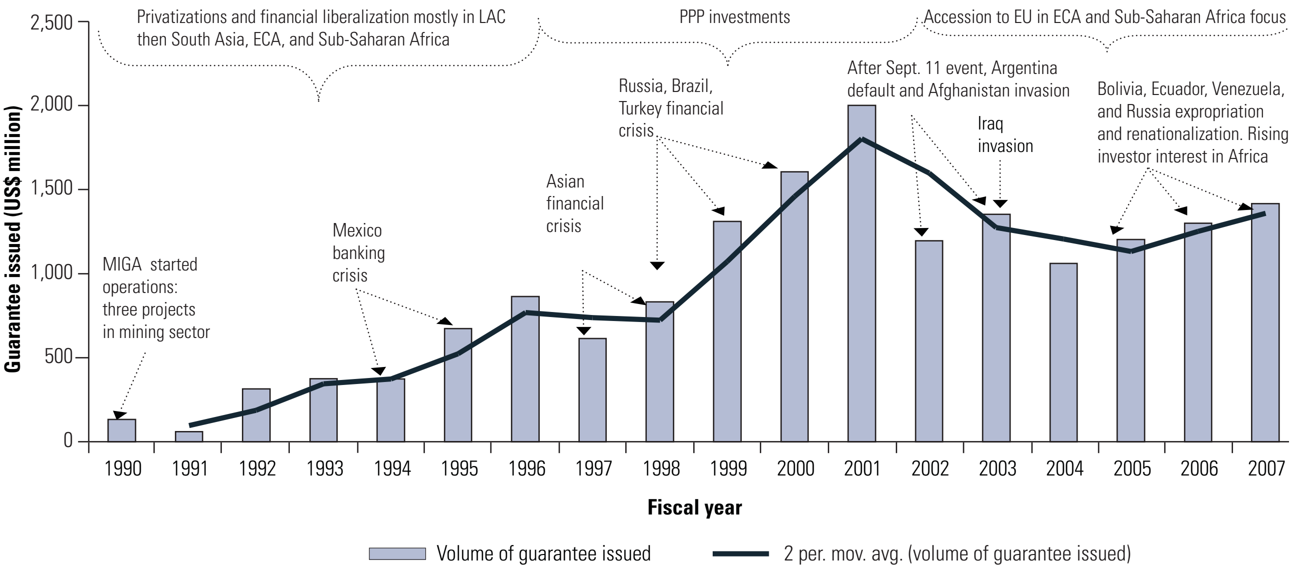
and the Caribbean and Europe and Central Asia Regions account for nearly two-thirds of MIGA contracts issued during this period; its presence in the Middle East and North Africa Region has been intermittent.

The Regional and sectoral trend of MIGA's portfolio closely tracks FDI trends. In the early 1990s, the demand for MIGA coverage was spurred by investments in the mining sector in the Latin America and the Caribbean Region. From the mid-1990s until the end of the decade, the privatization of state-owned utility companies and financial liberalization in the Region provided the impetus for foreign investors and lenders to obtain MIGA coverage (figure 2.2).

By 2003 and 2004, the rush of investment activities in the Russian Federation and the Commonwealth of Independent States group, as well as in countries preparing for accession into the European Union, shifted MIGA's portfolio allocation to the Europe and Central Asia Region. During the last two years, however, Africa has become the leading Region by number of MIGA contracts, which also reflects investor interest in the continent. Contracts issued for investments in the Middle East and North Africa, a current WBG strategic priority, represented 4 percent of total contracts issued; MIGA's presence there has been intermittent.

**Most of MIGA's clients purchase transfer restriction coverage followed by expropriation coverage, which is reflected in the large share of financial and infrastructure projects in MIGA's portfolio.** Financial and infrastructure sectors account for about two-thirds of MIGA guarantees by volume or number of contracts. Investors in financial sector projects tend to seek coverage against currency transfer restrictions, whereas investors in infrastructure projects generally purchase PRI against expropriation and breach of contract. Stand-alone breach of contract coverage, often combined with coverage for expropriation, accounts for about 10 percent of overall volume of coverage issued, but demand has rapidly grown for these products because of increased investments in PPP projects.

**Figure 2.2: MIGA Guarantees Issued and Trends**



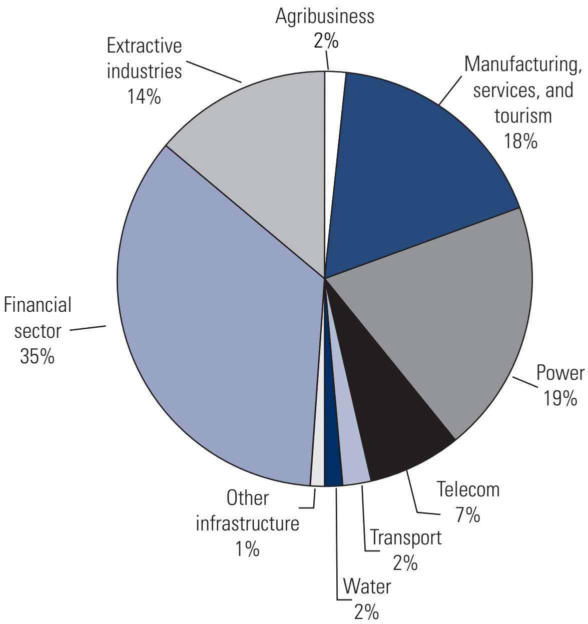

*Source:* MIGA.
*Note:* ECA = Europe and Central Asia Region; EU = European Union; LAC = Latin America and the Caribbean Region; MIGA = Multilateral Investment Guarantee Agency; PPP = public-private partnership.

Coverage for transfer restrictions also tends to be in high demand among MIGA clients investing in Latin America and the Caribbean, Asia, and lately in Europe and Central Asia. Investors in Africa, however, prefer to use the full range of MIGA PRI products—transfer restriction, expropriation, and war and civil disturbance coverage are in equally high demand, reflecting the perceived risks in the Region. Almost a third of MIGA's gross exposure in Africa is in the extractive industries sector, which is inherently risky because of its complexity.

**In response to the shift in global investment trends, MIGA's portfolio has shifted from manufacturing to financial and infrastructure projects.** Following rapid growth in the 1990s, guarantee contracts issued to manufacturing sector investments have been declining, in part because of the decline in new investments in the sector and in part because of the perception of investors that political risk in the sector is lower or could be self-insured. As of 2007, these contracts comprised only 11 percent of total MIGA guarantee contracts issued, compared with almost half in 1996 (figures 2.3 and 2.4). This pattern also reflects a robust growth of services in global FDI, particularly in the financial sector, as a result of financial liberalization and sector reforms in the 1990s.

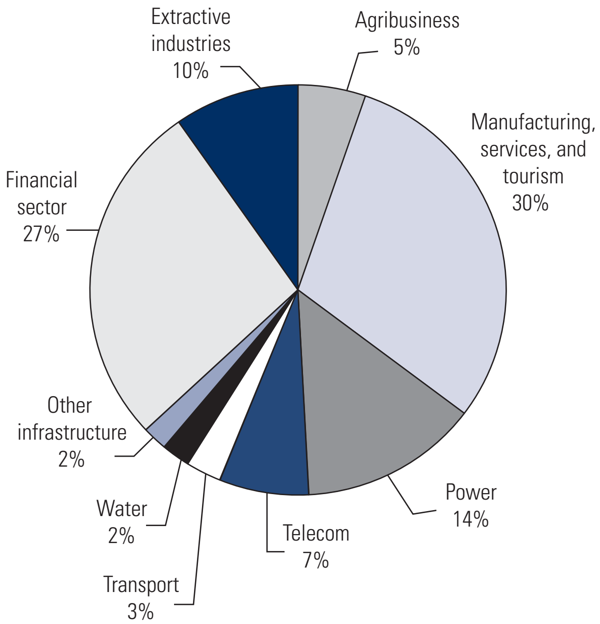
**Historically, MIGA's financial sector exposure has ranged from 30 to 40 percent of its total portfolio.** Most of this exposure has been motivated by compliance of parent international banks with regulatory requirements and their meeting of country exposure limits. Initially MIGA covered the equity investments against currency transfer restrictions of parent international banks that open a local subsidiary or start bank branch operations. In subsequent deals, MIGA provided coverage (mostly against transfer restriction risks) to the parent banks' shareholder loans to expand lending operations. That move allowed the shareholders to meet regulatory and capital reserve requirements. As these clients

**Figure 2.3: Distribution of Guarantees Issued by Sector (gross exposure), Fiscal 1990–2007**




*Source:* MIGA data.

**Figure 2.4: Distribution of Guarantees by Sector (number of contracts), Fiscal 1990–2007**




*Source:* MIGA data.

commenced operations in a host country and became familiar with MIGA, they tended to seek PRI coverage—first for their nonbank investments, such as pension funds and leasing operations, and then for the expansion of these operations in the same host country, and eventually for their bank and nonbank investments in other developing countries.

During the last two years, MIGA coverage in the banking sector consisted of either equity or shareholder loans to boost the Tier II capital of bank subsidiaries to prepare for the adoption of the Basel II requirements, in addition to expanding loan operations. Shareholder loans benefiting from transfer and convertibility coverage by multilateral development banks could qualify from lower capital risk weighting under the Basel II capital adequacy framework, provided the multilateral development bank has "very high quality long-term issuer ratings; that is, the majority of a multilateral development bank's external assessments must be AAA" (BIS 2006, paragraph 59). MIGA benefits from a shadow AAA rating as a member of the WBG. MIGA has also supported capital market transactions since 2003 in response to the demand for PRI coverage for cross-border and future flows transactions.

**In the infrastructure sector, privatization activities, which dominated the sector in the 1990s, have been replaced by PPPs in recent years.** An estimated 42 percent of MIGA's gross exposure in the infrastructure sector was channeled to projects in the Latin America and the Caribbean Region, particularly Brazil. Asia and Africa received 18 and 17 percent, respectively, of the amount of guarantees issued to the sector during fiscal 1990–2007.

MIGA's clients in the infrastructure sector either have several equity investments (such as international engineering companies and energy/utility firms) or have provided project financing to power, port, and road projects in one or more countries. Several of these investors are repeat clients, and although client familiarity has been good for MIGA's business, one of the unintended consequences is a trend toward concentration of its portfolio with a few clients.

**MIGA guarantees were also allocated to investments for the development of SMEs and investors.** Since its inception, MIGA has provided coverage (estimated at $1 billion from fiscal 1997 to 2003) for investments to support SMEs. In fiscal 2006, it introduced the Small Investment Program (SIP) to make PRI more accessible to small and medium-size investors, especially from Part II countries, who are investing in SMEs. SIP offers standardized terms, with a fixed premium rate by country, and a streamlined underwriting process. The program's initial coverage limit of $5 million was increased to $10 million in January 2008.[1]

Since its implementation in fiscal 2006, 30 percent of MIGA projects were within SIP and represent less than 1 percent of MIGA's outstanding portfolio to date. The majority of projects were in the sectors and Regions targeted by the program and were broadly consistent with country priorities or WBG strategies.

SIP projects, especially in conflict-afflicted countries, have potentially significant demonstration effects. The Independent Evaluation Group (IEG) has been unable to determine the success of the program because the outcomes have not been evaluated. Of the 15 projects that had coverage under SIP up to December 2007, 6 were cancelled after 1 or 2 years, almost the same cancellation rate as for regular projects. Some were cancelled because the project did not go forward. The cancellation rate, especially for SIP projects that did not become operational, meant that expected development impact was not realized and that MIGA could not fully recover the cost of underwriting SIP projects.

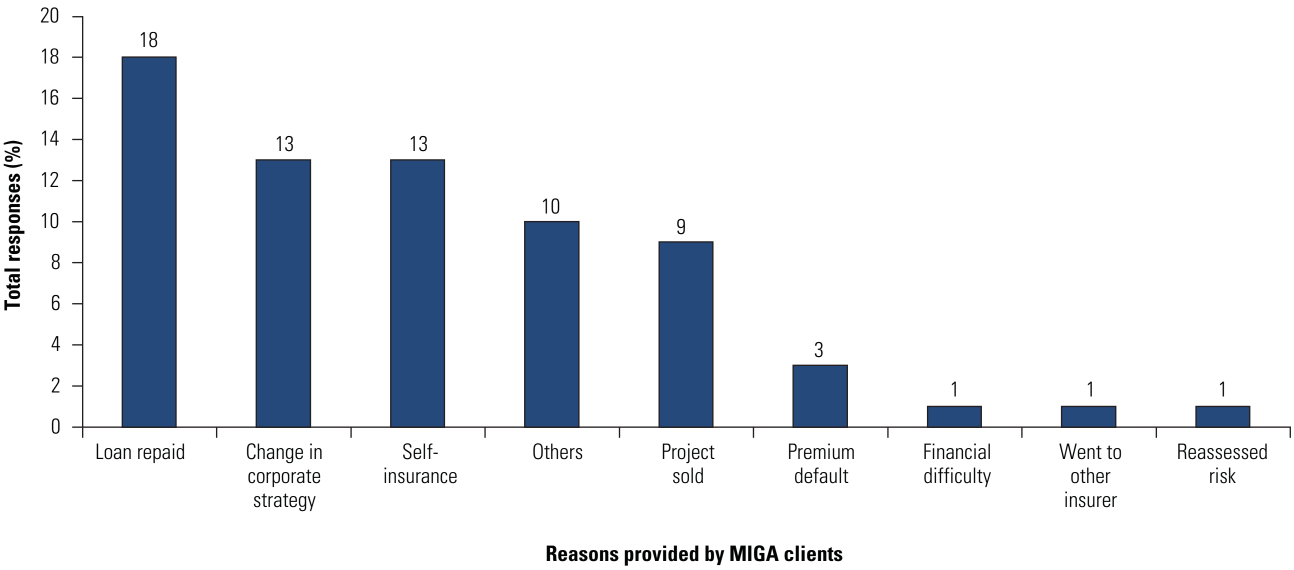
**MIGA, together with other donors, created three investment guarantee trust funds to facilitate foreign investment in conflict-affected countries such as Bosnia and Herzegovina, the West Bank and Gaza, and Afghanistan—which were not eligible countries—or where the risks were considered to be high under the regular guarantee program.** These funds were created as new instruments, different from the trust funds mentioned in the Convention, both to provide long-term insurance for eligible small and medium-size investments in these risky areas and to have a positive signaling effect to foreign investors. Under these plans, MIGA issues guarantees on behalf of, and pays compensation from, the trust funds.

The European Union sponsored the $12 million Investment Guarantee Trust Fund for Bosnia and Herzegovina, with a special credit line for this purpose. This fund has been fully utilized to provide guarantees for six projects—three in the financial sector and three in the services and the manufacturing sectors.

The Palestinian Authority, through an IDA loan, has contributed to the Investment Guarantee Trust Fund for the West Bank and Gaza, with additional funds from Japan and the European Investment Bank. More recently, MIGA created the Investment Guarantee Fund for Afghanistan with the support of the Islamic Republic of Afghanistan, IDA, the Asian Development Bank (ADB), and the United Kingdom.[2] MIGA had been able to tap into these funds and leverage its resources for four projects in Afghanistan under its SIP.

**MIGA has paid three claims since it was established—an excellent record for an insurer.** MIGA has paid $5.2 million (net amount) for those three claims. In June 2000, MIGA paid its first claim, for an expropriation related to a power plant project in Indonesia, which it has recovered from the government. In fiscal 2005, MIGA paid two claims totaling $0.6 million. One was a war and civil disturbance claim filed in relation to a hydroelectric plant in Nepal, and the second was related to a loan guarantee to a project in Argentina. In these two cases, because the amounts were small, payment was not recovered from the host governments.

**Figure 2.5: Reasons Given by Clients for Canceling a Guarantee, Based on Guarantee Contract Cancellations, Fiscal 2001–07**




*Source:* MIGA data.

Between the second quarter of fiscal year 2003 and fiscal year 2007, MIGA encountered 21 projects with claims or preclaims that had been adequately provisioned. More than half of these were infrastructure projects, and about three-quarters of this group were PPPs involving concessions from national or local governments. The Overseas Private Investment Corporation's (OPIC) total claims payout is valued at $964.7 million for 280 claims since it was created.[3] Claims payment by the other reporting members of the Berne Union Investment Insurance Committee for 2005 amounted to $113 million ($85.5 million for 2006 and $12.2 million for 2007), but outstanding claims are higher.[4]

**MIGA PRI has helped attract investments, but investors tend to cancel when perception of political risk improves.** For MIGA's operational sustainability, cancelled projects would have to be offset by a strong pipeline. A MIGA guarantee contract has a 67 percent chance of being cancelled or terminated before reaching its expiration date. Large exposures are more likely to remain active until expiration. Approximately 37 percent of MIGA guarantees are cancelled by the investors before the third anniversary of the contract, and a quarter of the cancellations have taken place during the third year.[5] Cancellations because of financial difficulty, inability to pay premiums, and switching to other PRI providers represent just 5 percent of the reasons given (figure 2.5). Thus, cancellations take place when the investments are still successful from a financial standpoint, and in some cases (self-insurance) the investors' perception of political risk has improved. These cancellations are not unusual for the industry and in some measure reflect MIGA's fulfillment of its fundamental mandate to attract investment to developing countries.

### *Effectiveness and additionality*

**MIGA's guarantees fill a gap in the provision of long-term PRI.** When the idea for an international investment insurance agency was conceptualized, the PRI market was dominated by national agencies, and eligibility criteria were driven by government mandates and national requirements. The few private insurers in the business offered limited PRI products—short-term coverage at high prices. Because of their limited underwriting capacity, they were reluctant to cover investments in higher-risk countries unless the risk was reduced through reinsurance or cooperation with national insurers.

The gaps left by the private and national insurers in providing long-term PRI to encourage FDI flows to developing countries served as the rationale for a multilateral presence in the PRI market. Then and now, MIGA's most visible and important value added rests on ensuring the availability of long-term PRI to investments in difficult parts of the world. For the equity holders, MIGA's PRI provides access to cheaper financing from banks, whereas financial institutions can obtain regulatory relief to free up capacity for their own internal risk management.

These additionalities have been recognized by market players in response to market studies; they also acknowledged that they are aware of MIGA's function as distinct from those of IFC and the World Bank. An internal 2007 study reinforced MIGA's strengths in the PRI market, particularly its advocacy potential and excellent claims history.

**MIGA is not only a political risk insurer; mediation of disputes, based on its special relationship with governments, is part of MIGA's broad mandate to remove obstacles to FDI flows to developing member countries.** The Convention mandates that MIGA assist in settling investment disputes; it can act as an independent mediator in cases involving an investor and the host government, even when the dispute is unrelated to any guarantee (Shihata 1988, pp. 257–85).

MIGA's direct access to host governments (as its shareholders) strengthens its ability to successfully mediate mutually agreeable resolutions to retain investments and restore projects to normal operation. As a multilateral entity, it is able to play the role of an honest broker, and the deterrence effect arising from its mandate is valued greatly by investors, who understand that host counties have more at stake than just individual projects—potentially the much larger and more important relationship with the WBG could be at risk. For host countries, resolution of disputes provides a positive signaling effect of the attractiveness of the country as an investment destination.

Most of MIGA's dispute-resolution efforts relate to projects for which it has issued guarantee coverage. It has also selectively mediated disputes involving non-MIGA investors and host countries, as in the case of its long-term mediation efforts in Ethiopia.[6] MIGA does not charge fees for mediation efforts that involve a client and the host government but seeks reimbursement for out-of-pocket expenses related to such missions in disputes unrelated to its guarantee. IEG evaluations of four projects in which MIGA's Legal Affairs and Claims Group intervened indicated that MIGA played a useful role in resolving several disputes related to power purchasing agreements and contributed to a successful debt restructuring that enabled the project to continue operating.

**MIGA cooperates with and leverages the participation of public and private sector insurers.** Co- and reinsurance arrangements with other insurers increase MIGA's capacity to support large projects[7] and allow it to manage the risk profile of its portfolio. In reinsuring the whole portfolio or individual projects of other insurers, MIGA allows them to extend their capacity. This enables other insurers to participate in projects in more challenging environments and for longer terms than they would normally underwrite. Host countries also benefit from an increased interest from other insurers. MIGA's partners recognize its superior loss avoidance and recovery ability.

Under its syndication program, MIGA has attracted more than $4 billion. Its panel of syndication partners consists of private sector insurers, including, among others, ACE, AIG, Axis, Chubb, Coface, Hannover Re, Lloyd's, Munich Re, Swiss Re, and XL Capital, as well as public insurers such as the Export Guarantee Department (United Kingdom), Servizi Assicurativi del Commercio Estero (Italy), Export Finance and Insurance Corporation (Australia), Compañía Española de Seguros de Crédito a la Exportación (Spain), Garanti-Instituttet for Eksportkreditt (Norway), Slovene Export and Development Bank, Export Development Canada, and the Overseas Private Investment Corporation (United States). In recent years, there have been concerns that MIGA may be ceding a greater share of its premium income to other insurers, which prompted a recent management review of MIGA's net retention policy and methodology.

**MIGA's longer-term vision gives comfort to investors entering into long-term investments in developing countries.** According to MIGA's client survey, a key attribute of MIGA is its long-term commitment to and relationship with countries. Investors indicated that when there is a crisis in the country, "MIGA stays," because of its development objectives, when private insurers might withdraw because of their profit orientation. MIGA's additionality, as indicated through client surveys and ex post evaluations, enables investors to access funding at a lower borrowing cost; seek improved terms and conditions for private investments, lowering their "hurdle rates"; have clarity regarding MIGA's risk definition because it reflects insurance industry practice; and have additional protection from the umbrella effect of WBG membership.

**Ex post evaluations confirm MIGA's additionality in a sample of MIGA's projects.** In 2006 IEG evaluated a sample of 21 mature MIGA projects (IEG–MIGA 2006) to assess MIGA's additionality as an insurer, its role in leveraging and complementing partners, and its contribution to its clients. For instance, MIGA brings WBG environmental and social safeguards to the design and implementation of their clients' investment projects.

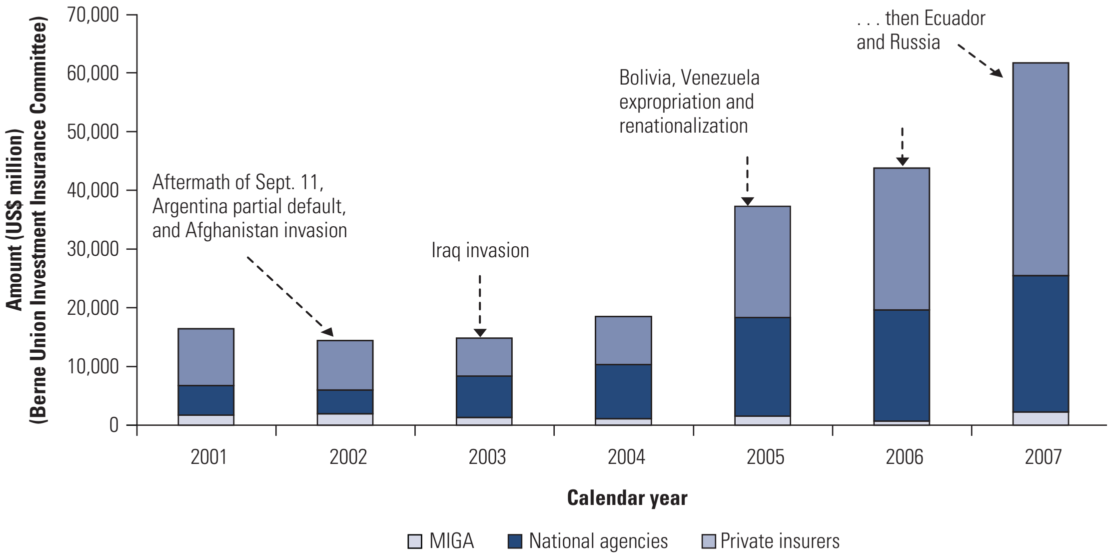
The results indicate that in the majority of projects (18), MIGA made important contributions. The high ratings reflect the perception of investors that, in many cases, MIGA's involvement was critical for the investments to proceed or provided comfort to clients entering new markets or new sectors (especially private provision of public infrastructure). MIGA's insurance was particularly crucial for investors in post-conflict countries. In one evaluated project, MIGA provided a tailored product that was not available from private insurers for the long term required by the investors. In six of the ex post evaluated cases, MIGA coverage was a condition for lenders to provide funds. An IEG review of the quality of underwriting for new projects (fiscal 2005–06) also showed that in more than half the cases, MIGA did not clearly define the particular value it brought to the project. It is unclear in these ex post and ex ante reviews whether those investments would have been made without MIGA's presence.

**MIGA's impact on projects beyond its role as an insurer has been limited.** In keeping with the nature of its guarantee product (that is, further removed from project implementation than a financier or equity investor), MIGA cannot be expected to have the capacity to influence project design. However, it can have a proactive influence in raising standards through its environmental and social safeguard policies and environmental guidelines. Until recently, MIGA did not proactively offer services or advice to improve project development outcomes. In an SIP project, MIGA played an important role by assisting the investor in successfully structuring the deal for the project. Contributing to a broader set of issues beyond its traditional role as an insurer is consistent with MIGA's development mandate, but it is important to do so in a way that is also consistent with market practices and the more remote position of the typical insurer in relation to the project company.

### Potential for use

**Political risk remains a considerable threat to global business and has spurred the rapid growth in PRI volumes since 2005.** Despite the variety of risk-mitigation products available to investors, the demand for PRI products continues to be robust, as reflected in the rapid growth of new business by Berne Union investment insurance members from 2005 through 2007 (figure 2.6). In 2001 total new business by members amounted to $16 billion; in 2007 new business reached $62 billion as investors prepared for the resurgence of traditional political risks, especially expropriation risk, which had been largely discounted until the early 2000s. The outlook for the next five years is similarly strong, according to a June 2007 global survey of 602 executives by the *Economist* Intelligence Unit (EIU 2007).

**Figure 2.6: Snapshot of the PRI Market: Total New PRI Business Volumes, Calendar Years 2001–07 (Berne Union investment insurers only)**




*Source:* Berne Union.
*Note:* PRI = political risk insurance.

The survey also revealed that although many businesses are not adequately managing their expectations of increased political risk, companies with better political risk assessment capabilities experienced fewer cases of expropriation, government payment default, or currency transfer restriction than other firms. Recent episodes of expropriations and nationalization in Bolivia, Ecuador, Russia, and Venezuela have underlined the continued need for MIGA's traditional PRI. MIGA can readily provide these products, given its expertise in the PRI market.

**MIGA has not taken full advantage of the opportunities available under its charter and operational regulations. It has been operating in its comfort zone.** Table 1.1 shows the eligible investments, investors, and risks that are allowed under the Convention. It also indicates the leeway available to MIGA in its scope of operation.

There is still room for MIGA to grow by taking advantage of the broad scope of the eligibility requirements and the flexibility allowed in its charter. MIGA has yet to push the envelope, especially in terms of covering nonequity direct investments and other types of investments eligible under the Convention. Since its inception, about 70 percent of MIGA's gross exposure supported equity investments; the share of direct equity was only slightly higher than shareholder loans and other equity-like investments.

Coverage of other investments such as nonshareholder loans (with an "equity link") comprised almost a third of all investments covered by MIGA. Investments involving production-sharing and management agreements and similar investments represent a miniscule share of MIGA's guarantees. This reflects sporadic demand but may also point to an unexploited opportunity.[8]

MIGA has only covered performance bonds as the underlying investment in two projects, production-sharing agreements in one project and management agreement in two projects. This represents an untapped opportunity, especially with the growth of PPP and extractive industries activities. Coverage to nonprofit organizations is another unexploited opportunity.

**MIGA has not thoroughly explored other avenues that represent an untapped growth opportunity that requires a serious, innovative business development push beyond MIGA's comfort zone.** The Convention broadly defined the scope of MIGA's operations while giving MIGA's Board of Directors the authority to amend the Operational Regulations as the need arises. That allows MIGA's guarantee program to be responsive to the changing needs of member countries and investors. Article 13(c) of the Convention also allows the Board, through a special majority, to extend eligibility to a national of the host country or to a company that is incorporated in that country or whose capital is chiefly owned by its nationals, such as those living abroad with large offshore funds.[9]

Further, the Convention and Operational Regulations allow the Board, by special majority, to add any other noncommercial risks—including acts of terrorism or kidnapping specifically directed against the guarantee holder—to be eligible for cover, except for currency depreciation or devaluation and events that occurred before the contract was signed.[10] There is also some leeway to provide guarantees in the host country's currency (Article 3(e) of the Convention and Paragraph 1.09 of the Operational Regulations) if it is a considered a "freely usable currency."

**There is room to improve client retention.** Repeat clients represent 22 percent of MIGA's customer base but account for 56 percent of its gross exposure. With improved communication and client aftercare, this retention rate could increase. One of the recurring complaints identified in a series of client studies commissioned by MIGA (in 1996, 1998, 2005, and 2007) was the lack of communication and follow-up with the clients after contract issuance. Perhaps because little importance was given to client aftercare, there was a lack of monitoring, or there was very high staff turnover. To a large extent, these impediments also affect client diversification, because client satisfaction could be the most cost-effective marketing that MIGA could undertake to diversify its client base and solve the persistent challenge of rectifying client concentration.

**MIGA needs to market itself to new investors from member countries, especially those that have become overseas investors.** With the recent boom in global capital markets and FDI to developing countries, a new and growing segment has emerged: South-South investors. Capital flows among developing countries, particularly FDI, are now growing more rapidly than investments from the developed world. The WBG estimates that investment from developing countries now accounts for a third of all FDI going to developing countries. These emerging investors represent new pools of financing in their own right, and they are potential new clients for PRI providers. South-South investments represent only 16 percent of the number of contracts issued and 14 percent of MIGA's gross exposure.

**Continuing involvement in PPP structures to support infrastructure development and improve services requires access to long-term PRI.** MIGA's support for PPP transactions as an alternative to privatization has remained strong since the late 1990s. The Organisation for Economic Co-operation and Development estimates that $1.8 trillion annually is required across five infrastructure subsectors (electricity, water, roads, rail, and telecoms) alone. The PPP is a mechanism involving private sector supply of infrastructure assets and services traditionally provided by the government. Adequate risk transfer from a government to the private sector is essential for such transactions to generate private investor interest.

MIGA is well placed to continue its support for these projects because of its experience, and the long-term nature of its insurance matches the long-term duration of PPP agreements. Most of the infrastructure projects it has covered since 2000 were structured as PPPs. Other insurers, national and private, are still building their expertise.

**More systematic support of innovative projects offers growth opportunities.** MIGA has provided coverage to several innovative projects, but most of these are one-offs. Recent examples include providing coverage against expropriation and breach of contract risks to a landfill project

**Table 2.1: MIGA Pricing of Guarantees (2007)**

| Elements of pricing | | | |
|---|---|---|---|
| **Expected loss** | **Risk load (unexpected loss)** | **Expenses** | **Cancellations** |
| Includes exposure type, expected frequency, severity, and recovery | Identifies risk load required to earn target return on risk capital (RAROC) | Expenses allocated to help ensure cost recovery | Historical experience, transition matrixes, and cash-flow timing incorporated |
| **Expected results** | | | |
| **Financial sustainability** | **Consistency** | **Transparency** | **Objectivity** |
| Cost recovery to ensure financial sustainability over the long term | Pricing consistency from one client to the next to attain pricing equity | Client rates based on an evaluation of the country and project risks | Objectivity in pricing sought through predictable and methodical pricing |

*Source:* MIGA and IEG adaptations.

in El Salvador that sought offsets through trading of carbon credits. So far, this has been a one-off, but there is significant potential for MIGA to offer coverage for projects seeking carbon credit offsets, especially those involving renewable energy, because other Berne Union investment insurers are still building this line of business.

Project Finance Yearbook 2006 estimated that the annual value of project-based carbon credit transactions increased to $2.5 billion in 2005 from $500 million in 2003.[11] It insured its first private placement in support of a toll-road project in the Dominican Republic in fiscal 2005, which allowed the project to obtain a single notch rating above the sovereign risk because of MIGA's PRI and its shadow AAA insurer strength rating.[12] It had more success in replicating support for projects involving asset and future flows securitization, although with the current massive problems in the financial markets, demand may remain low for some time.

Last year, MIGA issued guarantees for PRI and nonpolitical force majeure events for a port project in Djibouti. This experience shows that it can make specific adjustments to align its contract of guarantee with Islamic finance structure, offering significant growth potential for MIGA as other PRI players are still learning about Islamic financing.

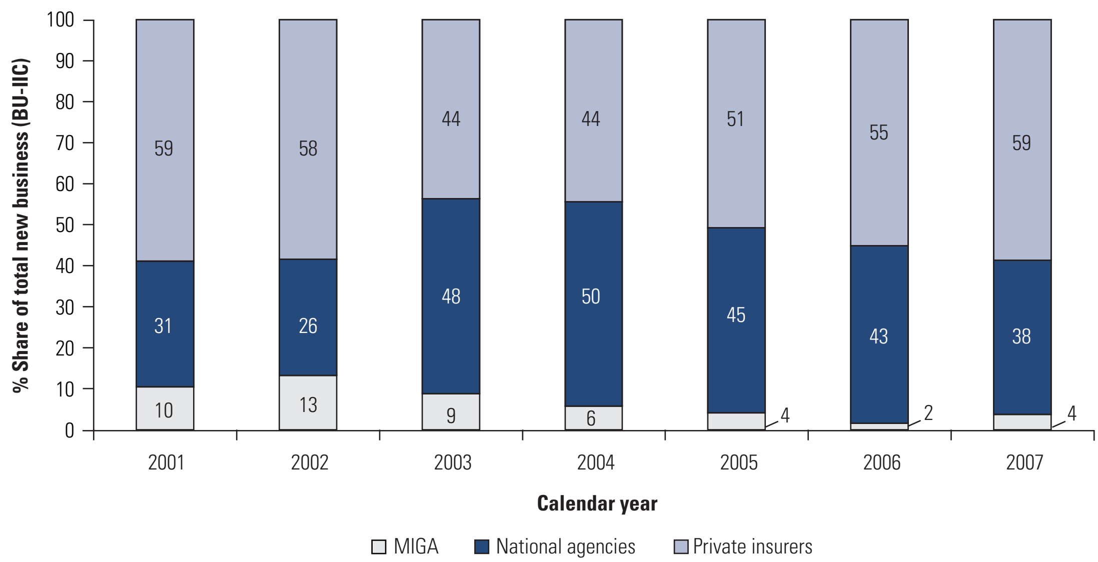
**MIGA established a pricing framework in 2004 that promotes pricing consistency, transparency, and objectivity while also ensuring cost recovery.** An in-depth analysis of MIGA's exposures, costs, and pricing was carried out during 2003. This work produced a comprehensive pricing framework that was adopted in 2004 and refined in 2007. This framework sets premiums for guarantees to cover risk (claims risk and reinsurer nonperformance risk), the portion of risk capital consumed by a project, administrative expenses, and expected cancellation. MIGA updates its in-house ratings for country and project risk quarterly as an input for the pricing model as well as current portfolio composition to capture concentration effects (see table 2.1).

### *Constraints to use*

**The market for traditional PRI products has been growing, but for the past five years MIGA's market share has been eroded by private insurers, who have ventured into countries that were traditionally served by national agencies and MIGA.** They have offered a wide range of guarantee and tailor-made financial products, as well as lower premiums (figure 2.7). Private insurers have gained market share because of their ability to offer tailor-made financial products that MIGA and some national insurers are unable to match because of the limitations in their charters.

This competition is not only hurting MIGA, but several national insurers have been unable to

**Figure 2.7: Comparing MIGA's Market Share with Shares of Other BU-IIC Members**




*Source:* Berne Union and MIGA.
*Note:* BU-IIC = Berne Union Investment Insurance Committee; MIGA = Multilateral Investment Guarantee Agency. Numbers may not total 100 percent because of rounding.

book new PRI business. However, the situation is more difficult for MIGA, because it is the only insurer among the Berne Union investment insurance members offering a monoline product. Competition from private insurers has also pushed down the premiums for PRI coverage across the board, which put MIGA and national agencies at a disadvantage. One of the comparative advantages of MIGA mentioned in 1995 and 1998 client studies was its low premium compared to private insurers. The erosion of this advantage presents a challenge to MIGA.

In addition, private insurers have been making inroads into high-risk countries, especially in Africa. In the late 1990s MIGA assumed larger exposures in medium- and high-risk countries, but since 2002, exposure in lower-risk countries has been rising as private insurers have gained an increasing foothold in the high-risk territories. In 2005, private insurers accounted for 50 percent of new PRI business in Africa among all Berne Union investment insurance members; in 2007, their overall share increased to almost 70 percent.

Another constraint is MIGA's eligible investments. MIGA can cover equity or quasi-equity investments, shareholder loans, and nonshareholder loans, and only if these are equity linked. Private insurers are not constrained by this eligibility requirement and have been able to grow their business volume insuring mostly debt. This trend is supported by the declining share of equity investments MIGA covers, while the share of loans with an equity link and quasi-equity has been increasing.

**In the long run, MIGA's Convention needs to be updated to accommodate changes in the global investment environment.** Notwithstanding MIGA's strengths in the PRI market, the limitations imposed by its Convention pose a large challenge in the current global investment environment. The most notable constraint is the inability to insure stand-alone debt. The requirement to have an "equity link" has proved to be a constraint to growth at a time when debt has been the main source of financing. MIGA is also unable to participate in other current growth areas such as comprehensive (that is, covering both commercial and political risk) nonpayment coverage; existing equity and portfolio investment/acquisition coverage unless the investment is also linked to expansion and modernization of the investment project; and local currency loan financing.

**However, there are potential changes to MIGA's products that would not require amendments to the Convention.** Given the tedious procedures in amending the Convention, MIGA can take advantage of the flexibility of interpretation of the Convention. MIGA can, of course, suggest changes to its Operational Regulations that require only approval of the Board. An example cited by MIGA staff during interviews with IEG was the revision of MIGA's strict application of the eligibility requirement relating to the timing of the investment. This strict regulation of "new investments" comes directly from the explanation provided in the Operational Regulations that the application for guarantees must have been filed before the implementation of the investment project. Project implementation is assumed to have begun either when resources of the investment project have been transferred to the project enterprise or when such resources have been irrevocably committed. Staff have commented that these elements are overly constraining, particularly for projects in the infrastructure and extractive industry sectors.

In addition, MIGA staff have brought up several policy issues that may need Board approval but would not require changes to MIGA's Operational Regulations or Convention. However, some of the suggested changes, especially those identified in the latest client study, may still require changes in the two key documents.

**MIGA faces several internal constraints, ranging from inflexibility of terms, to cumbersome processes, to lack of continuity in client relationships with staff.** According to a recent market study, and confirmed by IEG during staff interviews, MIGA is constrained by several weaknesses. First, the terms and provisions under the contract of guarantee are considered inflexible. Brokers and other political risk insurers noted that MIGA is unable to deviate from standard contract language and that its requirements, mainly on eligibility and price, are set throughout the contract duration and cannot be altered, even if circumstances change.

Second, the underwriting process is too long and cumbersome—largely because of MIGA's development mandate as part of the WBG—compared with private sector insurers. Although thorough, the underwriting process takes longer (usually around 139 days) than the private insurer norm of one week.

And third, clients report inconsistent experiences when working with MIGA staff, including perceived indecisiveness about covering a project, lack of client after care, and lack of continuity in client relationships because of high staff turnover. MIGA's business development is also hampered by the lack of an integrated approach for selling the guarantee product and the lack of clear definition of the roles and responsibilities for business development (IEG–MIGA, forthcoming).

**MIGA's processing time varies by sector and Region but has been increasing over the past few years.** MIGA's Operational Regulations state that all guarantees should be completed, to issuance of the guarantee, within 120 days of receipt of a Definitive Application (MIGA 2007b, §14). But on average, it has taken 270 days[13] to process a guarantee—from the application, through the underwriting process, obtaining Board and host country approvals, negotiating the guarantee contract, to signing the contract.

Processing times vary considerably by sector. Projects in the financial sector have taken an average of 182 days; projects in the oil, gas, and chemicals sectors have taken an average of 401 days because of the significantly more extensive environmental and social due diligence requirements in these sectors.

There are also sharp differences in processing times among Regions. Projects in the Middle East and North Africa take 430 days, compared with 193 days in Europe and Central Asia. Of particular concern is the increase in processing times over the years, caused partly by several recent large and risky projects (along with coverage of two large cross-border investments) and the greater emphasis on a project's expected development contribution.

In the interviews for this study and in IEG–MIGA's fiscal 2007 Annual Report (IEG–MIGA 2007), MIGA staff expressed concern about the loss of market share to the private sector as the Agency aligns its requirements, policies, and procedures more closely with those of the WBG. Although this alignment promotes MIGA's development role and the deterrence effect of its guarantee products, it also increases transaction costs for both the client and MIGA and undermines MIGA's competitiveness.

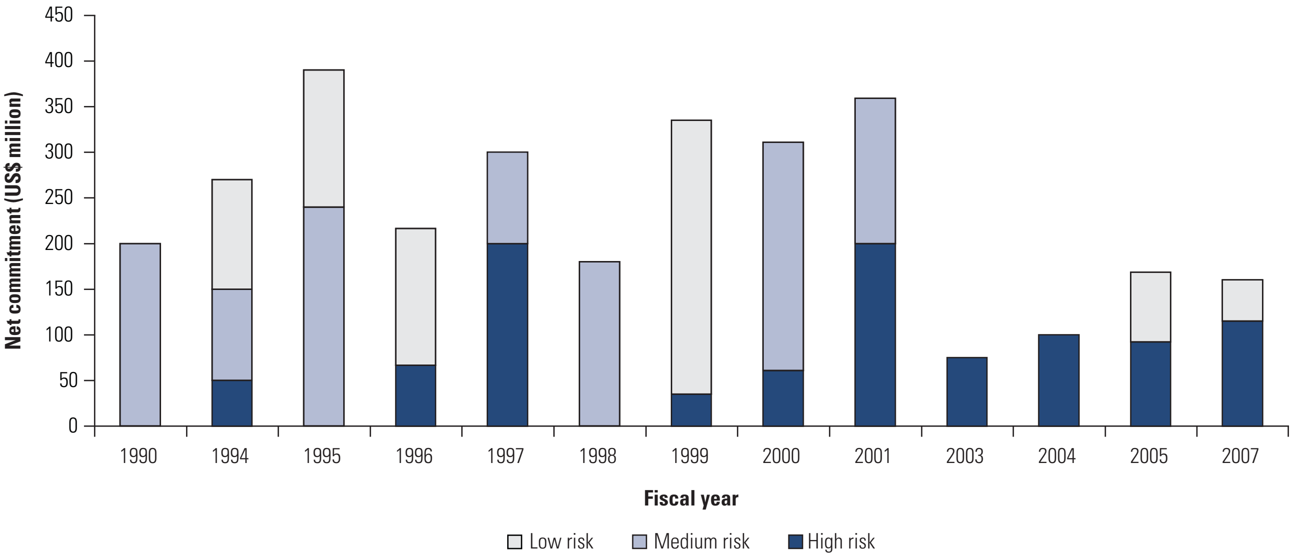
**Achieving efficiency in its due diligence process—rather than relaxing its requirements—poses a challenge to MIGA.** The key challenge for MIGA is to become efficient in conducting its due diligence process without affecting the quality of the projects it insures. There is a longer lag time between the submission of the definitive application and the actual underwriting for both regular projects and SIP, because it takes the investors a long time to submit the requested documentation.[14] Host country approval, a requirement before contract issuance, also takes longer than the 30-day period stipulated in the Operational Regulations.[15] Listing the required documentation in the definitive application or introducing some conditionality in the guarantee contract that can help ensure that development impact could align the due diligence process with the rest of the industry.

In practice, most Berne Union investment insurers analyze the project's commercial viability, in addition to political risk, but the depth of the analysis varies according to the type and size of the investment and the size of the investor. Infrastructure and project finance activities are subjected to greater scrutiny than other types of projects. Members consider the analysis of the investment project's commercial viability important in (1) preventing claims, (2) ensuring that the guarantee holder can pay its premium, (3) increasing the chances of recovery, (4) identifying sources of weaknesses in the project structure, (5) facilitating the adoption of policy language in the guarantee contract to address these issues, and (6) preventing fraud.[16] In all but a few national insurers, the investment insurers require financial statements, a copy of a feasibility study or business plan, shareholder agreement, licenses, environment-related reports, sales or distribution agreements, licenses, legal opinions, and so on—a list much like MIGA's informational requirements.

**There is room to increase MIGA's underwriting capacity, but business volume and cost structure need to improve to tap market potential.** As of fiscal 2007, MIGA's statutory underwriting capacity[17] was valued at \$10.6 billion (MIGA 2007a), but its outstanding exposure for the same period is half this amount (\$5.3 billion). Actual amounts issued for the same period totaled only \$1.4 billion.

MIGA has room to grow its business, but it must also address its cost structure. Average administrative cost as a proportion of average net premium income increased from 55 percent during fiscal 1995–2000 to 80 percent during fiscal 2005–07. To increase business solely by lowering premium rates to keep pace with the pricing of private insurers may not be a sustainable option because MIGA has cost structures that private insurers do not have, such as expenses related to being part of the WBG. In fiscal 2007, MIGA increased its country and individual project limits under its regular guarantee program to enhance its ability to make bigger deals. It also expanded the individual coverage limit under SIP to attract more investors. MIGA has also been trying to offload certain corporate costs to cut its expenses, but this has to be accompanied by growth in business volume that goes beyond its business as usual. Simplification of business processes also needs to be addressed.

**Figure 2.8: Total World Bank Net Guarantee, by Country Risk Classification, Fiscal 1990–2007**




*Source:* World Bank, Institutional Investor Country Risk ratings.

## World Bank Guarantees

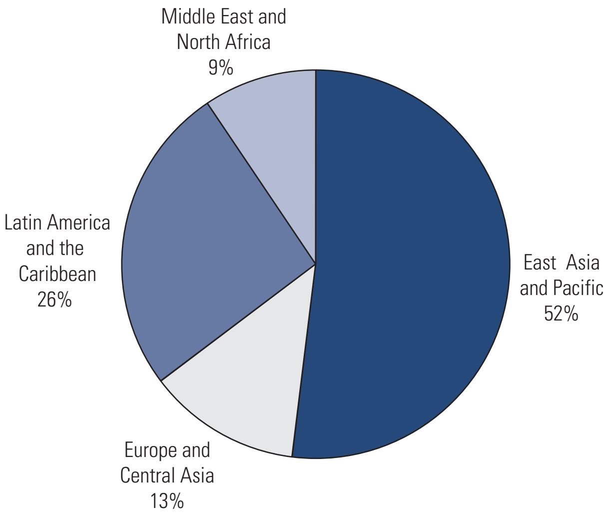
### *Patterns of use*

**Two distinct World Bank guarantee products have aimed to enhance sovereign access to commercial markets as well as to catalyze private investment projects by mitigating political risk.** As discussed in chapter 1, the World Bank has two distinct guarantee products: PCGs and PRGs. PCGs guarantee government repayment of a commercial loan or bond for *public sector investment projects*. PBGs are a type of PCG that support government borrowing that is not tied to a particular investment project. Both PCGs and PBGs are thus issued to support public sector borrowing. Along with IFC Subnational Finance Guarantees, they are the only WBG guarantee instruments to do so.

PRGs support *private sector investment projects* by mitigating political risk. PRGs are thus issued to support private sector borrowers and overlap with MIGA and IFC PRM products (discussed in chapter 3; see figure 2.8). PRGs are the only Bank financial instruments that reach the private sector other than the Financial Intermediary Loans that reach private commercial banks. Within PRGs, there are distinctions between PRGs originating from IBRD and those originating from IDA, including eligibility, pricing, and country allocations. The Bank also offers IBRD Enclave Guarantees, which are PRGs for foreign exchange–generating commercial projects in IDA-only countries. The Bank has also supported establishment of several guarantee facilities to wholesale PRGs through national or regional guarantee agencies.

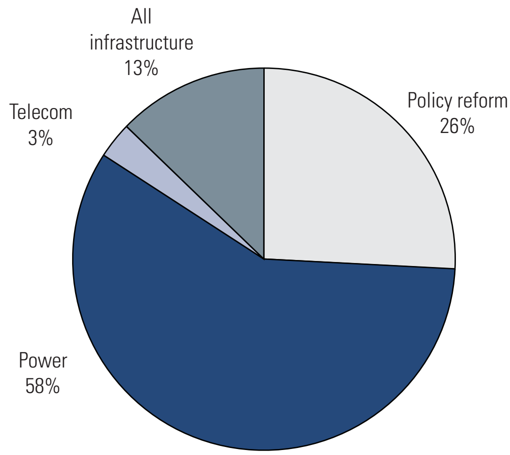
The objectives of World Bank guarantees, as identified in policy documents since 1994, have been to enhance sovereign access to commercial financing, catalyze private investment flows, broaden the sector and geographic destinations of private capital flows, expand the sources of financing for WBG projects (mainly for IBRD PCGs), influence sector policies and the regulatory environment for private sector participation in a sector, and enhance local capital markets and access to international markets.

**Figure 2.9: Distribution of IBRD PCGs by Region (net commitment), Fiscal 1990–2007**




*Source:* World Bank data.
*Note:* IBRD = International Bank for Reconstruction and Development; PCG = partial credit guarantee.

**Figure 2.10: Distribution of IBRD PCGs by Sector (net commitment), Fiscal 1990–2007**




*Source:* World Bank data.
*Note:* IBRD = International Bank for Reconstruction and Development; PCG = partial credit guarantee.

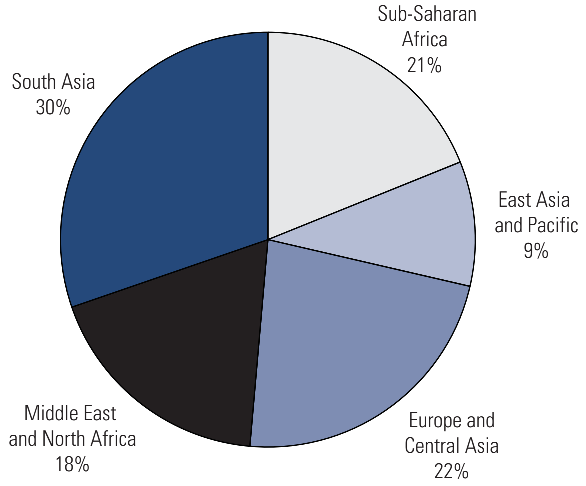
**A limited number of PCGs have been issued, mostly supporting large public power projects.** Since 1990, the Bank has issued 10 PCGs in 8 countries, including 2 policy-based guarantees. The 10 PCGs, worth $1.6 billion, supported projects worth $12 billion, with a leverage ratio of 7:1. By Region, 5 were in East Asia and the Pacific (3 in China, 1 in the Philippines, and 1 in Thailand); 2 were in the Middle East and North Africa (Jordan and Lebanon); and 1 was in Europe and Central Asia (Hungary). The two PBGs were in Latin America and the Caribbean (Argentina and Colombia; see figure 2.9).

All the project-based PCGs supported access to commercial finance by state-owned utility companies for large infrastructure projects, with an average project size of nearly $1.3 billion. Six of the eight project-based PCGs were in the power sector, one was in telecommunications, and the project in Hungary supported public investment in several sectors (see figure 2.10). The two PBGs supported economic reform programs in Argentina and Colombia.

All the PCGs were in IBRD countries except three in China, which was a blend country at the time of approval. The three projects in China supported commercial bank lending to the government of China for on-lending to state utilities, and all the other operations involved access to commercial funds from capital markets. All the PCGs were issued between 1990 and 2001, and no PCGs have been issued since 2001. None of the PCG operations involved MIGA or IFC. One PCG has been called—the $250 million Argentina PBG (in 2001), discussed below.

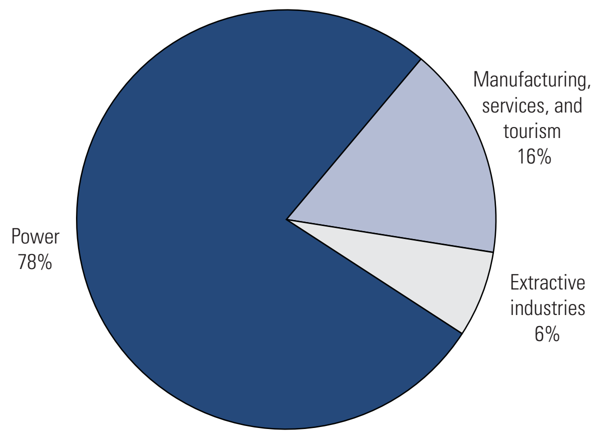
**Seven IBRD PRGs have been issued, for the most part in the power sector.** Since 1994, the Bank has issued seven IBRD project-specific PRGs worth $838 million, including one IBRD Enclave Guarantee in an IDA country. The IBRD PRGs supported projects worth $5.7 billion, with a leverage ratio of 6.8:1 and an average project size of $812 million. Two PRGs were in South Asia (both in Pakistan), two in Europe and Central Asia (Romania, Russia /Ukraine), two in the Middle East and North Africa (Jordan and Morocco),

**Figure 2.11: Distribution of IBRD/IDA PRGs by Region (net commitment), Fiscal 1990–2007**




*Source* World Bank data.
*Note:* IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; PRG = Partial Risk Guarantee.

**Figure 2.12: Distribution of IBRD/IDA PRGs by Sector (net commitment), Fiscal 1990–2007**




*Source* World Bank data.
*Note:* IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; PRG = Partial Risk Guarantee.

and the IDA enclave was in the Sub-Saharan Africa Region (Mozambique). Five of the IBRD PRGs were in the power sector, including four projects that supported independent power producers and one that supported privatization of electricity distribution utilities in Romania. The Russia/Ukraine project supported development of a private commercial satellite launch service, using Russian/Ukrainian rocket technology and equipment that operated from a mobile platform in the Pacific Ocean. The enclave guarantee supported private sector development of a natural gas pipeline between Mozambique and South Africa.

Clients have been mostly large multinational corporations such as AES, Boeing, and Sasol Limited (South Africa). Three of the seven IBRD PRGs were in countries that were high risk at the time of approval (Pakistan, Ukraine/Russia, and Mozambique). Three projects involved IFC or MIGA: IFC was involved in the Pakistan Uch Project and the Mozambique gas pipeline, and MIGA was involved in the Mozambique project. No IBRD PRG has been called to date.

**Although limited in use, IDA PRGs have reached high-risk, low-income countries.** Six IDA PRGs have been issued since 1999, worth \$378 million. The IDA PRGs supported large PPPs, with an average project size of \$620.4 million, compared to an average of \$108 million for infrastructure projects supported by normal IDA lending. The IDA PRGs have had a high mobilization rate of 9.7:1.

Three IDA PRGs were in Africa (Côte D'Ivoire, Uganda, and four West African countries), two were in East Asia and the Pacific (Vietnam and Lao People's Democratic Republic), and one was in South Asia (Bangladesh). All of these were low-income, high-risk countries at the time the IDA PRGs were approved (see figure 2.11).

Five of the IDA PRGs were in the power sector, in support of independent power-producer arrangements. The other project supported private development of a natural gas pipeline from Nigeria to Ghana, Togo, and Benin (see figure 2.12).

As with IBRD PRGs, clients for IDA PRGs have been large multinational corporations, including AES, Chevron-Texaco, and Sithe Global Power (United States). In two projects, the European Development Finance Institutions, a group of 16 European bilateral institutions, were among the investors. Four of the six IDA PRGs involved IFC or MIGA, and two projects involved IFC, the Bank, and MIGA (discussed below). An additional two IDA PRGs, both in Sub-Saharan Africa, have been approved but are not yet effective: a Senegal power sector project and a PRG to support private operation of the Uganda-Kenya railway link. None of the IDA PRGs have been called to date.

**Several efforts have been made to wholesale Bank guarantees through guarantee facilities.** Between 1995 and 2005, the Bank made eight efforts to wholesale PRI through local guarantee agencies, including five in the Europe and Central Asia Region, one in the Latin America and the Caribbean Region (Peru), and two multilateral efforts in Sub-Saharan Africa. The efforts took several forms, including a standby loan that would disburse only if a guarantee was called; direct loans to member countries that provided for the funds to be deposited into an escrow account with an agent bank when guarantees were issued; normal IDA loans, under which guarantee agencies were established; and direct Bank issue of PRGs identified by the local guarantee agency.

The effort originated in the Europe and Central Asia Region in the mid-1990s, where the facilities supported short- to medium-term trade finance operations. These included facilities in Albania, Bosnia-Herzegovina, Moldova, and Ukraine that were approved between fiscal 1995 and 1998. Subsequent facilities aimed to provide PRI for longer-term investment projects. The fiscal 2001 Russia Coal and Forestry Facility aimed to encourage new private investment in these industries by guaranteeing loans against political risk for terms of 5–10 years. The fiscal 2001 African Regional Trade Facilitation Project created a dedicated multilateral guarantee agency, the African Trade Insurance Agency (ATI). This agency was owned by 10 African states and empowered to issue guarantees and insurance backed by IDA funds. The fiscal 2005 West African Economic and Monetary Union (WAEMU) Capital Market Development Project used the Banque Ouest-Africaine de Développement (BOAD) to market IDA and MIGA guarantees for small and medium-size infrastructure projects. The fiscal 2005 Peru Facility offered PRI through the government's investment-promotion agency on loans of up to 15 years to catalyze investment in infrastructure PPPs.

### *Effectiveness and additionality*

**The PCGs helped public agencies tap commercial markets for better lending terms than they would have received without guarantees** (table 2.2). The tenures of the loans, in particular, were considerably longer than would have been possible without the credit enhancement. In the Philippines and China, for example, although the PCGs did not significantly lower the cost of borrowing, the 15-year loan tenures obtained were almost double what the market was offering. In higher-risk countries such as Lebanon, Jordan, and Thailand (shortly after the 1997 financial crisis), both the cost and terms of the loans were significantly improved. In Thailand, in particular, the guaranteed bond issued was rated three to four notches above Thailand's long-term foreign currency rating and generated significant investor interest, at a time when the appetite for bonds issued by crisis-affected countries was low.

In the case of the two PBGs, the guarantees exerted considerable leverage—generating financing of 4.7 times the value of the PBG in Argentina and 6.3 times its value in Colombia. The Colombia operation achieved investment grade status and enabled Colombia to reestablish access to U.S. capital markets at a time when investor interest was minimal. In Argentina, although the country was able to access non-U.S. capital markets at similar terms, the PBG enabled it to issue a significantly larger bond ($1.2 billion) than would otherwise have been possible at the time.

**PCGs also helped introduce or reintroduce borrowers to commercial markets.** A key objective of the PCGs was to introduce the borrowing agencies to commercial markets so they could borrow in the future without needing credit

**Table 2.2: PCGs Enabled Public Agencies to Access Commercial Finance at More Favorable Terms**

| Country | Rating at time of issue | Finance type | Market spread (% over UST) | Spread over PCG (% over UST) | PCG fee (%) | All-in-cost of borrowing (% over UST) | Diff. with PCG | Term without PCG | Term with PCG | Diff. with PCG | $ Millions PCG | $ Millions financing generated | Leverage ratio |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Jordan | B+ | Capital market | 3.00 | 1.1 | 0.50 | 1.60 | 1.40 | 2 | 7 | 5 | 50 | 50 | 1 |
| Philippines | BB– | Capital market | 3.00 | 2.5 | 0.50 | 3.00 | 0 | 7 | 15 | 8 | 100 | 100 | 1 |
| Lebanon | BB– | Capital market | 3.00 | 1.0 | 0.25 | 1.25 | 1.75 | 5 | 10 | 5 | 100 | 100 | 1 |
| Colombia | BB | Capital market | 6.50 | 5.0 | 0.50 | 5.50 | 1.00 | 5 | 10 | 5 | 159 | 1,000 | 6.3 |
| Argentina | BB | Capital market | 5.84 | 5.0 | 0.75 | 5.75 | 0.09 | 5 | 5 | 0 | 250 | 1,165 | 4.7 |
| Thailand | BBB– | Capital market | 8.50 | 2.9 | 0.50 | 3.40 | 5.10 | 0 | 10 | 10 | 300 | 300 | 1 |
| China | BBB+ | Loan | 0.75 | 0.6 | 0.20 | 0.80 | –0.05 | 7 | 15 | 8 | 150 | 150 | 1 |

*Source:* World Bank data.

*Note:* PCG fees are approximate, as different fees were charged during the noncallable period; they do not include commitment fees; and some fees were paid up front and others in installments. PCG = Partial Credit Guarantee; UST = U.S. Treasury.

enhancement. All the public agencies that accessed capital markets under the PCGs, with the exception of the Lebanese electricity utility, subsequently accessed commercial markets again, without guarantees.

In Jordan, the PCG helped the telecom utility become the first Middle Eastern corporation to tap the Eurobond market. It helped Jordan establish a track record and subsequently reaccess the Eurobond market, without the Bank's support. The Jordan operation also involved the participation of the local capital market, facilitating mobilization of domestic foreign exchange deposits. In the Philippines, the national power utility supported by the PCG has also continued to borrow from international markets.

The PCGs have also reintroduced borrowers to commercial markets following financial crises. In Argentina and Colombia, for example, although both countries had previously accessed international capital markets, the PBGs effectively reintroduced their large bond issues to international markets at a time when they were either closed to emerging market economies or constrained to small volumes. In Thailand, the PCG was issued on the heels of the financial crisis, when the country's access to commercial markets had been closed. Studies also suggest that sovereign bond issues such as the one in Thailand have had a positive effect on corporate bond markets by providing benchmarks and stimulating production of information, thereby lowering corporate bond yields and trading spreads (Dittmar and Yuan 2008).

**However, PCGs can remove the Bank's leverage in advancing sector reforms, and their timing can be inappropriate.** Three PCG projects had unsatisfactory outcomes—the two power projects in the Philippines and Lebanon and the Argentine PBG that supported its 1999 structural reform program. All three projects were accompanied by Bank loans, however, and the unsatisfactory outcomes reflected broader weaknesses in the programs rather than the guarantee instrument itself.

In the Philippines, inadequate implementation of policy reforms and tariff adjustments prevented the power utility from attaining financial viability. Following the collapse of the Argentinean financial system, the country's adjustment program went off track, and reforms that were intended to be supported by a Bank adjustment loan as well as the PBG financing were not achieved. In Lebanon, progress on sector reforms was limited and the Bank's self-evaluation of the project found that use of the PCG effectively reduced the Bank's leverage to promote agreed reforms by front-loading financial support for the project (World Bank 2002a).

In Colombia, when the PBG was issued, the government had been implementing a broad reform program supported by a Bank Financial Sector Adjustment Loan. The Bank's evaluation of the project observed that in this context, hybrid policy loan/guarantee operations might provide more policy leverage and better sequencing than stand-alone policy guarantee operations. Unlike direct Bank loans, where disbursement is based on expenditures, moreover, the timing of PCG-backed financing can be inappropriate. The Bank's self-evaluation of the Lebanon project found that issue of the bond in Lebanon required the utility to undertake a large foreign debt long before the funding was needed: five years after the bond was floated, only 50 percent of the funds raised had been utilized.

**The Bank's decision to extend repayment terms on the called PBG in Argentina effectively ended its ability to use rolling, reinstatable PCGs.** The Rolling Reinstatable Guarantee (RRG) mechanism for PCGs was introduced on a pilot basis in 1999, and three PCGs were issued using it between 1999 and 2001—in Thailand, Argentina, and Colombia. The benefit of RRGs is their ability to enhance credit terms by guaranteeing interest payments on bonds on a rolling basis, thereby covering the life of the bond if payments continued to be made.

Even at the time of the pilot, however, there was some dissension within the Bank about the value of the instrument as well as its potential risks to the Bank. Given difficulties in modeling and valuing the credit enhancement, RRGs were seen as being penalized by the market. This in turn was seen as affecting the value placed on direct Bank bond issues, thereby potentially raising the cost of borrowing for the Bank. In Colombia, for example, it was found that investors had given no value to the deterrent value against default implied by the Bank's preferred creditor status (IMF 2003).

In this context, in 2000 the Bank adopted a very cautious approach to future transactions using the RRG structure. Then in 2002, the PBG in Argentina was called when Argentina failed to service the outstanding bond. Rather than enforce the 60-day period in which Argentina had to repay the Bank for the guarantee to roll over, the Bank rescheduled the loan, causing the guarantee to lapse. The market immediately downgraded the issue and also downgraded the RRGs in Thailand and Colombia.

Since then, the market has considered the Bank's RRG a "dead" product, and in 2003 the Bank canceled a proposed $180 million PCG to support the Bolivia-Brazil Gas Pipeline Project because of lack of investor interest. Shortly thereafter, the Bank reaffirmed that "the RRG is not a viable structure from the Bank's risk management perspective," as it might affect the Bank's commercial borrowing terms.[18] At the same time, however, IFC continues to use the RRG instrument for its corporate bond PCGs. In retrospect, there appears to have never been a clear consensus within the WBG as to the appropriateness of the RRG.

**Based on the Bank's relationship with governments, IBRD PRGs have helped projects in high-risk sectors with untested regulatory frameworks reach financial closure.** When two PRGs were issued in Pakistan in the mid-1990s, the power sector had only recently been opened to private participation, the country was still a high-risk investor destination, and Pakistan lacked a track record in long-term commercial finance. In this context, Bank engagement in the Hub (the first private investment in power in the country) and Uch Power Projects played an important role in mobilizing commercial finance with 12- to 15-year maturities to finance the projects. Although the guarantee projects in themselves were successful, the government's broader PPP strategy in the power sector created an overcapacity in power generation that eventually placed significant fiscal burdens on the government.

In Romania, the fiscal 2005 power-distribution PRG supported the first successful divestiture of Romania's electricity distribution utilities. Prior efforts to privatize the utilities had been unsuccessful partly because of uncertainties regarding the policy framework and government commitment to the process. With the success of the PRG-backed privatization, several further distribution companies were privatized.

The 2003 Mozambique Gas Pipeline Project (involving both IFC and MIGA) also represented a large private investment in a sector in its initial stages of development in a high-risk country. Legislation in the gas sector had only recently been established; government agencies had limited experience in dealing with private sector projects; and political uncertainties in the country persisted. In this context, the sponsor found term financing difficult to secure and approached the Bank to help complete the financing package.

As a country's regulatory environment for PPPs improves, however, the added value of a PRG can be more questionable, given the greater likelihood that private providers will be in the market. Although the Bank had a long engagement in the power sector in Jordan, by the time the PPP was approved, the regulatory environment for private participation in the sector had been well established. In this context, the distinction between the benefits of the PRG compared with PRI provided by MIGA or other providers is less clear.

**The additionality of IBRD PRGs has been its long-standing policy dialogue and the potential for dispute resolution.** In all the power sector PRGs (Romania, Morocco, Pakistan, and Jordan), the Bank had had a long history of engagement in the sector. This placed the Bank in a position to help guide the development of a policy framework for engaging the private sector in power, advise on and help structure specific transactions, and be in a position to mediate disputes during implementation. In Romania, for example, the sponsor saw the Bank and a PRG as the preferred form of risk mitigation, because of the Bank's long-standing policy dialogue in the sector. In Mozambique, although several political risk insurers participated in the project, direct Bank engagement through the PRG was seen as critical for project implementation because of the Bank's substantive ongoing dialogue with the government.

Sponsors of the Ukraine/Russia Sea Launch Project indicated that they would not finance the project without the Bank PRG to deter the governments from actions that would prevent the production and export of launch equipment. The Sea Launch PRG also introduced a dispute-resolution mechanism that proved effective in resolving problems between the government and the sponsor. The mechanism also supported good governance, in that it provided investors with an avenue to resolve problems other than bribing government officials.

**IDA PRGs have supported the introduction of complex PPPs in high-risk countries using limited IDA resources.** Although just 10 percent of total PPIs in low-income countries and MICs were in Sub-Saharan Africa, 53 percent of IDA PRGs were in the Region. The six IDA PRGs covered an average of 10 percent of total project costs, which is considerably lower than initially expected.[19]

All six projects involved introduction of the private sector into complex PPPs in high-risk countries. The Vietnam Phu My Power Project, for example, was the first major competitively bid private infrastructure project in the country, and it was prepared at a time when the legal and regulatory framework in the sector was still new; government agencies had limited experience in dealing with complex contractual arrangements; and perceived country risks were high. The multicountry West African Gas Pipeline Project involved development of legal and technical agreements between four governments and the project sponsors to support the transport of natural gas from Nigeria to Benin, Ghana, and Togo through an undersea route along the coast. The Hydropower Power Project in Lao PDR was the world's largest private sector cross-border power project, and the Bank played an important role in the technical, economic, financial, environmental, and social appraisal of the project.

**In several large PPPs, IDA's engagement and relationship with governments were critical to securing adequate financing for the project.** In the context of limited access to commercial finance, complex undertakings in untested regulatory environments, and the low-income, high-risk status of the countries, IDA's PRGs played an important role in securing adequate finance for the projects. In Côte D'Ivoire, for example, IDA involvement was sought by the project sponsor to fill a financing gap after other sources of financing, including a possible increase in IFC's B-loan, had been exhausted. In Vietnam, the PRG helped secure commercial funding with a 16-year tenor at a time when the country had a non-investment-grade sovereign credit rating and restricted access to commercial markets. The sponsors of the West Africa pipeline insisted on appropriate risk mitigation that eventually involved a combination of an IDA guarantee, a MIGA guarantee, and Zurich/OPIC insurance. The exceptionally large power project in Lao PDR would also have been unviable for private lenders and insurers without the Bank's engagement through the PRG. According to Bank staff reports, the international lenders, Thai commercial banks, and project sponsors all saw the role of the WBG as essential in enabling the project to be realized.

**Bank engagement through the IDA PRGs has provided a platform to further the policy environment for PPPs.** The PRGs have provided an avenue for the Bank to be fully engaged in helping develop PPPs, even without Bank lending on the public sector side, and to further the overall investment environment. Each of the IDA PRGs was deployed in the context of a long IDA policy dialogue, aimed at establishing appropriate regulatory frameworks for private sector participation in the respective sectors.

Engagement through the IDA PRGs provided the Bank with a platform to further the reform process, monitor implementation of specific transactions, and help address emerging issues and problems. In Vietnam, the electricity law passed in 2005 opened the sector for private participation. Since then, three additional private energy projects have been established. In the West Africa Pipeline Project, the Bank built on its prior engagement in the energy sectors in Benin, Ghana, and Nigeria and advanced the reform process through dialogue with the governments and key stakeholders. In Lao PDR, through engagement in the PRG, the Bank helped advance institutional and governance reforms that were critical to improvements in public revenue management. In the Bangladesh power project, the Bank was able to help the sponsor renegotiate tariff agreements to ensure the financial viability of the project.

**Under some concession contracts supported by PRGs, governments have assumed a broad range of risks that have not yet been tested by events.** Whereas PRGs were intended to cover political risk, the line between political and commercial risk can blur, depending on the contractual obligations of the government that are being guaranteed.

The Bank's approach has been for the PRG to cover the minimum risks necessary to make the operation viable, but as such has included a range of risks beyond traditional PRI. For example, in cases where a PPP contract includes assured government payments to the private entity (such as a power purchase agreement), a guarantee that supports this obligation effectively assumes commercial risks, because the guarantee could be called if the government fails to make payment for any reason.

Moreover, several PRGs included coverage of natural force majeure events that were not otherwise insurable on the grounds that such coverage was essential to enable the project to move forward. In effect, however, this has supported a government guarantee of events beyond its control. As currently structured, these risks are not priced into the premiums charged to the sponsors and, in any event, the government does not collect a share of the premiums. No claims have been made yet, but a natural disaster that triggers a call on the Bank's guarantee might prompt questions as to why the Bank supported government guarantees of events that were beyond the government's control.

**The PRG facilities have suffered from very low utilization.** Only three of the eight guarantee

**Table 2.3: Guarantee Facilities Supported by the Bank**

| Project ID | Country | Project name | Approved amount ($ millions) | Product type | Fiscal year | Number of guarantees issued/value |
|---|---|---|---|---|---|---|
| P038614 | Moldova | Pre-Export Guarantee Facility | 30 | Contingent loan | 1995 | None |
| P045820 | Bosnia and Herzegovina | Emergency Industrial Restart Project | 10 | Loan | 1997 | 26/40 million Deutschmarks |
| P043434 | Ukraine | Pre-Export Guarantee Facility | 120 | PRG | 1997 | None |
| P051602 | Albania | Private Industry Recovery Project | 10 | Loan | 1998 | 24/$8.7 million |
| P057893 | Russia | Coal & Forestry Guarantee Facility | 200 | PRG | 2001 | None |
| P063683 | Africa (10 countries) | Regional Trade Facilitation Project | 128.7 | Loan | 2001 | 47/$54 million[a] |
| P089120 | West Africa (8 countries) | WAEMU Capital Market Development | 70 | RPG | 2004 | None |
| P088923 | Peru | Guarantee Facility | 200 | PRG | 2005 | None |

*Source:* World Bank data.
a. IDA account as of September 2007.

facilities (see table 2.3) issued any guarantees. The facility in Bosnia issued 26 guarantees worth DEM 40 million (against a target of 75 million German deutschmarks). In Albania, 24 guarantees were issued worth $8.7 million. In both cases, demand for the guarantees dropped sharply after a few years, and the facilities were closed. In Moldova, the facility was closed after 22 months without issuing any guarantees. Lack of demand was attributed to the high pricing of guarantees, as well as competition from comprehensive guarantees provided directly by the government.

The Ukraine Pre-Export Facility was cancelled in 1999 without becoming effective after the Ukrainian Parliament failed to ratify the project. The $200 million fiscal 2001 Russia Coal and Forestry Guarantee Facility was closed in 2005 without issuing any guarantees because of a lack of demand for the noncommercial risk guarantees. The WAEMU Facility, implemented through BOAD, also failed to market any guarantees and has been cancelled. No guarantees have been approved under the fiscal 2005 Peru Facility to date.

**Inaccurate estimates of demand and lack of readiness for implementation have undermined the facilities.** Although evaluations of these projects have drawn lessons along the lines that preparation of such projects should involve an in-depth market analysis prior to commitment, apparently none has been successful in accurately doing so. Although surveys have been conducted at appraisal, actual demand has not turned out to be as strong as anticipated, indicating some weaknesses in the survey methodologies. Although the private sector has generally indicated that political risk is a constraint to investment, it has been less clear whether this was the "binding" constraint. Thus, despite the availability of PRI through the facilities, multiple other factors emerged as greater constraints to investment.

The BOAD project reflected a promising model to market a range of political mitigation instruments for small and medium-size infrastructure projects—including MIGA PRI, Bank PRGs, and African Development Bank (AfDB) PCGs—under one roof. According to staff interviews, however, limited institutional capacity in BOAD undermined its success. Some lessons from the experience were that a $50 million project limit was too small for IDA PRGs and for several potential infrastructure projects; the requirement of a counter-guarantee proved to be an impediment, especially for the small and medium-size infrastructure projects contemplated for the facility; and MIGA PRI proved to be the most flexible instrument, with two projects identified and applications filed.

In the case of the Peru Facility, a Quality Assurance Group panel found several weaknesses in the appraisal of the project. Subsequent changes in the government's PPP strategy as well as a recent interpretation by the Ministry of Finance that the use of the facility would imply an expenditure in the national budget once the guarantee is issued have also undermined use of the facility.

**ATI suffered from a range of initial design deficiencies.** The IDA-funded ATI was established in 2001 as a self-standing multilateral insurance agency. It was owned by participating African states and empowered to issue its own insurance products (and not IDA PRGs) to facilitate trade and investment in Africa. ATI experienced poor initial performance, however. It suffered from a range of design flaws, erroneous demand assumptions, and weaknesses in institutional capacity. By 2005, it had issued just $110 million in insurance policies, compared with an initial target of $1,280 million by 2011.

Problems included lower demand than expected from private investors for long-term projects and more demand for short-term, comprehensive trade insurance from public/parastatal corporations, which it was prohibited from covering. Other problems were the capacity constraints arising from capital reserve requirements to back long-term policies and limited membership that precluded coverage of investors from most of the continent's major economies. In 2006 ATI was restructured to improve its issuing capacity and broaden its product range and potential market. In 2007 it issued 17 new policies, exceeded its premium targets, and paid its first claim (an essential element for an insurer). To date, demand has been driven mainly by public/parastatal enterprises.

**There has also been some question about the extent to which the facilities overlap with MIGA and IFC.** Concerns about the relationship between the guarantee facilities for long-term investment and MIGA's PRI have been raised, because MIGA is able to issue the same guarantees on an individual basis. Bank facilities have been justified in that they help stimulate overall investor interest in a particular country by advertising the government's commitment to the rule of law, rather than an individual investment supported by MIGA's PRI. To date, however, the facilities have not proved particularly effective in stimulating investor interest. The trade enhancement facilities supported by IFC might also be substituted for the short-term guarantee facilities established by the Bank. At the same time, the Bank facilities are designed to fill a gap in coverage of PRI for long-term local debt that MIGA is not able to cover.

Nevertheless, it is apparent that a more coordinated WBG approach to the creation of guarantee facilities should be established. The Quality Assurance Group report on the Peru Facility, for example, noted that a more proactive approach could have been made to engage MIGA/IFC expertise in the design of the operation, given that MIGA had generally negative past experiences with guarantee facilities and that IFC had limited expectations of demand based on its experience in the infrastructure sector in the Region.

### *Potential for use*

**The use of Bank guarantees has fallen far short of expectations, yet some Bank guarantee instruments have good potential** to be deployed under certain circumstances. Initial expectations were that the Bank would issue some $1–2 billion worth of guarantees a year, but it has issued only $2.8 billion in guarantees during the last 18 years. Total project costs (as a proxy for investment flows) supported by Bank PRGs averaged $500 million a year during the period, compared with a total flow of $130 billion a year in FDI to developing countries during these years.

Although the share of investment catalyzed by the Bank is small, as discussed below, the objective of Bank instruments is to catalyze additional investment to that already flowing, which represents a largely unquantifiable market. The limited use of guarantees is driven by a range of both internal and external factors, which are discussed below.

**The scope for IBRD PRGs appears to be limited.** Of the seven IBRD PRGs, two were in a blend country (Pakistan) and one was an enclave guarantee in an IDA country. Thus, just four PRGs have been issued in IBRD-only countries since the product was introduced in 1994. Although internal factors discussed below have constrained the use of the instrument, to some extent this also reflects the lower risk perception of doing business in MICs; their greater access to commercial finance; and their more established and tested regulatory frameworks. These factors have created environments where private PRI providers or specialized public providers such as MIGA are able to meet the demand for PRI.

Seventy-five percent of MIGA's business to date has been in MICs. There is less need for close Bank engagement in sector policy reform, appraisal of PPP projects, and continued monitoring and engagement in the implementation of a project the PRG affords. Use of the IBRD enclave PRG has also been very limited. Whereas the Board authorized up to $300 million a year for enclave guarantees, just one has been approved, for a total of $30 million. Some projects, such as the Lao PDR Nam Theun 2 Project, which may have qualified as an IBRD enclave operation, were instead supported with IDA PRGs.

**There is also unlikely to be significant scope for guarantee facilities.** Given the ineffectiveness of Bank guarantee facilities to date, as well as their potential overlap with MIGA and IFC products, the approach to Bank guarantee facilities should be cautious. Experience has revealed limited use of these facilities for a range of reasons. One of the main objectives of the facilities was to improve the overall investment environment by advertising a government's commitment to the rule of law; however, there is no evidence that any of the facilities have been effective in doing so.

There is also some question about the value of wholesaling a product whose main attributes are close Bank policy dialogue in sector reforms and assistance in appraisal of complex PPPs. Although some of the facilities were set up to support short-term trade finance operations, such facilities have been more conducive to private sector operations. Within the WBG, IFC has also developed facilities to meet such demand.

**Continued demand is likely to remain for IDA PRGs in high-risk countries.** In some transactions, an IDA PRG is likely to remain the instrument of choice. Situations in which an IDA PRG has been sought include those where the Bank's prior engagement in the sector or relationship with the government placed it in a position to both establish and help maintain a favorable policy environment for the private sector; either country or sector risk levels were sufficiently high to prevent adequate commercial financing (including that from IFC) from being made available at adequate maturities or reasonable cost; and the amount of financing requiring PRI has been such that MIGA and other private providers exceed their exposure limits.

Experience has shown that PRGs also offer a potentially effective tool to support regional integration in Africa. The West Africa Gas Pipeline Project, for example, supported a 20-year program for regional integration of the power energy systems by helping develop a comprehensive commercial, legal, and regulatory structure through a treaty between states and a detailed international project agreement between the states and the project sponsor. An important role for IDA PRGs is likely to remain in such circumstances.

**The potential also exists for PCGs to help countries regain access to capital markets during market downturns, as well as to introduce well-performing countries to capital markets.** PCGs have proved useful in helping countries regain access to markets as well as in introducing new borrowers to commercial markets. When capital markets are liquid there is likely to be less demand for PCGs, as has been the case until recently. At times of financial crisis, however, demand for PCGs has risen. Bank engagement through PCGs offers the potential to help channel the flow of commercial funds into underserved sectors.

A further market for PCGs exists among well-performing IDA countries. IDA countries have not been eligible for PCGs on the grounds that they lack the creditworthiness necessary to access international markets. However, some IDA countries, such as Ghana and Sri Lanka, have recently accessed international markets without the benefit of credit enhancement. It would seem that the PCG could be an effective tool to assist higher-income, well-performing IDA countries that are on the verge of accessing markets directly and in which IDA assistance is constrained by IDA allocations in obtaining more favorable market credit terms.

PCGs also offer the potential to help mobilize local capital markets for public investment needs. In Jordan, the bond issue supported by the PCG was able to mobilize domestic foreign currency savings in the form of deposits held by expatriate or returning Jordanians working overseas. A continued need exists for mobilization of local currency capital markets. In countries and regions with more developed capital markets, potential exists for PCGs to enhance local currency financing of public infrastructure projects.

### *Constraints to use*

**The PRG's last resort nature and the lower-than-expected level of commercial private investment in infrastructure have narrowed the scope for Bank PRGs.** Bank PRGs have aimed to fill the gap left by various PRI providers. Political risks can be mitigated by a variety of means, including the ability of large international investors to absorb country risk on their own balance sheets, public insurance agencies in large developed countries, bilateral investment treaties between countries, and multinational providers such as MIGA.

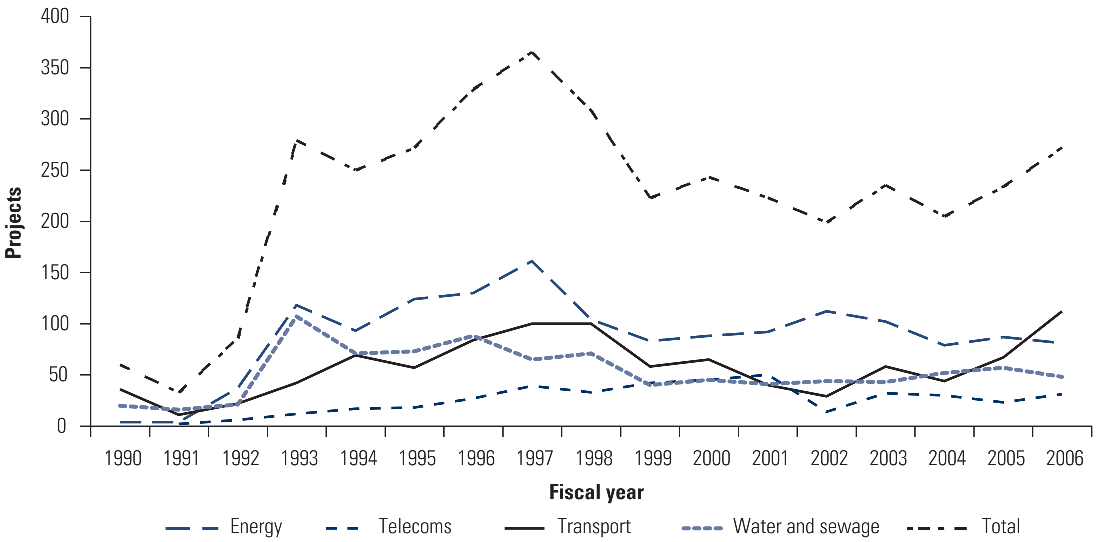
Within the overall market, the Bank's niche has been in large PPPs in infrastructure. This market has declined since a peak in the mid-1990s. Although there was a surge in investments in the mid-1990s, particularly in the power-generation sector, following the 1997 financial crises, the collapse of Enron in 2001, and a series of difficulties in existing private participation in infrastructure, there was a sharp drop in the volume of transactions taking place. To some extent the expectations for World Bank guarantees were overly optimistic based on the rapid growth of the mid-1990s, which was not sustained. Since 2005, however, there has been renewed growth in the number of PPPs, including investments by local and regional investors in infrastructure projects.

**Concentration of Bank guarantees on the power sector reflects some difficulties in developing commercially viable PPP projects in other sectors.** The Bank's guarantee policy framework has consistently emphasized the potential application of PRGs to sectors outside power, including water, transport, and telecommunications. Nevertheless, the Bank's guarantees have been heavily concentrated in the power sector (see figure 2.13).

To some extent, this is because the power sector, particularly generation, has been more conducive to PPPs. According to the PPP database, 40 percent of all PPPs have been in power. Limited commercially viable prospects in the water and transport sectors have constrained the use of guarantees in these sectors. Constraints in highways, for example, have included political sensitivity to public resistance to tolling; high-profile private toll-road project failures, which have made investors and governments cautious; a limited number of potential roads, particularly new roads in developing countries, with adequate project economics to attract private financing without substantial government contributions; and a complex legal and policy framework required for a concession that has proved difficult to achieve (World Bank 1996). Similar difficulties have been encountered in the water sector.

Some 15 Bank PRGs in nonpower sectors were planned and subsequently dropped. In Jordan, for example, a planned PRG to support the proposed Disi-Amman water pipeline that had been in preparation for a decade failed to materialize when the bid tariff was much higher than anticipated and the government cancelled the tender. A planned PRG in Croatia to support development of a highway was also dropped when the Bank's economic and financial appraisal found the project to be unfeasible. Just 2 percent of

**Figure 2.13: PPI Projects in Developing Countries by Sector, 1990–2006**




*Source:* World Bank and Public-Private Infrastructure Advisory Facility, PPI project database.
*Note:* PPI = private participation in infrastructure.

MIGA's business has been in the transport sector and 1.5 percent in water.

**The value of PCGs has been undermined by liquid capital markets since 2002.** Several external factors (as well as internal factors, discussed below) account for the absence of PCGs since 2001. In particular, liquid capital markets have enabled IBRD countries to access markets directly on favorable terms. In this context, the credit-enhancing value of the PCG is low, and the guarantee fee plus the underlying loan spread makes obtaining a PCG cost-ineffective.

By their nature, PCGs are also largely restricted to a relatively narrow band of countries that are close to accessing markets directly. If countries lack creditworthiness, then provision of a PCG for extended-term maturities is unlikely to make a difference. But if countries have full access to markets, then they have limited need for the credit enhancement provided by the PCG.

Within countries, many utilities that are potential PCG clients still operate with soft budgets and lack the commercial orientation or legal framework for borrowing on capital markets. Among commercially operated utilities, a further constraint remains a potential mismatch between local currency revenues and foreign currency debt raised by the PCG that exposes the state-owned enterprise to foreign exchange risks. These constraints are dynamic, however, and the recent reduction in the liquidity in international markets can increase the demand for PCGs.

**The pricing of Bank guarantees has not been a constraint.** Unlike MIGA, the Bank does not price PRGs for sector or country risk, because given the mandatory government counter-guarantee, the Bank passes the risk of default on the commercial loan to the government. The risk to the Bank is that the government will not repay the loan under the counter-guarantee. This risk thus represents the same one as a normal lending operation.

PRGs are therefore offered across countries and sectors according to a set schedule of charges based on loan equivalent pricing (table 2.4). This

**Table 2.4: IBRD/IDA Pricing of Guarantees (2008)**

| | | IBRD | | IDA |
|---|---|---|---|---|
| | Fee type | PRGs | PCGs | PRGs |
| Upfront charges | Front end fee | 25 bp | 25 bp | n.a. |
| | Initiation fee (1) | 15 bp on the guaranteed amount or $100,000 (whichever is higher) | n.a. | 15 bp on the guaranteed amount or $100,000 (whichever is higher) |
| | Processing fee, (2) | Up to 50 bp of the guaranteed amount | n.a. | Up to 50 bp of the guaranteed amount |
| Recurring charges | Guarantee fee | 30 bp per annum (on the maximum aggregate disbursed and outstanding guaranteed debt) | 30 bp per annum (on the present value of the guarantee exposure) | 75 bp per annum (on the maximum aggregate disbursed and outstanding guaranteed debt) |
| | Standby fee (3) | n.a. | n.a. | 10 bp per annum (on the maximum guaranteed debt committed but undisbursed) |

*Source:* World Bank.
*Note:* For all private sector borrowers, that is, only applicable to PRGs. Determined on a case-by-case basis. Exceptional projects can be charged more than 50 bps of the guaranteed amount. Data for guarantees approved in fiscal 2008. bp = basis point; IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; n.a. = not applicable; PCG = Partial Credit Guarantee; PRG = Partial Risk Guarantee.

has resulted in pricing that is generally competitive in the market and has not been a constraint to the use of Bank guarantees. According to a survey, just 10 percent of Bank staff interviewed identified the cost of a guarantee as a factor in a project being dropped (compared with 50 percent in MIGA and 80 percent in IFC). In three of the four joint Bank-MIGA projects in which both the Bank and MIGA issued guarantees, the Bank's PRGs were priced lower than MIGA's, despite the fact that they offer similar or higher-risk coverages (see below).

The pricing structure has led to some anomalies, however, and at current IBRD rates, IBRD PRGs are cheaper than IDA PRGs. The Bank's loan equivalent pricing for PRI products can place below, at, or above the PRI market. In the fourth joint project with MIGA—the IBRD enclave PRG in Mozambique, which was issued at a time of relatively high IBRD lending rates—the Bank's PRG was priced significantly higher than MIGA's PRI.

As discussed below, because the price for PRGs is offered to private sector clients, there is some concern that the Bank's pricing structure, based on the loan equivalency, can distort the market for PRI. Moreover, although some efforts have been made to share guarantee fees with the host governments, governments are currently not provided with any portion of the guarantee fee. The option to compensate governments might be further explored, however, because it could help offset costs associated with the contingent liability of the counter-guarantee; compensate governments for the risks they take with respect to factors out of their control, such as force majeure; and reduce disincentives for government support for PRGs.

**As most guarantee projects have been in power generation, Bank guarantees have involved extensive due diligence requirements.** Significant social and environmental assessments have been associated with all the Bank's guarantee projects. This has been necessitated by the nature of the projects and the sectors of the PRGs—complex, large infrastructure projects, mostly in power generation, some cross-border operations, and so on. In the Lao PDR project, for example, extensive analysis and mitigation of the social and environmental impacts included resettlement of residents, livelihood restoration, wildlife management programs, protection of natural watersheds, and mitigation of downstream impacts.

Although these efforts represent a key added value of Bank engagement, they have also added costs to guarantee operations that are not related to the use of the guarantees themselves. In some cases, it is apparent that application of the same standards required of public investment projects might be excessive in private sector projects. For example, in some power projects, due diligence was conducted on "linked" projects, such as construction of roads, transmission systems, and pipelines that were beyond the control of the project sponsor. As discussed below, this has led to exceptionally long preparation times for some PRGs.

Such efforts, though they enhance the prospects that adverse social and environmental impacts will be minimized, have added to the costs and time required for processing a transaction. That provides some disincentives for private sector clients to work with the Bank. According to staff interviews, these factors have led some clients to indicate that they would never work with the Bank again.

**Some of the Bank's PRGs have taken an exceptionally long time to prepare, although this has reflected the nature of the underlying projects.** According to a survey, 45 percent of Bank staff indicated that the long processing time was a factor behind a guarantee project being dropped. The average processing time for an IBRD PRG was 18.8 months, at an average administrative cost of $416,000 per project; IDA PRGs have averaged 20 months to prepare, at an average cost of $800,000 (excluding the Lao PDR Nam Theun 2 Project outlier). The high processing costs have been largely caused by the complexity of the underlying projects and the Bank's value additions, rather than the guarantee mechanism itself.

As noted, nearly all the Bank's PRGs have supported large power generation projects, with consequent due diligence implications. The Hub Power Project, for example, which took more than 10 years to prepare and absorbed some 25 person-years of Bank resources, was the first commercially financed project in a sub-investment-grade developing country and involved extensive policy dialogue, sector work, and coordination with some 40 international financiers, the sponsors, and the government (World Bank 1997a). The Lao PDR Nam Theun 2 Power Project, which cost more than $5 million in Bank administrative costs, involved considerable work on policy reform, technical studies, and consultation, as well as extensive social and economic appraisal.

As discussed above, although the extent of due diligence conducted in Bank PRGs has been driven by potential reputational risks to the Bank as well as the need to ensure viability of the project in the public interest, it also provides a strong disincentive for the private sector to work with the Bank.[20]

**Additional internal processing steps have provided disincentives to pursuing guarantee operations.** The long processing times, extensive procedures, and uncertainties involved in dealing with private companies remain disincentives to Bank staff in pursuing guarantee operations. All PRGs have been required to undergo an Operations Committee review, which has added additional effort to their processing. The inability of the Bank to issue a term sheet that outlines the structure of a PRG for a particular project without senior management approval (and consequent internal clearance procedures), for example, has constrained timely response to demand.

PCGs have an additional internal constraint in that the Bank is required to inform the Board prior to initiating discussions with government clients. The caution exercised in the approval of guarantees initially reflected the pilot nature of the operations. Now, however, although the number of guarantees has been limited, the Bank has had 18 years of experience with the products. The complexity of the projects has caused even further scrutiny. In the Lao PDR Nam Theun 2 Project, for example, the Board requested a semiannual progress report on the project's implementation, and two guarantee projects have been subject to inspection panel investigations.

According to staff, Bank management has also not sent clear signals as to whether guarantee operations should be pursued, with some regions actively seeking opportunities and others not. It is clear that more exposure and discussion of the potential use of guarantees in the Bank is warranted.

**The use of IDA PRGs was constrained by full country allocation requirements.** When IDA PRGs were introduced in 1997, issue of a guarantee absorbed IDA resources equivalent to the full amount of the guarantee. In the first six years of the IDA program, between 1998 and 2004, only three IDA PRGs were issued. This partly reflected the reluctance in the Bank to use IDA allocations to support private sector projects rather than public investment. In 2004 the IDA allocation for a PRG was reduced to 25 percent of the value of the guarantee, and in the three years since, an additional seven IDA PRGs have been approved (although three are not yet active).

**The last resort principle has some limitations.** According to some Bank staff, the designation of Bank guarantees as "last resort" instruments has also unduly constrained the use of Bank guarantees. In some cases, it is argued that whereas MIGA can cover PRI, the Bank's PRGs would give the Bank an opportunity to build on its policy dialogue and achieve broader reforms for private sector development, and that the PRG would be a better fit for the project. The last resort principle, however, requires deployment of MIGA PRI first and effectively prevents the Bank's engagement.

In addition, there are some cases where clients have a preference for a certain instrument or institution based on the circumstances of the situation. In such circumstances, the last resort principle is of limited relevance. As discussed below, rationalizing of pricing of PRM products across the WBG could help reduce the need for the hierarchy principle.

**The requirement for a counter-guarantee for all IDA PRGs is an advantage in some situations, but a constraint in others.** The IBRD Articles of Agreement require IBRD guarantees to be backed by a sovereign counter-guarantee, but the IDA Articles do not. Instead, requirement of a counter-guarantee for all IDA guarantees is a Board decision. Although in some circumstances there are clear benefits to requiring a counter-guarantee—such as the need to fully engage the Ministry of Finance in a project—in other cases the counter-guarantee requirement may be less necessary and serves to discourage government engagement because of its contingent liability implications.

**Internal incentives favor the use of IBRD lending over PCGs.** Because IBRD/IDA does not lend directly to the private sector, IBRD/IDA PRGs cannot be replaced by other IBRD/IDA lending products. In contrast, IBRD loans are a direct substitute for PCGs, in that a public investment project can be financed by either Bank funds or commercial bank funds supported by a PCG. According to staff, internal incentives strongly favor direct IBRD lending over use of a PCG. In some circumstances, moreover, direct Bank lending will offer the Bank greater leverage over design and implementation of the project.

PCGs offer the Bank an opportunity to support the same project with fewer Bank financial resources. By establishing the link between commercial financing and public investment projects in member countries, PCGs also offer a long-term contribution. It is apparent that there is no consensus in the Bank about the relative merits of PCGs versus direct Bank lending in different circumstances. The issue warrants greater discussion within the Bank and clearer guidance.

**The Bank has limited expertise in the financial structuring component of guarantees.**

In the Bank, guarantee projects have involved teams similar to those of regular loans that have worked on the underlying project, as well as "guarantee specialists" who worked on the financial structuring component of projects. Expertise on the financial structuring of guarantees has been confined to a limited number of staff, however. In the past, expertise was concentrated in about 10 staff in a central unit within the infrastructure vice presidency (supplemented by some Regional staff experienced in the use of guarantees) who worked with Regional sector staff as co-task team leaders of PRG projects. Over time, however, the staff of the central unit moved to Regions or retired and were not replaced.

In 2006 a decision was taken to "mainstream" guarantees, with Regional staff expected to identify, develop, and process guarantee operations. The central unit in the Sustainable Development Network anchor now retains only a few staff who provide financial expertise in support of PRG products as well regular Bank lending products. The Bank's Treasury vice president is now expected to undertake several functions related to guarantees: act as the repository of knowledge on policies, pricing, legal, systems and accounting; undertake outreach and training activities; and support development and integration of new products. The credit risk assessment of guarantees is undertaken by the Credit Risk Department.

**The Bank's PRGs have evolved into instruments with objectives well beyond the provision of PRI.** As reviewed above, PRGs have been used to engage the Bank in structuring complex PPPs; ensuring the technical, financial, and economic viability of the projects; advancing policy reforms; and ensuring close compliance with social and environmental guidelines and continued engagement in the project during implementation. The instrument has thus adopted a broad range of development objectives, rather than strict provision of PRI to catalyze the flow of private investment.

At its most limited, a PRG would only be concerned with the extent to which the government adheres to obligations under a project, and less with furthering policy reforms or helping ensure the technical and commercial success of the project. Indeed, the rationale for engaging the private sector is that there are built-in incentives for the private sector itself to conduct adequate appraisal and ensure project success. Although this route would likely increase the use of PRGs, it would also bring the Bank's PRG closer to instruments offered by MIGA and private PRI providers, as well as eliminate some of the main value added of Bank engagement.

At the same time, however, it is apparent that the Bank's public sector approach in appraising projects or requiring private sponsors to mitigate impacts that go beyond the project might be excessive. According to staff interviews, some private sector clients have indicated that they would never work with a Bank PRG again. It therefore seems that a better balance is needed between the PRG as an investor-friendly instrument that enhances the flow of investment through PRM and the PRG as an instrument to help broaden development objectives.

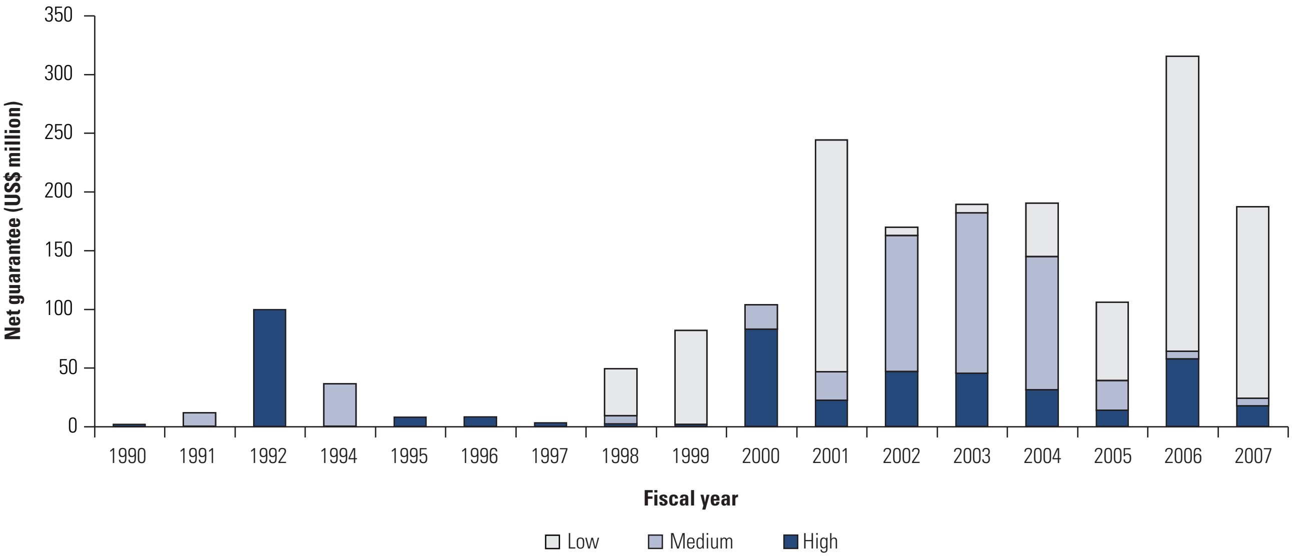
## IFC Guarantees

### *Patterns of use*

**IFC's guarantees have a wide range of potential applications.** IFC's Financial Instruments Guidelines state that IFC's guarantees may enable private sector clients to—

- Access long-term local currency financing.
- Increase exposure to sectors deemed strategically important for development, such as SMEs, residential mortgages, student loans, and trade finance.
- Access international investors for the first time or at a time when investors may otherwise be reluctant to extend credit to corporations within the client's sovereign jurisdiction.
- Introduce new instruments (such as bonds, commercial paper, note issuance facilities, and swaps) in local or international financial markets, thus diversifying financing sources.
- Access local or foreign currency funding on terms and with maturities otherwise not available.

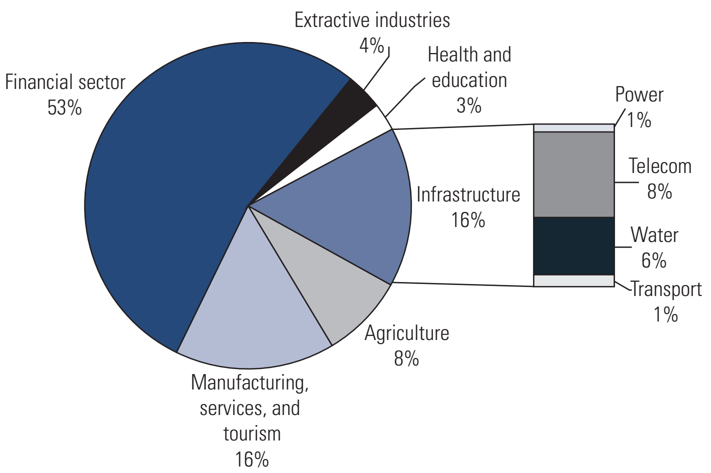
**Figure 2.14: IFC's Total Net Commitment (excluding GTFP), by Country Risk Classification, Fiscal 1990–2007**




*Source:* IFC data.
*Note:* Data for 1993 not available. GTFP = Global Trade Facility Program; IFC = International Finance Corporation.

- Expand a client's activities in a country or market segment where it may be close to its exposure limits by taking on some of the client's portfolio risk.

**Figure 2.15: Distribution of IFC Guarantees by Sector (net commitment), Fiscal 1990–2007**




*Source:* IFC data.
*Note:* This excludes GTFP. IFC = International Finance Corporation; GTFP = Global Trade Facility Program.

**Guarantees have been growing rapidly but still account for only a small portion of IFC's total financing** (figure 2.14). Between fiscal years 1990 and 2007, IFC committed 196 guarantee operations; 53 of these were under its GTFP. Guarantees accounted for 5.7 percent of IFC's total committed portfolio as of June 30, 2007.

The average growth of the guarantee portfolio over 1990–2007 was 31 percent annually from a very low base versus 10.5 percent for IFC as a whole.[21] The rapid growth in recent years has been driven by GTFP, whereas the level of deployment of IFC's traditional guarantee products has been stagnant. Guarantees have been concentrated in the financial sector (see figure 2.15), which accounted for 71 percent of all guarantees (including GTFP, whose guarantees are all in the financial sector).

There has been limited use of guarantees in the infrastructure sector, however. Although potential exists for the application of guarantees in situations of local-currency-earning infrastructure projects, IFC has done only 10 guarantee trans-

**Table 2.5: IFC's Local Currency Financing**

| $ millions | Fiscal year 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|
| IFC loans | 3,732 | 4,541 | 4,968 | 5,642 |
| IFC total local currency financing | 481 | 820 | 1,320 | 1,650 |
| IFC local currency guarantees | 46 | 55 | 233 | 137 |
| Growth in loans (%) | | 22 | 9 | 14 |
| Growth in local currency financing (%) | | 70 | 61 | 25 |
| Share of local currency in loans (%) | 13 | 18 | 27 | 29 |
| Share of guarantee in local currency financing (%) | 10 | 7 | 18 | 8 |

*Source:* IFC data.

actions in the infrastructure sector (8 percent of the volume of guarantees, compared with an 18 percent share of infrastructure in IFC's overall portfolio). Two of these were in the transportation sector, five with water utilities, two in power, and one in gas distribution.

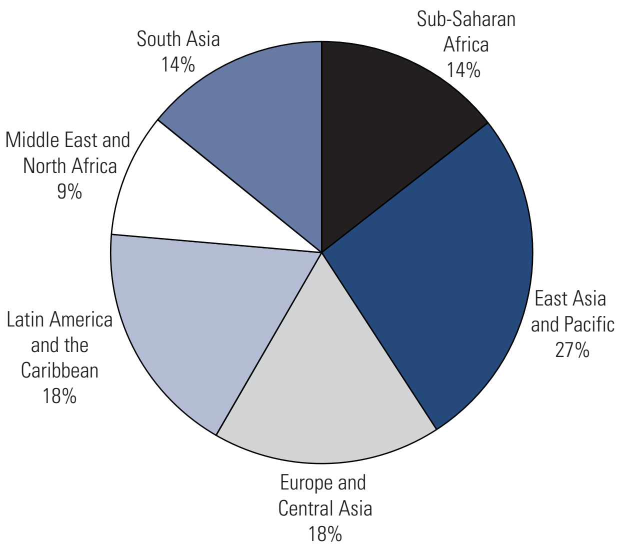
**IFC's guarantees have mainly supported local currency financing.** In three-quarters of IFC's guarantee investments, the underlying asset was denominated in local currency (excluding GTFP transactions). IFC's guarantees have helped clients that are earning local currency—particularly in sectors such as infrastructure, housing, education, or nonexport-oriented SMEs—obtain financing without incurring currency mismatches. In countries where derivative markets are nonexistent or issuing IFC local currency bonds is not feasible, guarantees are the only instrument available for IFC to provide local currency financing. Of the seven countries in which IFC guarantees enabled local currency financing in 2007, long-term local currency swap markets were not available in five.

With limited use, however, guarantees have made only a marginal contribution to the rapid growth in IFC's local currency financing. Although IFC local currency financing reached almost 30 percent of total loans in 2007, guarantees accounted for less than 10 percent of local currency finance (see table 2.5). The fast growth in IFC's local currency financing has been largely driven by growth in swap-based derivative transactions. IFC's Treasury introduced a series of initiatives in 2007 that provide incentives for local currency financing through loans or swaps by reducing the pricing of such local currency loans by 30 basis points. No similar incentives have been allowed for the provision of local currency financing through guarantees.

**IFC guarantee instruments have focused on Africa, reached SMEs, and embodied innovation.** A third of all IFC guarantee projects were in Africa, including 54 percent of GTFP guarantees. Excluding GTFP, guarantees were distributed broadly (see figure 2.16) into East Asia and Pacific (27 percent), Europe and Central Asia (18 percent), Latin America and the Caribbean (18 percent), and South Asia and Africa (14 percent each). Guarantees have also helped indirectly reach micro, small, and medium-size enterprises (MSMEs) by facilitating access to long-term local currency financing by leasing, microfinance, and consumer finance companies. This had enabled them to expand their MSME business.

In about two-thirds of all guarantee transactions, the ultimate clients were MSMEs, and about half of these operations were in Africa. In about a quarter of the cases, SMEs were direct clients of IFC's guarantees, mainly through the Africa Enterprise Fund.[22] A third of IFC's guarantee transactions have also had important innovation aspects, either by introducing a new instrument

**Figure 2.16: Distribution of IFC Guarantees by Region (net commitment), Fiscal 1990–2007**




*Source:* IFC data.
*Note:* This excludes GTFP. IFC = International Finance Corporation; GTFP = Global Trade Facility Program.

to the market or introducing new clients or investors to companies (Meddin 2005). Each of the Bank Group's six strategic themes is represented in the IFC's universe of guarantee transactions, with a particularly strong focus on Africa and innovation.

**Guarantees have been deployed by IFC in crisis and postcrisis situations.** A quarter of all guarantee transactions were in crisis or postcrisis situations. The instrument has been used to replace IFC dollar-denominated loans with local currency loans as part of balance sheet restructurings. Six projects in Pakistan were restructured following the 1996 crisis. Similar restructurings were done in Turkey and in Thailand following crises in these countries, although on a more limited, case-by-case basis. In Lebanon, IFC used guarantees to support Lebanese banks in their efforts to continue to play their regional role during the recent crisis there. Guarantees have also been useful instruments for companies in distress to mobilize working capital in the wake of economic crises.

**Guarantees tend to combine the use of advisory services, but mobilization of advisory service funding has often added to transaction costs.** One-fifth of IFC's guarantee operations involve the use of advisory services. Part of the reason for this relatively high level of occurrence is that guarantees often introduce investors to new, unfamiliar sectors where risks are high. In such circumstances, advisory services can be a powerful tool in building capacities and mitigating risks. Guarantee operations in the education sector in Africa for energy efficiency, microfinance, leasing, and SME programs tend to be combined with large components of technical assistance. Advisory services have also been used by IFC to implement reforms that can be supported with guarantee operations, as in the case of Mexico's PPP program. At the same time, the mobilization of advisory services to complement IFC guarantees has often been a time-consuming process, which tends to add significantly to transaction costs.

**IFC's guarantee operations have involved partnerships.** About a quarter of all guarantee operations involved partnering with other members of the WBG or other national or bilateral development institutions. A number of corporate bond or municipal bond guarantees were provided in risk-sharing arrangements with national development finance institutions, as in the case of IFC's bond enhancements in Saudi Arabia and South Africa. Partnerships helped combine complementary strengths and allowed for risk sharing. At the same time, a large number of players have tended to fragment financing, adding to complexity and increasing overall transaction costs, especially in the case of smaller projects.

**Guarantees have complemented other IFC instruments.** About half of IFC guarantee operations were with repeat clients, suggesting complementarity over time between the deployment of IFC's nonguarantee instruments and the use of IFC's guarantees. IFC's ability to take risks that others are unwilling to take on their own, as implied by the nature of the guarantee instrument, has often been based on IFC's comparative advantage in knowing the client through prior investment and advisory relationships. In the case of GTFP, for example, IFC is leveraging its extensive global network of relationships with financial institutions in emerging markets.

Guarantees also often come packaged with other IFC instruments that have enhanced the value of the guarantee. In 17 percent of the cases, guarantees were part of a larger financial package, which included IFC loans and/or equity.

### *Effectiveness and additionality*

IFC's guarantees have helped beneficiaries expand beyond current client or country exposure limits, particularly in trade finance. The demand for enhancement may reflect how close a bank is to country or client limits and may have only an indirect relationship with country or client risks. Banks often demand enhancement for clients they are familiar and comfortable with on the basis of long-term relationships. This can be seen in the case of the trade facilities, where IFC has provided enhancement services to banks that have been working together and are familiar with each other.

**IFC's guarantees have successfully introduced new financial instruments to clients.** In Morocco, IFC guaranteed for the first time a long-term subordinated loan, with similar characteristics as Tier II capital for a nonprofit microfinance institution. IFC facilitated the first-ever bond issuance by a nonprofit institution in Peru and the first corporate bond in Saudi Arabia. In South Africa, an IFC guarantee also supported the first long-dated municipal bond, issued by the city of Johannesburg. In Russia and the Baltics, for the first time IFC guarantees helped introduce mortgage-backed securities. The IFC-enhanced Johannesburg municipal bond and Saudi Arabia's first corporate bond were followed by others within a fairly short period of time, suggesting a demonstration effect.

**On average, guarantees have been less profitable than loans, but their development success rate has been similar to that of loans.** A comparative profitability analysis between loans and guarantees shows that guarantees tended to be less profitable than loans over the 1990–2007 period. Prior to 2000, guarantee operations tended to have both lower incomes and lower administrative expenses than loans, as a percentage of average outstanding balances. Since 2001, although guarantee fees tended to exceed loan spreads, guarantees became more expensive than loans to process. The higher administrative expenses for guarantees reflect greater complexity, smaller IFC investment size, and a higher percentage of cancelled projects than in the case of loans.

In terms of development outcomes, guarantee operations do not show statistically significant differences with IFC's averages, according to Development Outcomes Tracking System results. In terms of portfolio quality, the guarantee projects had the same average credit risk rating in 2007 as loans.

**IFC's guarantees have helped extend maturities, but the impact on all-in-cost[23] of financing is less clear.** IFC's guarantees have typically extended maturities beyond those available in local markets. For example, the loans extended under one of the African school facilities have maturities of 3–5 years, compared with the average 6- to 12-month financing offered prior to IFC's involvement.

However, the impact on all-in-cost of financing is less clear. IFC characterizes the product as allowing the borrower—in most cases—to achieve a lower all-in cost, but it is very rare that project documents attempt a comparison of the all-in cost to the client with the guarantee against the client without the guarantee. Anecdotal evidence is sometimes presented that shows that banks often do not price the full impact of IFC guarantees and pass the entire guarantee fee on to the client. In many instances, particularly in IFC's direct investments in Africa, IFC has been putting pressure on the banks to fully price the effect of IFC's credit enhancement. IFC's policies ask staff to look beyond the guarantee fee in the case of dollar financing to ensure that IFC's risk is priced correctly in case IFC needs to access the local market. This requirement may be extended more broadly, as all-in-cost pricing affects the demand and utilization of facilities and also has developmental benefits in terms of introducing sound practices of risk pricing.

It is often the case with structured guarantees that a transaction will not happen without the guarantee. In such instances, looking at the impact of the guarantee on all-in-cost may not be appropriate. When comparisons are possible, the price of the structured guarantee tends to have little impact on the all-in-cost to the client, as the IFC guarantee typically covers a small portion (often less than 10 percent) of the securitization amount.

At a more basic level, plausible assumptions about the rationality of guarantee clients and the voluntary nature of the transactions tend to ensure that guarantees—when they happen—are superior to available alternatives. Nevertheless, attention on the impact of guarantees on all-in-cost of financing may be justified when the sophistication and bargaining position of market participants is vastly asymmetric, as the case may be with some microfinance and SME clients.

**Providing single-credit guarantees to small investments in Africa has not been successful.** Over the 1990–2007 period, IFC committed 142 guarantees (excluding GTPF). Of these, 21 have been called. Three-quarters of all called guarantees have been for small projects in Africa. Of 19 Small Enterprise Fund and African Enterprise Fund guarantee projects, 15 have been called. A total of $8.7 million has been paid out of the $1.8 billion committed during the period. The African Enterprise Fund has been discontinued, and direct lending to SMEs has been largely replaced by a wholesaling approach to SME lending.

**The RSFs have shown mixed success.** The self-standing trade enhancement RSFs have shown disappointing results and have been replaced by a new approach—GTFP—which has shown a remarkable growth.[24] The school facilities in Africa have been moderately successful. The first school facility in Africa became fully utilized in less than two years, and a second facility has been approved. The approach was extended to another African country, where ramp-up has been slower than expected because of the sponsor's liquidity constraints and slow deployment of the associated technical assistance program. The energy efficiency programs in Central and Eastern Europe and in China have shown good utilization, and these facilities have seen no claims so far.[25]

An important new area of cooperation between IFC and the Bank is the MSME program in Africa, which combines IFC's PCGs and IDA funding. Two joint projects have been committed in Madagascar in the finance sector for a total of $12.5 million; of this, $10 million is IFC's own account and $2.5 million is from the government of Madagascar, as partial risk coverage for up to $25 million of new local currency MSME loans. As of September 2007, the two participating banks had disbursed about two-thirds of the $25 million total facility. Currently there are five similar projects under preparation—two in Mali, two Senegal, and one in Ghana.

**A number of other RSFs have not performed well.** A student loan facility in Asia was cancelled because of low utilization and a delinquency level above 10 percent, which has triggered the ramp-up termination threshold. A risk-sharing facility in Asia targeting middle-size enterprises was not utilized because of a change in strategy by participating banks, which decided to focus on consumer finance and retail banking.

In the case of a risk-sharing facility in Europe, some utilization took place, but difficult approval, reporting, and managing processes—which led to IFC being involved in each individual subproject—have limited deployment. An RSF in east Asia was not utilized because pricing was thin and the first loss provision was very high, at 20 percent. The joint IDA–IFC operation was also not utilized. Common reasons for lack of utilization include changes in market conditions; thin margins, which make it more difficult for banks to give up a portion of the net interest margin; unappealing risk sharing agreements for partnering banks; and difficult approval processes, whereby IFC was appraising every transaction.

**Models for deploying guarantees have been developed, but limited scaling up has taken place.** The first school facility in Africa has been replaced by another in Africa. The energy efficiency program started in Hungary and was then replicated in Central and Eastern Europe and in China. There have been bond enhancements for education institutions, municipalities, leasing companies, and banks, but always on a case-by-case basis. The GTFP has been the only success in scaling up. Progress has been made in standardizing and simplifying structuring, but there has been limited progress in scaling up and replicating. IFC continues to follow a largely opportunistic approach to the deployment of the instrument.

### *Potential for use*

**Several factors, both external and internal to IFC, suggest greater potential for the deployment of IFC's guarantee products than current levels suggest.** Trends in the external environment suggest significant potential demand in areas where the instrument is being deployed today. New development challenges such as climate change are emerging that require new approaches, including developing markets for carbon trading.[26]

Although there is abundant liquidity in emerging markets, the capacity to channel this liquidity efficiently into productive investments needs to be developed. This involves a focus on deepening the local capital markets, including local bond markets. IFC sees a growing demand for local currency financing. MSMEs are increasingly viewed as the main engine for sustainable and equitable growth. The need to develop market solutions to environmental problems, to deepen financial markets in developing countries in the context of abundant liquidity, the growing demand for local currency financing, and the need to expand access to financing to underserved segments of the economy—all these trends create a large and growing potential demand for the use of guarantee-type instruments.

Potential opportunities for IFC to add value and to facilitate funding of private sector development through tailored guarantees are likely to continue to increase, given the expanding range of opportunities for private investment in developing countries, as well as by the increasing currency assets generally managed by local pension funds that must adhere to strict local investment guidelines and by IFC's increasing involvement in local and international capital market activities on behalf of its clients.

External experts have also identified the potential for greater use of guarantee instruments by multilateral financing institutions, including IFC (World Economic Forum 2006). A comparison with other international financing institutions indicates similar or lower levels and similar trends in deployment of the instrument as in IFC, suggesting that there are common factors at work. At the same time, use of guarantee and insurance instruments by private providers has shown growth, although at different rates, depending on the type of instrument.

**IFC's strategic priorities and focus on additionality also indicate greater potential.** IFC has identified the imperative to work with and through others (IFC 2008) for larger impact, including through programmatic approaches and wholesaling. Guarantee instruments are particularly well suited for the application of these approaches. They also have special properties from the perspective of additionality, because they are more likely to *crowd in* rather than *crowd out* private flows than IFC's funded products. Other things being equal, IFC's focus on additionality could translate into more emphasis on the use of guarantee instruments. IFC's own experience with trade facilities and the GTFP suggests that although significant demand may exist, constraints on the supply side could limit IFC's ability to respond to such demand (see box 2.1).

**IFC is exploring different ways to respond to these opportunities, including through guarantee instruments.** The organization is placing a major focus on developing capacity in local currency financing. It has issued more IFC bonds in local currencies, supported development of derivative markets, and experimented

### Box 2.1: GTFP: A New Product in Response to Existing Demand

**Following the poor performance of its trade finance facilities, in 2003 IFC piloted a new approach based on a successful European Bank for Reconstruction and Development model.** From fiscal 1998 to 2003, IFC committed 21 trade finance facilities for a total of $542 million. Of the 21 facilities, 11 were never used, and of the 10 that were used, the average utilization rate was just 27 percent.

Although there was clearly a demand for short-term trade finance guarantees, IFC was not able to respond to this demand with its products. In 2003 an IFC review of this experience found that among the main reasons for poor utilization were delays in negotiating the necessary framework agreements with each participating bank, caused by imposition of stringent financial reporting requirements that were not standard market practice for trade-related transactions; the conclusion by participating banks that IFC's guarantee was not a firm guarantee and would not help reduce capital requirements, a conclusion caused by various representations they had to make according to IFC's covenants; and the imposition of high capital charges that were not in line with the lower-risk profile of trade transactions, which reduced the profitability of the facilities. The review also observed the European Bank for Reconstruction and Development's (EBRD) successful approach to trade finance and a decision was made to implement a similar approach in IFC. EBRD's experience gave IFC the confidence to start out in a decisive manner.

**The program has seen rapid growth, particularly in Africa.** The program started in 2005 and has grown rapidly. In fiscal 2007, total commitments had reached $767 million with the issue of 564 guarantees, of which $377 million was in Sub-Saharan Africa. The program doubled its coverage in fiscal 2007 to include 96 banks across 51 countries. More than two-thirds of all GTFP transactions have been in frontier markets. In a number of countries GTFP has been the first IFC deal—or simply the first deal—in years. About one-third are South-South transactions. PRM is a very important factor for the GTFP. Most of the transactions are in difficult environments, where the confirming banks have exposure constraints.

**The GTFP approach is fundamentally different from the traditional IFC approach to trade facilities.** The traditional approach is bilateral, whereas GTFP is an open, multilateral network architecture. The nature of the instrument is also different: in the past IFC guaranteed 25–50 percent of the confirming bank exposures and used a number of covenants on the participating banks on top of serious reporting and other requirements, but the instrument used in GTFP is a 100 percent unconditional demand guarantee. For country and client exposure limits, every dollar that IFC commits under the GTFP is counted at 50 percent for headroom purposes. GTFP had to develop a customized booking system, because IFC's standard systems for disbursements could not handle high-frequency short-term trade finance transactions.

Other success factors include limited competition with other parts of IFC's business; commitment at the top; a bold initial approach, with $500 million approved for the pilot program; delegated authority, special systems, and dedicated staff that could rely on support from a large department; moving close to established market practices; and limited competition in the Sub-Saharan Africa Region.

**GTFP has promising new applications and growth potential.** IFC is continuing to develop the program. Efforts are under way to further simplify documentation and bring structures even closer to market practices. Opportunities include wholesaling to address single exposure limits to preapproved clients and using the platform to expand the range of products to include short-term financing, swaps, carbon delivery guarantees, and other products that involve bank-to-bank interactions. Unlike the old approach, the GTFP has the potential to enable IFC to respond quickly to tightening market liquidity.

*Source:* IFC.

with programs such as MATCH. It has also experimented with different ways to work with MSMEs and to facilitate trade and short-term finance.

The imperative to experiment in this and other areas remains. The outcome of these experiments will affect the demand for guarantee instruments.[27] In a number of areas, experimentation and learning have converged on the development and improvement of guarantee-type instruments. Models have been developed, but replication on a large scale has not occurred, except in the case of the GTFP. What have the constraints been?

### *Constraints to use*

**Guarantees have been a fringe instrument for IFC.** They have been used in situations where deployment of IFC's direct instruments has been impractical. In this sense, guarantees have been an instrument of necessity rather than choice. They have been used in areas where IFC's capacity to invest directly is limited: local currency, MSMEs, and short-term finance.

This pattern of use determines both the challenges and the opportunities of the instrument in supporting IFC's strategic priorities. The challenges relate to IFC's tendency to apply its traditional project financier's approach to guarantees, given the fringe nature of the instrument. The opportunities reside in the areas of use for this product, which are areas where IFC wants to develop capacities, grow, and expand its presence.

**PCGs for single credits in local currency face some inherent limitations.** For investment staff, traditional single-credit PCGs are easier, because they are very similar to straight debt financing in terms of process and documentation. However, they face some inherent limitations. To make them economical for IFC, PCGs for single credits in local currency have to be for relatively large investments. Large investments are normally with relatively large clients that have existing relationships with local banks. In such circumstances, local banks often do not see a role for IFC that would justify lowering their spread enough to fully reflect IFC's AAA rating.

Also, in practice IFC's AAA rating has been better recognized and priced internationally than locally, where it is often hard to do better than the sovereign. As a result, it is typically more expensive for the client to use the guarantee instrument than a direct loan from IFC or from a local financial institution. IFC guarantee transactions have higher drop rates than IFC loans. According to responses to the staff survey conducted for this study, in 81 percent of cases, a high guarantee fee was the main reason for the droppage (see appendix B). Clients are often willing to pay a premium for IFC's name. However, IFC has a more remote relationship with the client in a guarantee than in a direct investment. As a result, these benefits are less tangible for the client. Moreover, adding a third party—the guarantor— tends to increase transaction costs relative to alternatives, when and if available.

**Conditions are more favorable for traditional partial credit guarantees in the case of credit enhancements to local financial institutions that operate in high net interest rate margin environments and to issuers of corporate bonds.** Microfinance, consumer finance, and leasing companies in developing countries often operate in environments that allow lending at high net interest rate margins. Interest rate margins of 20, 30, and even above 50 percent are not unusual in micro and consumer finance in countries such as Brazil, Mexico, and Indonesia. In environments of interest rate margins of such magnitudes, clients may not be too sensitive to what is a relatively small increase in their all-in-cost of funding.

Opportunities for traditional PCGs also appear to be significant for enhancement of local corporate bond issuances. Pricing for corporate bonds tends to be more rational than for loans, and this allows the IFC credit rating to be more accurately reflected in the market. Also, for corporate bonds, enhancement often makes the difference between a success and a failure. However, bond enhancement is highly sensitive to market conditions and requires the capacity to react quickly. Hence, a traditional project finance approach is not always the most appropriate.

**IFC's approach to RSFs has constrained their deployment and utilization.** It is hard to make a case against excessive prudence, particularly in the midst of an unfolding crisis. Still, IFC's overly conservative stance toward the structuring of RSFs has constrained their use and that there is room for a more flexible approach consistent with the principles of efficient risk sharing.

IFC has taken an inflexible approach against sharing in first-loss positions. The approach has been to look for third-party—often donor—money to fund a first-loss cushion. In the case of the energy-efficiency programs, the source of such money has been the Global Environment Facility. In the case of some of the SME facilities in Africa, IDA has provided resources. A foundation has funded a first-loss position in a student loan program.

Mobilizing funding for first loss from a third party has been a difficult and time-consuming process. At times, it has taken IFC two to three years to mobilize trust funds for this purpose. That has added to transaction costs. In addition, IFC often demands high first-loss levels, ranging from 5 to 30 percent in some cases. Strict eligibility criteria for booking assets under the facilities have also constrained use at times.

Combined with the use of circuit breakers when losses approach first-loss limits, the above features have tended to make *risk-sharing facilities* a misnomer. IFC started doing RSFs by sharing risks *pari passu* with the beneficiary and without first-loss provisions. A more conservative approach has been introduced over time. IFC has accumulated the data and the experience to give it the confidence to take bigger risks, simplify processes, and give the flexibility to partners to use their strengths. For example, in Eastern Europe, hundreds of small projects have been approved in energy efficiency, and none of them has gone bad. In the IFC-IDA SME facilities, although some claims have been paid, numbers and amounts have been so small that the first-loss reserves have not been eroded—on the contrary, they have increased as a result of accumulated interest.

In all these cases, origination has been decoupled from first loss via the third-party funding, yet the experience has been positive. IFC needs to revisit its approach to structuring RSFs.

**Subrogation in foreign currency is still a constraint.** The 1997 revision of IFC's guarantee policy introduced greater flexibility in the deployment of the instrument by allowing subrogation in the local currency in the event of a call on a local currency guarantee. However, IFC introduced limits to the aggregate notional volume of such guarantees. There are currently various limits on the notional committed value of all guarantees of financial instruments where IFC's post-call claim is denominated in a local currency for which there are no adequate hedging instruments for currency and interest rate risk. Although this limit is not a binding constraint at the moment, it increases transaction costs and reflects a formalistic rather than a pragmatic approach to risk.

An argument can be made that in a situation of claim and subrogation, the main risk is a credit event, not a currency event. If a currency mismatch is present in a project, the currency risk in the transaction cannot be eliminated by subrogation in a hard currency. And if there is additional risk by allowing subrogation in the local currency, the risk is not likely to be too high. Some multilateral financing institutions have recently allowed for greater flexibility as far as subrogation in the local currency is concerned and have reportedly seen an increase in demand for guarantee products.

**The traditional project financier's approach to guarantee-type instruments has constrained the use of the product.** IFC tends to apply a uniform approach to all projects, irrespective of the levels and types of risks. The same comprehensive approach to risk is applied across the board, instead of using a segmented approach focusing on the key risks that matter the most in the particular circumstance, based on the lessons of experience and project analysis.

In GTFP agreements, for instance, although some accommodations have been made, IFC still has negative covenants, ratios, and other restrictions that limit the ability of clients to use the guarantees for capital, exposure, and provisioning relief purposes. That limits the attractiveness of the product. Charging commitment fees over the unused portion of RSFs has irritated partner banks. It is not clear whether the same rationale exists for applying a commitment fee in RSFs, as in the case of funded commitment.

**IFC's processes and systems are not well suited to handle some types of guarantee transactions.** IFC carries the legacy of a project finance institution. This is evident in a project finance culture that relies on heavy documentation and a back office system that cannot handle high-frequency transactions. For example, the RSFs have problems handling claims. Each legitimate claim is treated as a loan disbursement and is handled accordingly. This creates delays and is a further discouragement to the use of the instrument. GTFP, for instance, had to establish its own back office to handle high-frequency transactions.

IFC needs to differentiate processes according to types of instruments, following—to the extent possible—practices the market is used to. IFC's average processing time has been declining in recent years but is still close to 10 months. Guarantee operations are not significantly different than the IFC's average in processing time. Some guarantee transactions have taken a long time to develop, given high complexity and the participation of more players. There is a clear learning element, however, as replications have tended to be significantly less expensive. This pattern is clearly visible, for example, in the case of IFC's energy-efficiency facilities. According to survey results, high processing costs have been the main reason that about 43 percent of clients drop IFC's guarantee transactions (see appendix B).

**A rigid approach to structuring RSFs limits IFC's ability to exploit fully the benefits of partnering with local institutions.** By their nature, guarantees involve working with and through others, often local financial institutions. These institutions have the advantages of local knowledge and information, and on this basis they can supervise certain clients more effectively than IFC.

Once incentives are aligned and IFC has gained comfort with the abilities of the local financial institution, IFC could allow a degree of flexibility to the local institution in managing the utilization. Instead, even with existing and familiar partners, it tends to impose onerous reporting and eligibility requirements and at times wants to appraise every project. Working with and through local institutions would necessitate greater openness and willingness to allow the use of legal practices and precedents that have been developed and applied locally. This rigidity and the high transaction costs have discouraged use of the instrument.

**The incentives structure tends to discourage the use of the instrument.** Incentives at IFC favor booking large transactions. Deals involving guarantees for SMEs, micro, and leasing companies tend to be small. Incentives do not favor working on complicated small projects using products with which staff are not familiar, such as those involving guarantees.

With the emphasis on development impact, attitudes are beginning to change. There are other aspects of the incentives system that tend, although inadvertently, to discourage guarantees. For instance, Treasury allows a 30 basis point reduction in pricing for local currency financing through the derivative market, but not through guarantees. The incentive is based on the historic difference between the London Interbank offered rate and IFC's real funding costs, but it creates a bias against guarantees and in favor of direct local currency funding by IFC where the opportunity exists. An argument can be made to extend the same incentives to guarantees for local currency loans.[28]

**IFC has not institutionalized innovation.** Innovation in IFC is a slow, highly decentralized process of product mutation. IFC has a new product group that deals with risk aspects but does not have groups focusing on the development of new products. IFC's Treasury has been instrumental in innovating and spreading innovation. However, mainstreaming can be led by the industry and regional departments. Innovation does not necessarily imply coming up with more complex products. It often involves simplification and ensuring consistency with established market practices. A more systematic approach to product innovation would also greatly facilitate broader deployment.

IFC would also need to move away from small innovations that tend to get lost and do not lead to cumulative improvements, to a focus on innovative efforts for a few key themes that can lead to quantum jumps in business. This is consistent with the efforts to move toward a programmatic approach and away from one-off transactions. Guarantee instruments are well suited to be part of this approach.

**Complexity and lack of familiarity with some products tend to discourage scaling up.** Some guarantee structures can be replicated on a larger scale. But products that are more complex and require a high degree of familiarity to become an effective business development tool are slowing deployment down. People on the front line need to understand the product so they can match it with the situation. Decentralization brings risks in representing IFC's products. Treasury is decentralizing, putting key staff in the field.

## Conclusion

A range of factors contribute to the limited use of the instrument, but factors under the control of the three WBG institutions play a significant role.

MIGA's Convention and Operational Regulations present many restrictions and hinder MIGA's adaptability to new market trends. However, MIGA has not been sufficiently aggressive in innovating within the flexibility allowed by current policies. It has not adapted to more current market practices with its increasingly cumbersome internal processes.

Internal constraints to the deployment of Bank PRGs include the application of standards designed for public sector operations to private sector projects, more onerous internal processing requirements than are involved in the deployment of traditional Bank instruments, and internal incentives that favor the use of Bank lending over Bank guarantees. In addition, the inflexible use of counter-guarantees for IDA PRGs, although useful in some circumstances, has tended at times to diminish the attractiveness of the product.

IFC has tended to apply a traditional lender's approach to guarantee-type instruments. It has taken a conservative stance with RSFs, which has constrained their deployment and utilization. Though IFC has made significant progress in innovation and in standardizing structures, limited replication and scaling up that has taken place to date have been a result of remaining complexities, poor familiarity with the products, and the lack of a systematic approach to innovation. In general, guarantees have tended to be used as *last resort* instruments by IFC and the Bank.

# Chapter 3


The main street in the university city of Irbid, Jordan, has more Internet cafes per mile than any other street in the world. The World Bank guaranteed one of the first private investment telecom projects in Jordan. Photo © Frédérique Harmsze.

# The Delivery of PRM Products across the WBG

Chapter 1 looked at the design of WBG guarantee instruments and chapter 2 at their deployment in practice. This chapter examines the interactions among the three WBG institutions in the delivery of guarantees. The focus is on PRM products because this is the area where overlaps exist in the product offerings of MIGA, IFC, and the Bank.

**Concerns have been raised that the organization of the provision of PRM products within the WBG is not optimal and that overlap between the three institutions may confuse clients and reduce efficiency.** There have been several initiatives to address this issue. In fiscal 1997 the Board reviewed the WBG's guarantee activities and examined proposals to improve the operational synergy in the provision of risk-mitigating products (World Bank 1997b). A policy document established the principles for deployment of a Bank PRG over MIGA PRI (World Bank 2000). In fiscal 2005 there was an attempt to develop a more coordinated approach between the Bank's Project Finance and Guarantees Group and MIGA to increase the use of existing guarantee instruments, especially in the infrastructure sector. More recently, a task force was established to explore options for optimizing the delivery of guarantees within the WBG.

All the WBG's policy documents on risk-mitigation products have consistently emphasized the need for close interaction among the three institutions to ensure complementarity and to minimize duplication of services. The issues of overlap and competition among the three institutions exist only with respect to PRM, as this is the only area covered by the products of all three institutions. The space of PRM products is different from the space of guarantee products: it includes the part of guarantees that covers political risk as well as nonguarantee products that provide PRM. In this chapter we look at the PRM products of the WBG, the organization of their delivery, the issues of overlaps and competition, and the coordination and cooperation mechanisms in place.

## The Market for PRM

**The objective of WBG PRM products is to catalyze investment that is not flowing because political risk is perceived to be too high.** The World Bank estimates average FDI flows and external private loans to developing countries at $210 billion a year in the period 1990–2005 (World Bank 2007a). The total project cost supported by all WBG guarantee instruments was $5.3 billion annually. Assuming total project cost to be a proxy for investment flows, WBG guarantee instruments thus supported the flow of approximately 2.5 percent of total investment flows.

Similarly, of the new investment flows covered by guarantees, a recent internal study estimated MIGA's share to be between 2 percent and 4 percent of the total market. From the WBG's perspective, however, although the shares are not large, the objective is not to increase its PRM coverage of existing investment flows but instead to catalyze additional investments that are not taking place because of high perceptions of political risk.

This potential market is largely unquantifiable. It ranges from small family businesses considering opening plants in high-risk developing countries, to large conglomerates scouring the world for investment opportunities, to commercial banks seeking to manage their exposure risks around the world.

**The varied market for PRM can be met by a broad range of formal and informal products.** The perception of political risk remains high among potential investors in developing countries (EIU 2007). A range of options exists to mitigate this political risk, with demand for both the type and extent of coverage varying according to the particular circumstances of the investor and the potential project. The circumstances might include the degree of investor familiarity with the country and/or sector, the overall perception of political risk in the country, the degree of sector- or project-specific riskiness, the investor's exposure relative to prudential norms and limits on a country and/or sector, and commercial bank country exposures vis-à-vis prudential limits and regulatory requirements.

The particular circumstances can also dictate the type of coverage opted for by the investor. According to the internal market study, self-insurance (or no formal third-party guarantee) is chosen some 65 percent of the time. In other cases, loans from large commercial banks that have established relationships with host governments, or the implied PRM provided by multilateral agencies lending to private firms (such as IFC loans, as discussed below), can provide a sufficient measure of comfort. Bilateral investment treaties between countries that use arbitration to provide reciprocal protection for investors against political risks might also provide some comfort.

Some investors have the option of large national guarantee agencies for overseas investments, such as OPIC in the United States or Nippon Export and Investment Insurance in Japan. MIGA, for example, derives minimal business from U.S. or Japanese investors, in large part because of the existence of these national guarantee agencies. Several private sector providers, mostly members of the Berne Union, also provide PRI products, and many opt for self-insurance. The circumstances will also dictate the extent of coverage sought, ranging from a single to multiple risks or from explicit insurance to an implicit understanding that the third-party agency will act to protect the interests of the investor.

## WBG Political Risk-Mitigation Products

**As conceived, the WBG's guarantee products were designed to complement each other.** Several WBG guarantee products offer PRM including MIGA PRI, the Bank's PRG, and IFC's PCG, which offers comprehensive political and commercial risk coverage.

As originally designed, these products were intended to complement—not compete with—one another. IFC's first guarantee policy, adopted in 1988, the same year that MIGA was established, had a whole section on the division of labor between IFC and MIGA. It emphasized that IFC's and MIGA's guarantee operations were different and that "both programs are potentially more complementary than competitive."

At the same time, however, the policy recognized that the coverages offered by IFC and MIGA might overlap. IFC indicates that, unlike MIGA, IFC as a matter of policy does not offer coverage for only one or a few risk elements—for example, transfer risk alone—because doing so may potentially jeopardize its de facto preferred creditor status as well as impinge on MIGA's role. Bank policy documents have also emphasized the differences between the PRG and MIGA and IFC products. Unlike PRGs, MIGA's PRI does not require a sovereign counter-guarantee and MIGA could also guarantee equity, which the PRGs could not (see table 3.1).

**Flexibility of policies has blurred original product boundaries.** All the WBG's guarantee policies contain some degree of flexibility in interpretation. IFC and Bank guarantee policies, for example, allow a significant degree of freedom in

**Table 3.1: The WBG's Political Risk-Mitigation Products**

| Guarantee products that provide PRM for long-term private investment products | Guarantee products excluded as not providing PRM for long-term private investment projects |
|---|---|
| IDA/IBRD PRGs | IBRD PCGs—provide support for public investment projects |
| MIGA PRI | |
| IFC PCGs | IFC GTFP—provides support for trade finance, largely short term |
| **Nonguarantee products that provide PRM for long-term private investment products** | |
| Approximately 10 percent of normal IFC investment operations | |
| IFC B-Loans | |
| IFC CELT | |
| IFC GOLF | |

*Source:* IEG.
*Note:* CELT = credit-enhanced lending transaction; GOLF = Global Offshore Liquidity Facility; GTFP = Global Trade Finance Program; IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; IFC = International Finance Corporation; MIGA = Multilateral Investment Guarantee Agency; PCG = Partial Credit Guarantee; PRG = Partial Risk Guarantee; PRI = political risk insurance; PRM = political risk mitigation; WBG = World Bank Group.

terms of types of risks covered and extent of coverage. Although MIGA's policies are the most restrictive in terms of eligibility requirements and risk coverage, they also allow significant room for learning and experimentation. For example, MIGA guarantees were expected to focus on foreign equity holders, which allows MIGA to insure nonshareholder loans if it also insures that an equity holder in the same project has led to guarantees for nonshareholder loans (such arrangements account for about a third of MIGA's guarantees). As another example, Bank PRGs are only mandated to insure loans. In one case, however (the West African gas pipeline), innovative structuring of the guarantee effectively enabled the PRG to guarantee the underlying equity investment.

**Innovation in the guarantee product space has increased the range of WBG political risk-mitigation products**. IFC has introduced several new partial risk-guarantee products that carry some political risk coverage. The GOLF effectively provides coverage against transfer and convertibility risk (see page 77 for a more detailed description). In its first and only application so far, GOLF encourages mortgage-backed capital market transactions by guaranteeing an offshore liquidity facility that can be drawn on if a restriction on currency transfer or convertibility is imposed.

Under its regular guarantee program, MIGA has also been developing this line of business and has provided coverage against transfer restrictions and convertibility risks to residential mortgage-backed securitizations in Latvia and Kazakhstan and to accounts receivables securitization in Brazil. IFC has also introduced credit-linked guarantees, a flexible partial risk-guarantee product that can cover various bundles of risks.[1] Although both of these products have seen limited use to date, they represent a departure from the traditional approach of offering full-risk guarantees.

In another example, in the mid-1990s, the Bank introduced the guarantee facility structure, initially for short-term trade finance in Eastern Europe but subsequently for wholesale guarantees to smaller long-term infrastructure investments (see table 3.2 for comparisons of instrument deployment).

**IFC's innovations in the nonguarantee product arena have introduced products that embed coverage for political risk.** An example is IFC's Credit-Enhanced Lending Transaction (CELT). IFC introduced CELT in the late 1990s, adapting a similar product used by the European Investment Bank and EBRD, to help address challenges arising from internal and regulatory country exposure limits that large international banks face in moving into emerging markets.

**Table 3.2: Comparisons of the Deployment of WBG Risk-Mitigation Instruments**

| | Risk coverage | Total value of underlying projects | No. of projects | Committed amount | Regional deployment to date (top three) (%) | Low-income country deployment to date (%) | High country risk deployment to date (%) | Sector deployment to date (%) | Project size deployment (5)[b] |
|---|---|---|---|---|---|---|---|---|---|
| IFC PCG | Comprehensive | $8.6 billion | 142 | $1.8 billion | AFR: 35<br>EAP: 18 | Low: 55 | High: 46<br>Med/Low: 54 | Finance: 51<br>MST: 14<br>Infrastructure: 13 | Small: 31<br>Medium: 39<br>Large: 23 |
| IBRD/IDA PRG | Transfer/convertibility, expropriation, war, breach of contract, some commercial risk, some natural events | $9.4 billion | 13 | $1.2 billion | AFR: 31<br>SAR: 23 | Low: 75 | High: 70<br>Med/Low: 30 | Infrastructure: 92<br>MST: 8 | Small: 0<br>Medium: 6<br>Large: 94 |
| IFC loans or equity investments with PRI as main reason[a] | Transfer/convertibility, expropriation, war, breach of contract | $28.8 billion | 404 | $5 billion | ECA: 29<br>AFR: 26 | Low: 34.5 | High: 35<br>Med/Low: 65 | Finance: 31<br>Infrastructure: 27 | Small: 22<br>Medium: 44<br>Large: 31 |
| MIGA PRI | Transfer/convertibility, war, breach of contract | $78 billion | 566 | $16.6 billion | LAC: 31<br>ECA: 31 | Low: 32.5 | High: 45<br>Med/Low: 48 | Finance: 33<br>MST: 31<br>Infrastructure: 24 | Small: 23<br>Medium: 49<br>Large: 28 |
| IFC B-loans | Transfer/convertibility only | $112 billion | 629 | $14.5 billion | LAC: 41<br>ECA: 20 | Low: 22.6 | High: 31<br>Med/Low: 69 | MST: 38<br>Infrastructure: 23<br>Finance: 17 | Small: 3<br>Medium: 51<br>Large: 43 |
| IFC GOLF | Transfer/convertibility only | $100 million | 1 | $19 million | ECA: 100 | Low: 0 | High: 0<br>Med/Low: 100 | Finance: 100 | Small: 0<br>Medium: 0<br>Large: 100 |
| IFC CELT | Transfer/convertibility, war, breach of contract | $0.51 million | 4 | $0.49 million | ECA: 100 | Low: 0 | High: 0<br>Med/Low: 100 | Finance: 100 | Small: 0<br>Medium: 50<br>Large: 50 |

*Source:* IEG, based on World Bank, MIGA, and IFC data.

*Note:* All percentages are by number of projects, not volume. CELT = Credit-Enhanced Lending Transaction; GOLF = Global Offshore Liquidity Facility; IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; IFC = International Finance Corporation; MIGA = Multilateral Investment Guarantee Agency; MST = multisector task; PCG = Partial Credit Guarantee; PRG = Partial Risk Guarantee; PRI = political risk insurance; WBG = World Bank Group.

**Regions:** AFR = Sub-Saharan Africa; EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; SAR = South Asia.

a. Estimated for fiscal 1990–2007 based on the actual data for fiscal 2005–07.

b. Small = less than $10 million; medium = $10–100 million; large = more than $100 million.

With CELT, a parent international bank will guarantee repayment of an IFC loan to its subsidiary under all circumstances except if nonpayment is caused by political events. In addition to the credit risk of the parent, IFC thus bears the political risk on these projects, including the traditional political risks covered by MIGA and the Bank's PRGs. Four CELT transactions have been completed to date for a total of about $500 million, all in the Europe and Central Asia Region.

**Traditional IFC products also embed implicit political risk cover.** IFC's normal lending and equity investments also carry a degree of implicit political risk cover (IPRC). As a multilateral organization and member of the WBG, IFC faces lower country risks from political and economic conditions than a private investor. Through its participation in a project, IFC can transfer that risk reduction to other investors, "furnishing comfort without issuing a formal guarantee" (Haralz 2007).

According to IFC's client surveys, perceived risk reduction or political risk cover is among the main reasons that clients use IFC as a source of finance. An IEG review of IFC projects between fiscal 2005 and 2007 conducted for this evaluation found that in approximately 10 percent of investment projects, IPRC was indicated as a primary reason for IFC's involvement in the project and its main additionality.

IFC's B-loan program is another instrument that provides participating banks with implicit cover against transfer and convertibility risk. The 1997 internal review of WBG guarantees (World Bank 1997b) identified the B-loan as IFC's main political risk-mitigation product. Participation in IFC's B-loan program provides an implied rather than explicit cover and can mitigate transfer and convertibility risk through IFC's preferred creditor status.

These traditional products have long been part of IFC's arsenal. What has changed in recent years is that IFC's business development capacity has strengthened, and that has been accompanied by a more aggressive marketing of the implicit political risk cover as a substitute for PRI.

## Institutional Organization of the Delivery of PRM Products

**The WBG is the only multilateral to have three distinct institutions providing PRI, PRI with counter-guarantees, and comprehensive credit guarantees.** The ADB, AfDB, and the Inter-American Development Bank, for example, offer PRI (with or without sovereign counter guarantees) and comprehensive credit guarantees to private sector clients. In each institution, guarantees are provided by private sector departments within the main institution that can offer any of the three guarantee products. The same institutions, moreover, are also able to offer direct investments to the private sector, thereby offering a full range of financing and risk-mitigation products.

A recent independent panel report in the AfDB considered separating the private sector development unit from the main organization but recommended that the AfDB retain a unified structure to be better able to mobilize all its resources toward a common private sector development objective. The report also recommended creating a single point of entry for all private sector transactions.

**However, multilaterals with unified structures have not seen a larger share of guarantees in their businesses.** Each of the major multilateral institutions has also seen limited growth in the provision of guarantees for medium- to long-term investment. ADB has issued just 27 guarantees (both PCGs and PRGs) in its history, and in 2006 guarantee commitments accounted for just 2 percent of its loan commitments. EBRD has issued three guarantees in infrastructure and more than 60 in the financial sector, for a total volume of 3 percent of its total investment operations. Guarantees account for 3.6 percent of the European Investment Bank's investment portfolio. In AfDB, guarantee commitments accounted for just 1.5 percent of its commitments in 2006. IFC's guarantee operations consist of 6.6 percent of its loan commitments, and IBRD's guarantee operations represent 1.6 percent of its total lending operations.

A review of the organization of the provision of guarantees in several of these multilaterals found that a range of internal policy and structural constraints have inhibited a more widespread use of guarantees. Factors undermining greater use were similar to those found in the WBG in this evaluation and included the complex nature of guarantee products, an internal lack of information and knowledge, the de facto preference for loans, and the lack of a dedicated guarantee unit with sufficient authority to coordinate the provision of guarantees.

**There are significant differences in the organizational structures of the three WBG institutions.** The literature on organizational design distinguishes among five broad organizational structures: functional, product, market, geographical, and process oriented.

MIGA is de facto a single product institution and its organizational structure is of the functional type.[2] MIGA remains a Washington-based organization. Buyers of MIGA PRI tend to come from headquarters of the sponsors, usually located in major business centers in the United States, Europe, or Japan, rather than from regional offices.

IFC combines geographical and market (industry) structures with an increasing focus on geographical structures integrating product and process components. Until recently, it did not have product-based organizational units. Recently, however, it established an equity department, and with the reorganization of the financial market departments, it has introduced departments based on product or product lines such as the short-term finance department. IFC's advisory services have been recently organized along business lines.

The Bank is similar: the geographic structure is becoming dominant, but market (industry) and process elements continue to be important. Currently, the Bank and IFC are going through a similar process of decentralization and are decentralized to a similar extent.

**Organizational structures determine the loci of decision making.** In MIGA top management in headquarters presents all project decisions to the Board for concurrence. A Project Review Committee consisting of MIGA senior management meets on new guarantee proposals early in the underwriting process to provide guidance to underwriting teams.

In the Bank, although many lending decisions have been delegated to Regions, a complex approval procedure is still followed for guarantees, with all guarantee operations requiring senior management approval. Projects are initiated by Regional departments and typically involve obtaining support from the central guarantees unit, obtaining senior management approval of an indicative PRG term sheet, obtaining inputs from Regional staff through the Regional Operations Committee, and finally obtaining inputs from Bank-wide staff and senior management approval through the Operations Committee before being presented to the Board.

In IFC, the system involves a high degree of coordination between the industry departments in headquarters, industry department staff based in the field, and Regional departments in the field. Senior management acts as arbiter in the case of disagreement but is still heavily involved in project-by-project decisions. Increasingly, the tendency is for IFC decision-making authority to migrate to the field under delegated decision-making authority.

**Distinct repositories of expertise have evolved.** In IFC, the Treasury is the custodian of product knowledge and expertise regarding guarantees, but industry and regional departments identify and develop prospects that might use risk-mitigation instruments. In MIGA, product expertise is separated into key functional units: operations (underwriters); legal, economics, and policy (country risk analysis); and finance (pricing). In the Bank, regional units now prepare guarantee projects with some support from a small central unit, if needed. The Bank's Treasury Unit retains the responsibility of maintaining knowledge and developing new products.

Table 3.3 identifies some key areas of expertise in delivering PRM in the WBG. MIGA has two

**Table 3.3: Potential Synergies of Expertise across the WBG**

| Area of advantage | Institution | Potential synergies |
|---|---|---|
| Evaluating, rating, and pricing PRI risk | MIGA | MIGA has two departments that evaluate, rate, and price PRI risk. IFC has benefited from MIGA's specialization with evaluating and pricing this risk with respect to some of its projects. The potential exists to incorporate MIGA's evaluation and pricing of PRI risk within IFC's all-risk PCGs and IBRD/IDA's PRGs to allow a more uniform approach to pricing PRI, some unbundling of pricing components, and greater transparency in risk pricing. |
| Structuring private sector financing | IFC | IFC staff have the most experience in helping clients structure private sector financing for projects. With limited capacity in IBRD/IDA, potential outsourcing of the financial structuring component of PRG projects to IFC to complement Bank sector expertise can enable the Bank to expand its capacity for PRGs without needing to build its own capacity in financial structuring of private sector projects. |
| Claims management | IFC/MIGA | MIGA and IFC both have the most experience managing claims and near-claims situations. The legal expertise that MIGA and IFC have developed in their claims practices could be applied to IBRD/IDA clients and claim situations. MIGA also has the mandate and the experience to mediate disputes between investors and governments unrelated to its own guarantees that provide opportunities for learning. |
| Regulatory framework building, high-risk, and groundbreaking projects | IBRD/IDA | IBRD/IDA has the most extensive experience providing guarantees for high-risk projects that break new ground, involve cross-country projects, and/or involve developing extensive regulatory frameworks or breach of contract. In the past, both IFC and MIGA have referred projects to the Bank for potential deployment of PRGs in such circumstances. |
| Relationship with governments | IBRD/IDA | IBRD has the closest relationship with governments and the best potential leverage in the event of a dispute. Both IFC and MIGA, although retaining their own capacity to resolve disputes with governments, have relied on Bank support in the past. To fully enable this process, MIGA has developed mechanisms to ensure that its projects are consistent with the Bank's country strategies. Similar mechanisms might be introduced for IFC products carrying significant PRM to ensure that the Bank's interventions can be fully effective. |
| Marketing | IFC | Both IFC and MIGA have dedicated marketing staff. IFC has the broadest network of private sector clients and international commercial banks that are key drivers of the demand for PRI. MIGA has a smaller staff but has developed a variety of marketing tools and established relationships with other insurance providers and brokers. Relative strengths of the marketing approach in each institution could be combined to provide stronger and more unified marketing of all WBG PRM products. |
| Evaluating commercial risk | IFC | IFC has the strongest experience and practice in evaluating and pricing commercial risk. At present, no other WBG institution currently offers commercial risk coverage for private sector firms. However, with breach-of-contract coverage—offered by both Bank PRGs and MIGA PRI—increasingly blurring the distinctions between political and commercial risk, potential engagement of IFC's capacity in assessing commercial risks might be warranted. |

*Source:* IEG.
*Note:* IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; IFC = International Finance Corporation; MIGA = Multilateral Investment Guarantee Agency; PRI = political risk insurance; PRG = Partial Risk Guarantee; PRM = political risk mitigation; WBG = World Bank Group.

departments that undertake evaluation, rating, and pricing of political risk. IFC is the only institution that has the capacity to assess commercial risk. IFC staff have the most experience helping clients structure private sector financing for projects; the Bank's capacity in this area remains small. Along with its overall leverage, the Bank's strengths in PRM are its sector knowledge, policy dialogue, and close relationship with governments that are embedded in its Regional and sector departments. IFC has the most extensive marketing infrastructure for the same broad group of clients.

**IFC has the most extensive business development infrastructure.** IFC is the only WBG institution that has meaningful business development capacity with private sector clients. Business development is done by field and Washington-based staff, often jointly. Some 600 staff of 3,200 (as of February 2008) are actively involved in promoting IFC's range of products, including risk-mitigation instruments. Half of them are based in the field.

The Bank, in contrast, has not undertaken consistent marketing and promotion of PRGs, with only occasional updates of product brochures and some promotional efforts undertaken. PRGs have tended to originate through governments rather than directly from project sponsors. By and large, the Bank has lacked consistent and systematic contact with a range of potential private sector clients.

MIGA has a dedicated marketing unit that functions mainly as a corporate relations department but does not undertake systematic business development of its guarantee operations. Operational staff are primarily responsible for maintaining regular contact with potential clients, along with MIGA's executive vice president. The extent of MIGA's business development, marketing, and outreach efforts involves a group of 26 underwriters (operational staff), 2 staff responsible for syndications, 8 lawyers, 3 staff responsible for postcontract management, and 24 staff in an external outreach department. Yet a series of client studies since 1995 have consistently noted the need for MIGA to improve its relationship with the client. IEG–MIGA's 2008 Annual Report also noted the absence of a business development plan in MIGA's fiscal 2005–08 strategic directions that would include objectives, responsibilities, and resources, and would have allowed MIGA to measure at the end of each period its effectiveness in business development and origination (IEG–MIGA 2008b). It also noted that assignment and responsibilities of individual staff for managing specific clients and key accounts are unclear.

**The Bank and IFC have tended to be more engaged in the underlying project, although MIGA's engagement is increasing.** Given the possibility that poor project economics enhance pressures to renege on commitments, PRI providers have enhanced appraisal of projects.

Within the WBG, the Bank's PRG is probably the most engaged PRI product, with Bank staff conducting extensive technical, social, environmental, and economic assessments of projects. The Bank then stays engaged in the project through regular monitoring and supervision.

IFC is also concerned with the commercial viability of its borrowers under straight and B-loan operations, as well as of clients of its PCGs. As a political risk insurer, MIGA has limited ability to influence project design and outcomes because its relationship with projects is more removed than it would be if it were a lending institution. However, as part of the underwriting process and consistent with its business model, which was introduced in 2004, MIGA now has teams of underwriters, economists, and environmental and social specialists to conduct due diligence field assessments for most nonfinancial sector projects.

Although project monitoring and supervision systems in MIGA have been minimal in the past, following several IEG recommendations, MIGA is gradually introducing greater monitoring and evaluation of its projects. This trend is in line with MIGA's broad development mandate, but it needs to achieve this efficiently. Thus, there has been some convergence with respect to the degree of involvement in project appraisal and supervision by the three WBG institutions in their guarantee-related operations.

## Overlaps, Competition, and Market Niches

**As comprehensive insurance, IFC's PCGs cover both PRI and commercial risk.** The main feature of IFC's PCG is its coverage of all risks, both commercial and political (see table 3.4). The product has an advantage over traditional political risk guarantees in situations where clear definition and isolation of specific risks are difficult. However, PCGs have been expensive, as the "loan equivalence" approach to their pricing has tended to result in higher client costs than direct lending has. Consistent with these features, IFC's PCGs use to date has been mostly limited to local currency financing needs in the banking sector in high-risk countries.

Unlike MIGA PRI and Bank PRGs, IFC's PCGs have not been used in a significant way in the infrastructure sectors. That indicates limited use of PCGs to meet demand for specific, clearly identifiable political risks, such as breach of contract. Nevertheless, market studies show increasing demand for comprehensive guarantees.

Following the Argentine crisis in 2001 in particular, clients that had comprehensive guarantees were able to recover their investments, whereas those that had PRI only were not able to, because their policies did not cover default caused by economic difficulties, local currency devaluation, or borrower insolvency (*Political Risk Insurance Newsletter* 2007). ADB, which offers both comprehensive PCGs and PRGs to the private sector, has seen stronger demand for its PCGs than its PRGs. This trend toward comprehensive coverage has also been observed in the practices of some export credit agencies and private financial institutions.

**MIGA offers a flexible product and a recognized brand name.** MIGA has a well-recognized brand in the industry. Its clients can buy single risk coverage or a combination of any or all of the four risks, making it the most "unbundled" product within the WBG.

This flexibility allows clients to purchase exactly what they need, depending on the circumstances of the project. A clear demand exists for this flexibility. More than 40 percent of MIGA guarantee projects to date have been for a single risk, and 65 percent were for either one or two risks.

Another distinct feature of MIGA's PRI is that it can be appended at a very late stage in the development of a project without significantly affecting its financial structure. It is therefore the least disruptive project-financing structure, unlike the Bank's and IFC's guarantee and PRM products. In most cases, especially for nonshareholder loans, PRI coverage is required as a condition of loan approval or disbursement, which helps the client obtain a longer loan period and better terms. MIGA has been able to enhance its capacity to take advantage of this feature despite limitations posed by its Convention that require it to insure investments prior to the investor committing any amounts. MIGA's product is also the most standardized among the WBG instruments for PRM, which allows for quicker deployment.

Thus, MIGA's PRI has comparative advantages over other WBG products in situations where specific political risks can clearly be identified, isolated, and managed; the project is at an advanced stage of development and possible funding sources have been identified; and the client wants specific, narrowly defined risk mitigation, as in the case of banks seeking relief for regulatory capital.

**IFC's B-loan product can substitute for MIGA's transfer and convertibility insurance in some situations, although it can complement other types of MIGA political risk coverage.** The implicit political risk coverage of IFC's B-loan structure can reduce banks' regulatory capital requirements and address specific provisioning and country exposure limits concerns (Hays, Audino, and Cavanaugh 2001). IFC's B-loans have been used predominantly in the manufacturing and financial sectors, both sectors with relatively low political risk intensity. Nearly 70 percent of the loans have been in medium- to low-risk countries (mostly in the

**Table 3.4: Comparison of the Main Attributes of the WBG Political Risk-Mitigation Products**

| | Risk coverage | How investor benefits | Strengths | Weaknesses 1: inherent product limitations | Weaknesses 2: policy-driven limitations | Opportunities | Threats |
|---|---|---|---|---|---|---|---|
| IFC PCG | Comprehensive | Receives comfort,[a] improved credit terms | Provides both commercial and political risk in one product; covers local currency financing; applicable where risks are unclear | Expensive; does not cover equity investments | Unable to separate risks; last resort product | Strong market demand for CI; meets local currency demand | Substitutable by direct IFC loans |
| IBRD/IDA PRG | Transfer/convertibility, expropriation, war, breach of contract, some commercial risk, some natural events | Receives comfort, improved credit terms, and is not liable for loan repayment | Increases government commitment to success of project; accompanied by policy dialogue and so forth | Demand mainly limited to PPPs and sectors with heavy government engagement in high risk countries; some heavy baggage inherent | Sovereign guarantee required in all cases cumbersome processing; high transaction costs; debt only; last resort product; limited marketing | Continued demand in high-risk low-income countries with untested regulatory environments; OBA | Improved regulatory environment reduces demand; limited commercial PPPs |
| IFC loans or equity investments with IPRI as main reason | Transfer/convertibility, expropriation, war, breach of contract | Receives comfort | Cost-effective; can provide adequate cover in lower risk situations and where clients are more familiar with country and absorb risk on own | No assured compensation to client | | Lower-risk situations increasing | Failure to ensure compensation in a few cases could end demand for IPRI |
| MIGA PRI | Transfer/convertibility, expropriation, war, breach of contract | Receives comfort, improved credit terms, mediation services and compensation in the event of loss | Flexible coverage of all PRI risks; main product for equity investments; dispute resolution; MIGA brand name in the PRI market; high PRI specialization and expertise; possible to add at end of financial structuring; minimal time and processing; fits check | No comprehensive coverage (commercial risk and political risk cover); no local currency loan financing coverage | No stand-alone debt; equity coverage; exclude domestic investors; lengthy process to change Convention limitations | Large available capacity; capacity for higher risk given excellent claims history; potential to increase demand by removing policy limitations | Declining market for traditional PRI only; bureaucratic baggage increasing to keep up with WBG demands |
| IFC B-Loans | Transfer/convertibility only | Receives comfort, improved credit terms | Package of IFC services; cost effective | Debt only; no assured compensation to client | | Combining with PRI, guarantees, securitizations | |
| IFC GOLF | Transfer/convertibility only | Receives comfort; compensation in the event of a loss | No waiting or evaluation periods prior to claim | Single risk only, complicated structure, opportunity costs of funding liquidity facility | None | Cross-border securitizations | |
| IFC CELT | Transfer/convertibility, expropriation, war, breach of contract | Carves out political risks | Package solution to various funding, risk management, and PRI needs of clients | Uncertainty as to eligibility for c-l relief, provisioning | None | International banks with subsidiaries in emerging markets | |

*Source:* IEG.

*Note:* CELT = Credit-Enhanced Lending Transaction; GOLF = Global Offshore Liquidity Facility; IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; IFC = International Finance Corporation; IPRI = implicit political risk insurance; MIGA = Multilateral Investment Guarantee Agency; OBA = output-based aid; PCG = Partial Credit Guarantee; PPP = public-private partnership; PRG = Partial Risk Guarantee; PRI = political risk insurance; WBG = World Bank Group.

a. The WBG will act to resolve disputes as they arise.

Europe and Central Asia and Latin America and the Caribbean Regions), suggesting that their risk mitigation might apply in relatively lower-risk situations or in countries where banks may have reached exposure limits. Although B-loans can meet the demand of commercial banks for PRM, unlike MIGA PRI, they do not provide explicit cover.[3]

There might still be a demand for traditional PRI to accompany B-loan products, and in these circumstances, the products are complementary. IFC has worked with private PRI providers to include options for B-loan participants to purchase certain types of political risk coverage. There have also been instances where an IFC B-loan has been combined with MIGA PRI, as in the Manila North Tollways Corporation project.

**In some circumstances, IFC's implicit PRM can be sufficient comfort to investors.** From the client's perspective, an IFC straight loan may, under some circumstances, be a substitute for a commercial loan plus formal PRI. IFC's IPRM may offer some advantages over traditional PRI. For example, investors that "self-insure" might find IFC participation itself to be adequate. Moreover, obtaining a commercial loan plus PRI adds costs and time to closing a transaction, given the involvement of multiple parties who will each conduct its own due diligence procedures and have its own documentation and requirements. Such transaction costs may be a more important factor in smaller projects: 50 percent of IFC's projects with IPRM were smaller than $50 million.[4]

In addition, IPRM may be an attractive option in situations where political risks, although present, are general and difficult to specify and isolate in advance and are lower (about 65 percent of IFC's IPRI projects were in medium- or low-risk countries). At the same time, there will always be clients who either have no funding needs but still want PRI or want explicit insurance that assures them of compensation in the event of losses.

**The Bank's PRG and MIGA's PRI compete in breach of contract coverage.** The breakdown of breach of contract coverage of MIGA and the Bank's PRGs is quite similar. Both coverages focus on infrastructure projects in high-risk countries. There are some important differences, however, in that the Bank PRGs are packaged with unique policy dialogue services. Nearly all Bank PRGs were deployed in support of large, complex PPPs, where a proactive government role was important to project success. Bank engagement in these cases went well beyond the provision of PRI in itself to provision of a range of value-added services. However, Bank engagement and requirements also added significant time and financial costs for the project sponsors.

Deploying the Bank PRG has also required pre-existing Bank programs and involvement with the government. To some extent, the product has been also rationed by supply-side constraints, and there has been a self-selection mechanism at work in that only if the demand for PRI is accompanied by the demand for strong dispute-resolution potential and proactive government engagement will a PRG be sought.

**GOLF offers similar coverage to MIGA's transfer and convertibility cover, although it is not a self-standing product and has only been used once.** GOLF has several distinctive features relative to traditional PRI products: (1) it is not offered as a stand-alone product but as part of a package with other financing; (2) as such, there is no additional due diligence required for IFC to offer the product, and additional documentation is minimal; and (3) it has the characteristics of self-insurance and this limits the product to only those countries in which borrowers perceive the currency transferability and convertibility risks to be minimal. IFC's GOLF provides single risk coverage for transfer and convertibility risk. With 40 percent of MIGA's business to date being single issue transfer and convertibility risk, GOLF overlaps closely with MIGA's transfer and convertibility risk cover. IFC, in fact, markets the product as a more streamlined version of conventional PRI.

For investors, the main advantage of the GOLF structure is that there are no waiting or evaluation periods of the type typically associated with PRI policies. Traditional transfer and convertibility coverage typically require a waiting period of 60 days to evaluate whether an event has met the policy conditions, but GOLF is automatically triggered if the issuer is unable to transfer money to an offshore account and unable to service interest payments to bondholders. GOLF is also advertised as economizing on transaction costs vis-à-vis working with traditional PRI providers.

Given that GOLF has been deployed only once, it is hard to test this assertion. However, IFC implemented two similar securitization transactions: one with MIGA PRI and the other with GOLF instead of MIGA participation. The first transaction took about three months longer to move from concept to commitment stage than the second. Given that it typically takes PRI providers less time to conduct due diligence on projects than it takes credit providers, it is unlikely that MIGA involvement per se can cause delays in closing such transactions.

**IFC's CELT is an alternative to traditional PRI for banking sector clients.** CELT is a funded transaction in which IFC takes the political risk of the host country and the credit risk of the parent company to the eligible borrowers. It was first introduced in 1997 with ABN-Amro in Kazakhstan. It has been used since then in transactions with Societe General and Bank Intesa in Ukraine, Russia, and Serbia. Overall, IFC has completed four CELTs for a total of $475 million.

PRM is an important aspect of the transaction. From the client's perspective, the structure substitutes for PRI; IFC has, in fact, marketed the product as a PRI substitute. MIGA could have provided PRI in all CELTs if those were loans from the parents. It is important to note, however, that there are important differences between a CELT and traditional PRI, including the fact that the CELT is a funded transaction and PRI is not. A distinctive advantage of the CELT over a traditional PRI is the package solution to various funding, risk management, and PRI needs of the client. Two of IFC's CELT clients are also important MIGA clients and are familiar with MIGA's product. IFC's field presence has also been a factor in the client's choice of CELT over MIGA PRI. At the same time, in other situations, the same client bought transfer restriction and expropriation of funds coverage from MIGA. Thus, investors still choose the type of risk-mitigation instrument that suits their specific needs.

**There are significant overlaps between the client bases of the three institutions.** All the PRM products of the three WBG institutions serve essentially the same broad group of clients. All of MIGA's top 10 guarantee holders are also existing IFC partners. More than 80 percent of MIGA's top 50 guarantee holders are IFC partners, and close to 60 percent of existing MIGA guarantee holders are also IFC partners. Similarly, most of the beneficiaries of the Bank's PRGs are also clients of IFC and/or MIGA.

The overlapping clientele highlights what has been observed about demand for guarantees, particularly PRI: many investors seek a variety of PRI coverage types to suit the specific needs and circumstances of their investments. This has been a consistent finding in the various market studies commissioned by MIGA over the years—investors do not purchase all their PRI from a single provider (Booz Allen Hamilton 2005; Moran and West 1998).

**There is strong anecdotal evidence that overlaps have led to some competition between agencies and confusion among clients.** Interviews with staff and clients indicate that there have been instances where staff of different institutions have approached the same client independently, each institution has worked on the same project without the knowledge of the other, or clients have been in a position to play one institution against the other. The survey administered for this evaluation also produced examples of overlaps and competition. World Bank and MIGA documents on the WBG guarantee instruments have also recognized issues of overlap that have led to competition among the three institutions and confusion among clients as to who is doing what. Some of the various products' differentiating features, such as counter-guarantee by the host government, are on the supply side and are thus invisible or immaterial to clients.

**The evaluation did not find strong evidence that overlaps have led to loss of business opportunities, but competition has often resulted in higher costs for clients.** In judging how severe the overlaps are, it is important to note that (1) the evaluation did not find clear evidence that overlaps and competition have led to loss of business opportunities for the WBG, but they have tended to impose excessive costs to clients; (2) overlaps, imperfect coordination, and approaching clients in an uncoordinated fashion are features present to some extent in any large, complex, and decentralized organization, including within IFC and the Bank; and (3) MIGA perceives overlaps as more threatening, as it has the most restrictive product space of all the WBG institutions.

**A weakness in the current structure is that products are not offered as a single menu of options to prospective private sector clients.** Because clients may perceive that the WBG institutions are poorly coordinated and compete with each other for business, there is a reputational risk for the WBG. The WBG needs to facilitate client choice in a coordinated fashion by presenting a single menu of options.

One approach is to promote common marketing arrangements among the three institutions. IFC is in a strong position to identify projects for the WBG's full range of risk-mitigation products in that it has the broadest network of private sector clients and extensive relationships with international commercial banks, which are key drivers of the demand for PRI.[5] Thus, it may be advisable for the Bank, MIGA, and IFC to complement their own marketing efforts with common marketing arrangements that specify incentives for promoting the products of all three institutions.

**Overlaps imply a need for coordination, and complementarities offer opportunities for cooperation.** Although the guarantee products of each institution were originally intended to complement rather than compete with each other, some of the distinctions have eroded with changes in the product mix as well as the market. Potential competition also comes from nonguarantee products that embed political risk coverage. Thus, complex relationships of both substitutability and complementarity exist among the WBG PRM instruments. That implies a need for coordination and cooperation.

## Cooperation on Projects—Efforts and Results

**MIGA and the Bank have both provided PRI in five large high-risk projects.** Four infrastructure projects involved both MIGA and a Bank PRG (table 3.5). MIGA also participated in the unsuccessful attempt to wholesale PRI through the Banque Ouest Africaine de Development in West Africa. They were large projects, averaging more than $900 million. Several were cross-border, including the Lao PDR Nam Theun 2 project—where the dam was in Lao PDR and most of the off take was in Thailand—and the West Africa Pipeline, which involved four countries—Nigeria, Benin, Togo, and Ghana. The large size of the projects and covered amounts as well as the complexity meant that a single agency was unlikely to be able to provide full coverage. This led to the participation of multiple PRI providers, including the Bank and MIGA.

**Cooperation can involve higher transactions costs for clients.** In some cases, cooperation came at a price, however. The involvement of various parties tended to fragment financing and increase transaction costs. Large projects such as Uch Power or Lao PDR Nam Theun 2 involved a large number of financiers and added to complexity and transaction costs. In the case of the West Africa gas pipeline, for example, PRI from IDA, MIGA, OPIC, and a private sector provider (Zurich) required the project sponsor to enter into multiple contractual agreements with different structures, coverage, and mechanics. Large projects, such as Uch Power or Lao PDR Nam Theun 2, involved a large number of financiers, and PRI from multiple parties added to complexity and transaction costs. It is unclear what benefits the sponsor of the Lao PDR power project gained from having three PRI coverages of $42 million each (from IDA, MIGA, and ADB). Benefits to MIGA from these joint projects were risk sharing and reduced due diligence costs, given the

**Table 3.5: Joint Bank-IFC-MIGA Guarantee Projects**

| Country | Fiscal year | Project name | MIGA role | IFC role | PRG role | Other PRI providers |
|---|---|---|---|---|---|---|
| **Joint Bank-IFC** | | | | | | |
| Pakistan | 1996 | Uch Power Project | | B-loan of $75 million and A-loan of $40 million | PRG for $75 million | Export-Import Bank PRI for $153 million |
| Côte d'Ivoire | 1999 | Azito Partial Risk Guarantee | | B-loan of $30 million and A-loan of $30 million | PRG for $35 million | |
| Senegal | 2005 | Kounoune Power (67.5 megawatts) | | A-loan for $20.624 million | PRG for $72. million, credit of $15.7 million | |
| **Joint Bank-MIGA** | | | | | | |
| Ghana, Nigeria, Benin, Togo | 2005 | West African Gas Pipeline (IDA S/UP) | PRI for $75 million | | PRG for $50 million | Steadfast Insurance Co. PRI for $125 million; re-insurance by OPIC |
| Lao PDR | 2005 | Lao PDR Nam Theun 2 Power Project (formerly under PE-P004206-LEN) | PRI for $90 million | | PRG for $42 million | ECA coverage of $200 million; ADB PRG for $42 million |
| **Joint Bank-IFC-MIGA** | | | | | | |
| Mozambique | 2004 | Southern Africa Regional Gas Project | PRI for R90 million of the upstream and R630 million of the downstream | Equity investment of $18.5 million in upstream portion | PRG for R140 million of the upstream and R70 million of the downstream | Of the downstream MIGA guarantee, R310 million was reinsured – R155 million each by SACE of Italy and EFIC of Australia. |
| Uganda | 2007 | Private Power Generation (Bujagali) Project | PRI for $115 million | A-loan of $100 million; C-loan of $30 million | PRG for $115 million | |
| **Joint IFC-MIGA** | | | | | | |
| Mozambique | 1997 | MOZAL | PRI for $40 million | A-loan of $108 million | | |
| Angola | 1998 | AEF Flecol | PRI for $2.3 million | A-loan of $0.61 million | | |
| Slovakia | 1999 | EuroTel. Brati. | PRI for $26 million | A-loan of $27.49 million | | |
| Philippines | 2001 | Manila Tollways | PRI for $85 million, plus $22 million equity | A-loan of $45 million | | |
| Dominican Republic | 2005 | Basic Energy | PRI for $11.1 million | A-loan of $22.65 million | | |
| Argentina | 2005 | Banco Galicia CL | PRI for $58.9 million | A-loan of $40 million | | |
| Southern Europe | 2006 | Mercator Retail | PRI for $20.3 million | A-loan of $51.23 million | | |
| Russia | 2006 | Bema Warrants | PRI for $364.8 million | A-loan of $39 million | | |
| Uruguay | 2007 | Orion | PRI for $300 million | B-loan of $70 million | | |
| Peru | 2007 | Lima JCI Airport | PRI for $11.5 million (Phase I only) | Equity of $20 million (Phase II only) | | |
| Central Europe | 2005 | BalAEF MBS | PRI for $10.1 million | A-loan of $7 million | | |

*Source:* World Bank, IFC, and MIGA data.
*Note:* EFIC = Export Finance and Insurance Corporation; FY = fiscal year; IFC = International Finance Corporation; MIGA = Multilateral Investment Guarantee Agency; OPIC = Overseas Private Investment Corporation; PRG = Partial Risk Guarantee; PRI = political risk insurance.

Bank's full economic, technical, social, and environmental appraisal.

**The PRG has been combined with IFC lending to increase the amount of financing for a few large high-risk projects.** Joint Bank–IFC PRG financing took place in the Côte D'Ivoire Azito project, the Pakistan Uch Project, the Mozambique (Southern Africa Regional Gas Project) gas pipeline, and the Uganda Bujagali project. MIGA also provided coverage to the investors of these last two projects.

In all these countries the Bank had a longstanding policy dialogue and had been involved in developing the regulatory framework for private sector participation. The project in Côte D'Ivoire was the first PPP in the power sector in Africa, and the Mozambique project was the first to test the new legislative framework in the gas sector and the only IBRD enclave guarantee. In these contexts, even with the participation of IFC, adequate levels of commercial finance could not be raised and the sponsors approached the Bank for a PRG.

In Pakistan, two successive power projects illustrate the potential synergies of IFC participation. Under the first project (Hub) in which IFC did not participate, the Bank's PRG helped obtain 12-year loan maturities with a guarantee for 23 percent of the project cost. In the subsequent Uch project, in part because of greater investor familiarity with the country but also because of IFC's participation, 15-year maturities were obtained with a PRG that covered only 12 percent of project costs.

**Subnational finance exploits the comparative advantages of the Bank and IFC.** The joint IFC–Bank Subnational Finance Department has institutionalized some synergies between IFC and the Bank in subnational finance. In fiscal 2006, the Bank and IFC collaborated on an IFC guarantee operation to support the Chuvash regional government in Russia. The experience involved dual roles that exploited the Bank's relationship with regional governments and its strengths in public policy, the social sectors, and fiscal management along with IFC's financial structuring experience and ability to finance without a sovereign guarantee.

Several issues arose during the experience, however, including the availability of Bank staff, who tend to be programmed more in advance than the IFC, within a timeline imposed by the client's budgetary authority to issue the bond; and the question of how Bank staff would be recognized for their contributions that would not result in a Bank product and how their participation in subsequent supervision of the project would be funded. Issues identified in other subnational projects include limited staff familiarity with the products and processes of other Bank institutions, the possibility of delays caused by parallel decision making in the Bank and IFC, and finding the right balance in the extent of policy/institutional reforms that should be included in a capital market operation that funded public expenditures.

**IDA lending has also been combined with IFC PCGs to enhance SME access to finance, although difficulties persist.** An important new area of cooperation between IFC and the Bank is the SME program in Africa. This program combines IFC's PCGs and IDA funding. So far, two joint projects have begun in Madagascar and five projects are under preparation. The programs have two participating banks, which have disbursed about 64 percent of the $25 million total for SME loans.

However, several issues have arisen out of the experience: Different processes and misaligned incentives have made it difficult to mobilize IDA resources for first-loss provisions; the need to fit these operations into existing IDA loans or operations in the country has been a limitation; and procurement and conflict-of-interest policies have added to transaction costs. A lack of continuity of staff working on these transactions has limited opportunities to replicate the program.

Thus, the IDA–IFC SME programs have had high transaction costs and have been difficult to replicate. To some extent, high transaction costs are inherent in the development of new products and solutions. Lessons from this first experience are being reflected in ongoing work and are likely to lower the development costs of new projects under preparation.

**The pledge of shares and sharing of arbitral awards issues have limited direct cooperation between IFC and MIGA.** IFC and MIGA have jointly been involved in about 10 projects over the last 10 years. Most of these joint projects have been relatively large transactions in the infrastructure and financial services sectors, where MIGA has typically provided political risk coverage on the equity (or junior tranches in the cases of securitization) side of the financing and IFC has provided debt financing. In one cross-border high-risk transaction in the manufacturing sector, MIGA's PRI has been critical in providing comfort to the investor to make a large equity investment. In the first cross-border securitization of residential mortgages in Eastern Europe, a MIGA guarantee ensured that the notes pierced the foreign currency country "ceiling."

A few issues have emerged in the limited cases where the two institutions have worked together. In some instances, IFC staff working on joint projects had the impression that MIGA's involvement added to processing time. IFC implemented two similar securitization transactions: one had MIGA PRI and the other did not have MIGA's participation but had similar enhancement that IFC provided. The first transaction took about three months longer to move from project data sheet-extended review to commitment than the second. IFC management has been consistently concerned about the possibility of IFC becoming a beneficiary of MIGA coverage under certain circumstances. IFC management has also been reluctant to engage MIGA in its B-loan program on the grounds that minimal involvement of the WBG would be the preferred option when available and it would involve an unnecessary double use of the WBG's preferred creditor status.

The pledge of share issue has also been a matter of contention for some time, and although solutions have been worked out, the issue re-emerges every time IFC and MIGA work on a joint project. A generic solution is needed to avoid miscommunication with clients and to enhance opportunities for the two institutions to cooperate on projects. This issue has not been an impediment to MIGA working jointly with other investors; in cases where the issue has arisen, it has been resolved through a claims cooperation agreement. MIGA requires that it cover the shares as evidence of ownership of the investment. Such clear evidence is critical for recovery from the host government. The claims cooperation agreement for the Bujagali hydroelectric power project provides a template to resolve the pledge of shares and sharing of arbitral awards, but it needs to be institutionalized for joint WBG projects.

**Cooperation has been driven as much by clients' preferences as by internal institutional reasons.** There have been benefits to joint WBG projects, but their occurrences have been relatively few and cooperation has tended to add to costs. In some circumstances, WBG products can be direct substitutes rather than complements. In such cases, internal pressures to promote joint projects can bring few gains and significant costs for clients. The objective should be to enable deployment of the product with the best fit for client needs rather than to promote joint products for internal institutional reasons. The principle of minimal WBG involvement is embedded in various WBG policies; basically, WBG involvement is expected to be kept at a minimum to make transactions possible.

## Coordination Mechanisms

**Given the potential for overlaps, several mechanisms to ensure coordination between the WBG have been established, although with varying effectiveness.** Given both the potential synergies in products and the potential overlap in clients and the need to ensure that clients are not confused by the array of WBG risk-mitigation instruments, the need to ensure proper coordination among the three WBG institutions is clear. Efforts to coordinate deployment of guarantees to reduce duplication and ensure complementarity have included (1) establishment of a hierarchy of instruments to govern the deployment of the various WBG products; (2) involvement of all three institutions in the Country Assistance Strategy (CAS) preparation process; (3) establishment of a Guarantee Review Committee (GRC), chaired by the IFC executive vice president, with representation from all three institutions; (4) increased linkages at the sector, policy, and operational levels among the three institutions; and (5) staff training across the WBG to increase familiarity with the all products. However, as discussed below, although these efforts have improved coordination to some degree, they have not been fully effective.

**The products were designed to not compete with each other, but their differences—created by institutional mandates and policies—are somewhat artificial and not necessarily client friendly.** In any particular circumstance, if policies are strictly followed, there is only one WBG institution that can meet a client's needs for a guarantee product for a particular type of investment. Thus, by design, the guarantee instruments of the three WBG institutions have distinctive features that make them complementary rather than substitutes. However, several key differences among Bank, MIGA, and IFC PRI products are driven by internal operational mandates and policies. This creates an artificial supply-driven product differentiation that is not necessarily aligned with patterns of demand and that forces a client to deal with a completely different institution based on the type of investment. This has complicated the implementation of coordination mechanisms.

**The hierarchy of instrument principle has provided some guidance, but its implementation has been difficult.** In 1997 a hierarchy was established under which the deployment of WBG risk-mitigation instruments would adhere to the principle of market first, MIGA/IFC facilitating the market second, and the World Bank (with its sovereign counter-guarantee) as a last resort. In 2000 a further clarification was made on the deployment of IDA/IBRD PRGs vis-à-vis IFC and MIGA products. The Bank's PRGs would be considered for deployment only when one or several of the features (explicit counter-guarantee, influence of the Bank, linkage to the Bank's sector dialogue, or conditionality) were critical from a risk management and/or market point of view. Thus, Bank PRGs would be deployed when sector reform was in its early stages and the operation was larger and riskier and highly dependent on government support or undertakings.

These principles remain relevant, but internal reviews have acknowledged that implementation has been complicated by the fact that the hierarchy principle has often conflicted with the preferences of governments and market participants. Thus, the hierarchy of instruments has been mainly a supply-driven approach to the deployment of instruments rather than a reflection of market demand. Internal reviews have also noted that the three WBG institutions have not always adhered to the principle, sometimes pursuing the same projects independently of each other.

**The principles that govern the relationship between MIGA and IFC products have not been clear.** The hierarchy of instruments principle applied mainly to IBRD/IDA instruments relative to other instruments, and the principles of deploying MIGA PRI and IFC's instruments have not been articulated. The WAEMU Capital Market Development Project established more detailed principles of deployment of Bank PRGs, MIGA PRI, and IFC-type PCGs. In the WAEMU guarantee facility, IDA's PRGs, MIGA PRI, and AfDB's PCGs and comprehensive guarantees were to be marketed by BOAD to prospective investors/lenders as separate but complementary products and deployed on the basis of project profiles. Detailed guidelines for deployment were prepared, but the facility was not successful, so the rules and guidelines for deployment could not be tested.

IFC has marketed GOLF and CELT products as superior to traditional PRI, creating some tensions between IFC and MIGA. It also appears that in marketing efforts, IFC has at times emphasized substitutability between its implicit political risk coverage and formal PRI. This leaves potential clients with the impression that if IFC is involved in a transaction, there is no need for MIGA's involvement.

**Guarantees are sparingly featured in CAS cycles.** The initial expectation for IDA guarantees was that CASs would clearly establish whether guarantees were justified and the extent to which such instruments would be used. CASs were expected to indicate the sectors and projects where guarantees would be more appropriate than loans.

A review of 40 recent CASs (20 IDA and 20 non-IDA countries) was carried out to assess the extent to which guarantees were taken into consideration during the formation of CASs. Reference to potential deployment of a MIGA guarantee was frequent, but just 13 of the 40 identified a potential use of an IFC or Bank guarantee. In cases where guarantees were referenced, moreover, they were general in nature, with almost no specifics on the potential application of the instruments.

**A WBG-wide GRC had limited success in harmonizing approaches, and it added to transaction costs.** In March 1999 a GRC was established to coordinate the Bank PRGs with the activities of IFC and MIGA. The committee was chaired by the IFC's executive vice president and had some success in improving the tone of and relationship between institutions, particularly between IFC and the Bank. Discussion and formal endorsement of a potential PRG by the GRC helped minimize internal disagreements, ensure consistency with the hierarchy of instrument principle, and enhance the prospects of MIGA and IFC participation in the PRG projects.

The GRC was confined to reviewing Bank PRGs, however, and did not consider complementarities or overlaps of proposed IFC and MIGA risk-mitigation instruments. Some staff perceived it mainly as a mechanism to carve out spaces for IFC and MIGA in PRG-supported projects, rather than to ensure the deployment of the most suitable instrument. The GRC was not successful in promoting business, simplifying processes, or harmonizing approaches. In fact, it created a further layer that added to transaction costs. It ceased to exist in 2005, when the previous IFC executive vice president departed and those functions were transferred to the Bank's Operations Committee.

**Several further mechanisms to coordinate risk-mitigation products at the Regional, sector, policy, and operational levels have been established, although gaps remain.** MIGA has introduced a range of mechanisms to improve coordination with the Bank and IFC at the institutional, policy, strategic, and operational levels. For example, it participates in several sector boards, has integrated its technical assistance services into the Foreign Investment Advisory Service, and is harmonizing its environmental and social policy and performance standards with those of IFC's. More systematic consultations between MIGA and Bank country and industry departments have also helped ensure that MIGA-supported projects are consistent with the WBG's strategy in a country. For MIGA, this coordination at the project level has been both a way to manage risks going forward and a necessary condition to be able to use its relationship with the Bank and governments to work out potential problem situations.

The same degree of consultation on IFC projects carrying IPRC is not apparent, however. Often IFC's ability to deliver on its IPRC is premised on the tacit or active cooperation of the Bank. There is, however, no mechanism to ensure that the IBRD and IFC cooperate in the context of an IPRC event. IFC and the Bank have at times had different views on government policies in the context of specific IFC-supported projects; that can affect IFC's ability to deliver on its IPRC. Given the reliance of IFC's IPRC on the WBG's relationship with governments, more coherent views and systematic coordination are clearly desirable.

**A degree of informal coordination has also been effective.** Staff interviews indicate that a degree of coordination takes place informally between staff who share information, market intelligence, and bring information to each other's attention. IFC's infrastructure department, for example, advertises the Bank's PRG and advises clients to take advantage of it when appropriate. Bank PRG staff have from time to time referred projects to MIGA or IFC; on a few occasions these referrals have led to MIGA or IFC projects. MIGA has also referred clients to the Bank's PRG as a more appropriate instrument (such as the case of Phu My 2 in Vietnam). This coordination is ad hoc, however, and often depends on individual relationships.

**Limited coordination in the development of new products is also apparent.** The experience of IFC's introduction with products that carry PRI (CELT and GOLF) and the Bank's introduction of guarantee facilities indicate that there is limited coordination in new product development. Information exchange and some sharing of expertise have taken place, but there has been no systematic review of the implications of new products across the WBG. The Quality Assurance Group review of the Bank's guarantee facility in Peru, for example, concluded that a more proactive approach could have been made to engage MIGA/IFC expertise in the design of the operation and strengthen complementarity. It was observed that MIGA had had generally negative experience with guarantee facilities that could have been instructive and that IFC had significant experience with infrastructure investments in the Latin America and the Caribbean Region and had expressed reservations about demand that could have been better explored.

In October 2006 IFC constituted a New Products Assessment Group to help ensure a coherent and efficient approach to new product development. The group assesses the expected risks and benefits of new products and recommends whether the product should be introduced. IBRD/IDA has established a similar group, the Finance Instrument Subcommittee, which also oversees financial product innovation. Given that the products reach the same clients, an opportunity exists for the respective units responsible for new product development in the three institutions to establish links to facilitate mutual exchange of inputs from their perspectives on new product development.

**Lack of staff incentives and familiarity with the products of the other institutions has prevented exploitation of clear synergies in marketing the WBG's products.** A survey of staff who have worked on guarantee products in each of the three institutions indicates that there is a high degree of unfamiliarity with the products of other institutions. For example, only 23 percent of IFC staff indicated that they were familiar with IBRD/IDA PRGs, and less than half were familiar with MIGA PRI. In addition, there are no incentives for staff, including those in field offices, from one institution to promote the products of the other. In the case of the municipal finance operation in Russia, for example, there was some question as to how Bank staff would receive recognition for work that did not result in a Bank product.

**There is significant potential for more systematic links between Bank/IFC advisory services and the deployment of WBG risk-mitigation instruments, particularly in infrastructure.** Synergies between WBG advisory services on regulatory reform and structuring specific PPP transactions have also not been fully exploited. At present, IFC investment teams typically get involved in a transaction when the structure of the deal has already taken shape. MIGA's involvement is usually at an even later stage, when the financing structure is largely in place. Some of the Bank's PRGs, however, have been introduced as part of the bidding documents for PPPs.

Greater upstream engagement of WBG risk-mitigation products might be enhanced with closer links to Bank and IFC advisory services that help establish an appropriate regulatory framework and develop a specific PPP transaction. IFC's corporate advisory services, in particular—that is, helping governments design concession agreements and privatization—represent a potentially important mechanism to more systematically introduce WBG risk-mitigation products earlier in a project's development. As the CAS is involved in the initial stage of project design, it can include options in the bidding package for the winner to take advantage of Bank PRGs, IFC financing, or MIGA PRI. Stronger links offer the potential to coordinate WBG involvement and offer an optimum product configuration from the client's perspective.

**The Bank applies a completely different approach to product pricing for private sector**

**Table 3.6: Comparison of WBG Pricing (guarantee fees)**

| Project | Bank | MIGA | IFC |
|---|---|---|---|
| West African gas pipeline project (IDA) | .75 | 1.15 | |
| Nam Theun 2 power project, Lao PDR (IDA) | .75 | 1.65 | |
| Private power generation project (Bujagali), Uganda | .75 | 1.3 | |
| Southern Africa regional gas project, Mozambique (IBRD enclave) | 2.0 | 1.3 | |
| IFC GOLF mortgage-backed securities, Russia (IDA) versus MIGA Raffeisen Leasing, Russia (MIGA) | | 1.01 | 0.5%/ LIBOR + 2% |

*Source:* WBG data.

*Note:* Guarantee rates are for principal amounts of ID guaranteed loans (IDA), aggregate principal amount (IBRD), and current coverage (MIGA) and do not include processing, front-end, initiation, or standby fees. IFC and MIGA offered the same coverage for their comparison, and the Bank had equivalent or greater coverages than MIGA. IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; LIBOR = London Interbank offered rate; MIGA = Multilateral Investment Guarantee Agency; WBG = World Bank Group.

**clients.** In 2004, MIGA introduced a model that provided pricing guidance for its guarantees based on cost plus risk. In 2007 it refined the pricing model to account for financial, market, and policy considerations. Current actual pricing continues to be based on cost plus risk, with some adjustment to account for market factors.

Application of this model still has some weaknesses—such as the inability to accurately capture per project administrative costs—yet it represents a pricing approach that reflects the nature of the risks being covered. In contrast, Bank PRGs are not priced for sector, country, or type of risk covered but are instead offered across countries and sectors according to a set schedule of charges that are based on loan-equivalent pricing. A comparison of the Bank's PRGs and MIGA's PRI in four joint projects indicates that pricing of IDA PRGs was lower than MIGA's PRI in three IDA projects; however, the IBRD enclave PRG in Mozambique, priced at IBRD terms at the time, was priced higher than MIGA's PRI.

A comparison of IFC's GOLF and MIGA PRI in a project in Russia, for which both provided transfer and convertibility coverage, indicates that the cost of IFC GOLF is much higher if coverage is triggered but is half the price if the facility is not used (see table 3.6). IFC is piloting and using a new capital pricing and risk approach for internal risk-management purposes, including pricing. Nevertheless, IFC has not yet developed a good system for pricing specific risks; in the few instances where it has covered political risks, as in the case of a CELT transaction, it has used MIGA pricing as a reference. Both IFC and MIGA prices are sensitive to market signals, but Bank pricing is not.

**A more uniform approach to PRM pricing could help eliminate potential market distortions and reduce the need for hierarchical application of instruments.** The Bank's set schedule of PRG pricing is not consistent with the pricing approaches MIGA uses for its PRI. The Bank's long but unsatisfactory experience with Financial Intermediary Loans—the only other Bank instruments that reach the private sector—revealed that undermining commercial lending rates led to market distortions and crowded out the private sector (IEG 2006). Table 3.7 presents benefits of a more uniform approach to PRM pricing.

The Bank's Operating Principle 8.30 also requires that in financial intermediary lending, on-lending occur at or near market rates. Should this logic be extended to PRGs, which also reach private sector clients, then PRG pricing should be revisited and perhaps more closely aligned to MIGA's model.[6] This alignment would reduce the potential for market distortions as well as reduce the need for the rationing on the supply side through the hierarchy of instruments principle, in that it would allow the most appropriate WBG product to be deployed according to the particular cir-

**Table 3.7: Benefits of a More Uniform Approach to PRM Pricing**

| Benefits | How benefits would unfold |
|---|---|
| Help eliminate market distortions | The WBG guarantee operations are part of a broader market that measures and prices political and commercial risks. By adopting a more uniform pricing approach that more closely reflects actual risk and cost, the WBG can help avoid giving the market confusing signals regarding risk pricing, thus helping enforce market discipline and efficiency in resource allocation. |
| Explicitly recognize pricing incentives provided to clients | By adopting a more uniform pricing approach that more closely reflects actual risk and cost, the WBG can more clearly recognize and track the pricing incentives given to various types of clients to pursue strategic development objectives and maintain competitiveness in the market for PRM. |
| Monitor and improve delivery efficiency | By adopting a more uniform pricing approach that identifies the cost of administrating and delivering guarantees, the WBG can better track the factors that impede delivery efficiency. |
| Improve the allocation of risk capital | Each of the WBG institutions has recourse to a capital base that can help it meet any guarantee obligation that arises. By adopting a more uniform pricing approach that incorporates the cost of this underlying risk capital, the WBG can better recognize and optimize the costs of capital incurred in its guarantee operations. |

*Source:* IEG analysis.
*Note:* PRM = political risk mitigation; WBG = World Bank Group.

cumstances of the project, rather than according to price.

Such an approach may at times reduce the price of a PRG, such as the case of the IBRD enclave operation in Mozambique. In other cases, higher fees charged to the private sector firm might be transferred to the government to offset costs associated with issuing a counter-guarantee. For IFC, an important although difficult question is whether efforts should be made to unbundle the implicit political risk coverage embedded in IFC's traditional products.[7] It is important to note that in today's market reality, the major players are typically financial conglomerates, which often take a relationship approach rather than product-by-product approach to pricing. Under such an approach, loans are typically the loss leaders, and market players look at investment banking, equity, and other products for return. Thus, multiproduct firms tend to cross-subsidize across products.

As a multiproduct firm, IFC can also be forced by the market to cross-subsidize across products. The demand for MIGA PRI is affected by the level of loan spread in the market, but MIGA as a single-product firm does not have the flexibility to subsidize across products.[8] These differences present some challenges to the application of a consistent pricing approach across the three institutions.

## Improving Delivery: Some Organizational Realignment Options

**Given the existence of both overlaps and complementarities among the WBG PRM instruments, Board members and management have asked about alternative ways to organize the delivery of WBG guarantee products so that synergies are maximized and redundancies eliminated.** In this context, efforts have been made through several internal notes and presentations to take a fresh look at the way the delivery of guarantee products is organized within the WBG (World Bank 2005, 2007b). Various options have been presented, ranging from the status quo with increased coordination at the level of country/sector strategy, environmental analysis, and joint Board papers to explicit

**Table 3.8: Simple Comparison among Organizational Options**

| | Efficiency | Minimizing conflicts of interest | Coordination |
|---|---|---|---|
| Client integrated | High | Medium | Medium |
| Country integrated | Low | Low | High |
| Product integrated | Medium | High | Low |

*Source:* IEG analysis.

institutionalized incentives and policies for staff collaboration, to organizational integration, meaning jointly administered staff, budget, and targets (World Bank 2007c).

With the objective of making a better use of the array of guarantee instruments within the WBG to better attain its mission, this evaluation presents some options involving organizational realignment and briefly analyzes their potential benefits and costs. The options examine three alternative integration perspectives: client, geographic market, and product (see table 3.8).

### *Private sector–client-integrated approach*

**Description and rationale.** Under this approach, all products for private sector clients would be offered in an integrated fashion. Of all WBG institutions, IFC has the most extensive relationships with private sector clients, the most systematic business development capacity, and presence on the ground. IFC also offers the broadest set of products to private sector clients. Thus, under this approach, the decision making regarding the delivery and deployment of risk-mitigation products—including political risk—would be placed within the IFC. The separate legal identities and balance sheets of MIGA, IFC, and the Bank (with respect to the PRGs) would be preserved.

In this scenario, marketing, business development, product choice, and supervision of PRGs and PRI products could be led by IFC, and MIGA could do underwriting. For the purpose of aligning incentives, IFC's internal system for double booking investments between IFC's regional and industry departments and the joint venture approach applied in the case of joint projects could be extended to include MIGA and Bank PRGs.

**Potential benefits.** This approach could combine the relative strengths of IFC and MIGA with respect to working with private sector clients: the marketing, business development, and structuring capacities of IFC, and the processing and booking processes of MIGA. IFC would be able to offer private sector clients a richer package of financial products that would now include stand-alone PRI. The expanded menu of products could create efficiencies through economies of scope in marketing a variety of financial services to private sector clients. This approach would provide a single point of entry and address the coordination issues among IFC, MIGA, and the Bank. It has the potential to minimize internal competition, overlaps, and client confusion.

**Potential adverse effects.** Conflicts of interest may arise, given that IFC would be making the decisions, but consequences could be borne by the balance sheets of MIGA and the Bank. There may also be a conflict of interest in IFC's determination of which product to recommend to a client. Given IFC's preference for funded solutions, this approach may result in fewer choices for private sector clients relative to the status quo. MIGA's PRI has often been an unfamiliar or misunderstood product by IFC staff and—in most cases—perceived as a second best option to IFC's clients.

This arrangement could thus add another constraint for the growth of MIGA's business. Another potential issue is the incentives to offer PRGs under this approach. Demand for Bank PRG solutions has often come from governments, and a private sector–client-focused structure may not be able to capture this source of demand effectively. Further, a number of PRG transactions involved years of preparation and discussions with the governments, and it is not clear whether the incentives to maintain the long-term dialogue with the government and sponsors would be preserved under IFC leadership. Thus, under this option the IDA/IBRD PRG product may see even less deployment than now.

### *Country-level integrated approach*

**Description and rationale.** Under this approach, coordination and integration of guarantee products would take place at the country level. The developing member country is viewed as the ultimate client, and all the tools at WBG's disposal would be used to further the country's development priorities. The deployment of WBG guarantee products is thus coordinated at the country level, in close partnership with the country's government, rather than with respect to private sector client needs. This approach would imply that all decisions about the deployment of WBG guarantee instruments would be in the purview of a common management arrangement, taking into consideration the full array of WBG products available.

**Potential benefits.** Such an approach would enhance coordination among the deployment of *all* WBG products, not just among the guarantee instruments. As discussed earlier, substitutability and a certain degree of competition exist between some guarantee and nonguarantee products; coordination at the country level could address this issue by facilitating deployment of all WBG products in line with country needs. With respect to PRM, the advantage of this approach is that it builds on WBG's comparative advantage in mitigating political risks through close partnership with the government authorities.

**Potential adverse effects.** This approach may entail conflicts of interest, particularly between IFC investments and Bank policy advice. Conflicts of interest are much less pronounced in the relationship between MIGA and the Bank, as MIGA does not benefit from the commercial success of a project. Thus, MIGA does not face a conflict of interest in its dealing with the Bank country director, where the Bank director may be providing advice that may have an impact on the commercial profitability of a project.

The joint World Bank–IFC operational departments (oil, gas and mining, and communications and information technology) have developed procedures to deal with such conflicts of interest. The experience of the global product groups, however, is not an indicator of the likely success of this approach, as these groups do not involve integration at the country level.

Another potential negative of this approach is that it could add to processing time and transaction costs, as it may rely more heavily on Bank procedures and processes in dealing with private sector clients. A possible inefficiency would be the loss of staff underwriting skills if it is carried out by the World Bank. Staff knowledge of guarantee products and underwriting expertise at the country level would have to be built.

### *Product-level integrated approach*

**Description and rationale.** Under this approach, all insurance products would be under one roof. As the WBG institution specializing in PRI, MIGA would consolidate all the PRM and insurance products of the WBG. Thus, IDA/IBRD PRGs would be delivered under the decision-making leadership of MIGA. This option could also entail expanding the scope of MIGA by enriching its mandate with other insurance products (including commercial) not currently offered by the WBG, to keep up with trends in demand and market developments. This would not affect the deployment of IFC's existing products.

**Potential benefits.** This approach would allow greater specialization in the delivery of guarantee products. Structuring and assessing the risks of guarantees could be quite different than for loans and equity investments. Thus, it might be argued that clients would be better served technically by such specialization. A dedicated product-based structure would also minimize potential conflicts of interest in the offering of funded versus non-funded solutions. MIGA would reach a critical mass that would allow it to take more risks, innovate on a more systematic basis, and develop systematic business development capacity. Using MIGA's relatively lenient processing to deliver Bank PRGs would result in efficiency gains.

**Potential adverse effects.** The approach may not address the competition to PRI from traditional nonguarantee IFC products that embed implicit political risk coverage, as well as the

**Box 3.1: The 2005 Proposal to Develop Synergies between the World Bank and MIGA Guarantees**

***Rationale.*** Similarities between MIGA's breach-of-contract coverage and IBRD/IDA's PRG provided the impetus to create a working group comprising the Bank's Project Finance and Guarantee Group and MIGA that would institutionalize the collaboration between the two "so that synergies for the use of guarantees as an important tool in mobilizing the private sector for infrastructure delivery are aligned and potential synergies between the various guarantee products are fully exploited." Demand was growing for these guarantee products, and despite previous joint guarantees in several projects,[a] there was confusion among the private sector, the Bank's Regional staff, and governments to differentiate between the breach-of-contract coverage and the PRG. This confusion has inhibited their successful deployment.

***The Recommendation.*** The Project Finance and Guarantee Group recommended that the management of the Bank's guarantee program be transferred to the MIGA executive vice president, who would act as an officer of the World Bank with respect to Bank guarantees; it also recommended that the group report directly to the executive vice president. It also concluded that the merger would provide the right institutional set-up for the two units to work closely together with the end goal of "positioning guarantees as the WBG's primary risk-mitigation instrument in mobilizing private investment." The proposed integration was expected to increase the relative strengths of the Bank and MIGA for optimal service delivery to private sector clients and governments, enhance the coordination of product offerings, close potential product gaps by providing a "one-stop shop" for guarantees, and create an enhanced platform for sharing knowledge and facilitating product innovation and structuring of new forms of risk sharing.

***The Outcome.*** The working group made recommendations about the organizational structure and modalities for integration, such as linkage to the Infrastructure vice presidency, avoidance of conflicts of interest, and human resources and budget frameworks; however, no progress has been made on the integration since the working group submitted its report in 2005. Since then, the Project Finance and Guarantee Group unit has been dissolved and its function had been dispersed to the Bank's country and Regional offices. Although this arrangement links the decision to offer the PRG to clients with the policy dialogue, the uptake by the private sector has been slow since this function was dispersed. Possible explanations include that decisions to use guarantees are normally made at the investor's headquarters and not at their representative offices and that Bank staff at the country or Regional offices do not have the necessary expertise to market the product.

*Source:* World Bank, MIGA.
*Note:* IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; MIGA = Multilateral Investment Guarantee Agency; PRG = Partial Risk Guarantee; WBG = World Bank Group.
a. Such as Nam Theun 2 Hydroelectric Power Project in Lao PDR and Thailand; UMEME Power Distribution Project in Uganda; Bujagali Hydroelectric Project in Uganda; South Africa Regional Gas Project in Mozambique; and the West African Gas Pipeline Project in Ghana.

competition coming from product innovation. If PRGs continue to be booked on the Bank balance sheet, then conflicts of interest would remain.

An important issue would be how to preserve the unique and distinctive features of Bank PRGs, which derive from Bank dialogues with the government, under such a structure. Applying the internal booking system of IFC may be an approach to consider in this regard. Given MIGA's mandate to encourage FDI flows into developing countries, the changes to its convention could make sense, but it will be a lengthy and complex process.

**A version of the product-focused approach was attempted in 2005,** when a working group made recommendations about the organizational structure and modalities for the integration of Bank PRG and MIGA under the leadership of MIGA's executive vice president. However, no progress has been made on the integration since the working group submitted its report in 2005 (see box 3.1).

**A flexible and pragmatic approach may not require organizational changes.** It is important to note that organizational changes in themselves do not automatically produce desired outcomes. For instance, other multilateral development banks have, as a rule, adopted country-integrated approaches to the delivery of their products; however, their operations differ significantly, including the relative shares of their private and public sector activities.

The literature on organizational change identifies incentives, culture, and "commitment at the top" as more important factors for achieving strategic objectives than simply redrawing organizational boundaries (Mintzberg 1994). If these ingredients are in place, desired results can often be achieved without organizational changes. Many of the benefits identified above can be achieved within the current structure, provided incentives and commitment at the top are in place.

For instance, the benefits of joint marketing to private sector clients can be achieved among IFC, MIGA, and Bank PRG by properly aligning incentives, including by following models currently used within IFC—such as shadow booking, double booking, joint ventures, and so forth. Efficiency gains can be achieved by harmonizing among the three institutions the procedures and practices of working with private sector clients along the lowest cost common denominator. MIGA's scope of action can be enlarged gradually, first by encouraging innovation within the scope of the current operational regulations (as recommended by this evaluation) and over time by relaxing constraints in the authorizing environment. Such a hybrid approach may provide a more flexible and pragmatic response to changes in internal and external environments.

## Conclusion

WBG guarantee instruments have been designed as complementary products. In reality, however, there have been overlaps and competition within the WBG in the delivery of PRM to private sector clients. Overlaps, despite complementarity by design, have been driven by innovation and flexibility in interpretation of policies. Competition for the Bank and MIGA PRI has come from new and traditional nonguarantee IFC products that incorporate explicit and implicit political risk coverage.

The WBG has not suffered from any paucity of coordination mechanisms in delivering guarantee products, although these mechanisms have been only partially successful and significant gaps exist with respect to coordination needs. Cooperation in joint projects has brought benefits as well as additional transaction costs. Changes in organizational structures have created new challenges and offered new opportunities to enhance WBG coordination in the delivery of guarantee products.

**This evaluation found that the delivery of the WBG's guarantee instruments has several strengths,** including the following: (1) WBG guarantee instruments are effective tools to promote the WBG's development objectives; (2) they expand the range of instruments available to the WBG to best meet client needs; (3) each instrument can meet the demand for risk mitigation under different circumstances; (4) MIGA, a relatively small institution of 120 people, has issued $17 billion of guarantees that supported the flow of $78 billion in foreign investment in developing countries and accounts for about 4 percent of the global market for PRI; (5) the Bank's PRG instrument has supported some of the largest and most complex PPP infrastructure projects in high-risk developing countries that would have been unlikely without the engagement of the Bank; and (6) IFC's guarantee instruments have led its penetration of the market for local currency finance, and its ability to take commercial risk has placed it in a unique position of meeting the demand for commercial and political risk mitigation.

This evaluation therefore recommends that the WBG maintain its broad range of guarantee instruments, as they offer WBG clients a greater choice of products to meet their needs.

**At the same time, a range of important weaknesses in the WBG's delivery of guarantee instruments is apparent.** Although the overall demand for WBG guarantees is conditioned by varying market conditions, the WBG needs to create an environment in which guarantee products are deployed in a flexible manner in response to evolving client needs. In this respect, the evaluation found a range of internal weaknesses that effectively inhibit the deployment of the WBG guarantee instruments:

- Competition among institutions for the same clients and of the kind that often imposes additional transaction costs on clients and adds reputation risk for the Bank

- Weaknesses in the marketing efforts for MIGA and Bank products that limit client awareness and choice
- A range of supply-driven policy and mandate restrictions that inhibit the deployment of WBG guarantee instruments in specific situations
- Limited internal awareness, skills, or incentives in the Bank and IFC to use guarantee instruments in relevant situations
- Inconsistent pricing of the Bank PRG instrument, which runs the risk of WBG products being differentiated based on price
- Weak links between advisory service activities on PPPs in infrastructure and deployment of guarantee instruments that do not take full advantage of the opportunities to systematically introduce a range of WBG risk-mitigation products earlier in a project's development.

# Chapter 4

MIGA guaranteed the water treatment project in China. Photo by Roger Batstone.

# Recommendations

## WBG Management

To overcome the current limitations of the delivery system of WBG guarantees and PRM instruments and enhance its use and development potential, IEG recommends the following to WBG senior management:

1. **Take a strategic approach and make a decision on whether to maintain the existing organizational structure while addressing some of the important problems, or develop and propose an alternative organizational structure to the Board**.

2. **Under any scenario, take action to introduce greater flexibility in the use of guarantee instruments in response to dynamic country and client needs and market developments by taking the following actions:**

   - **Revising existing policies and regulations on guarantees to minimize supply-driven product restrictions where most needed and to allow product differentiation on the basis of value added.** Current policies and regulations contain supply-driven restrictions that do not eliminate overlaps yet tend to add to transaction costs and reduce the WBG's flexibility to respond to client needs. Processes that add value with respect to risk mitigation and safeguards need to be maintained and strengthened. The hierarchy of instrument principle has often conflicted with the preferences of market participants and has been a supply-driven approach to the deployment of instruments. Similarly, the product differentiations based on eligibility and mandate restrictions in the three institutions have also reflected artificial supply-driven product differentiation that is not client friendly. For example, restrictions such as IFC's constraints of not offering partial risk and full credit guarantees and MIGA's equity link have been associated with loss of business opportunities or higher transaction costs. A more rational approach would be to reduce the mandate/policy differentiations while emphasizing the distinct value the products add. Such an approach would, however, expand the opportunities for overlaps and therefore require enhanced coordination. Under any scenario, establishing the mechanisms for enhanced coordination should precede the greater flexibility in the product spaces of individual WBG institutions.
   - **Ensuring that adequate incentives exist for staff to offer the full array of WBG guarantees and PRM products to private sector clients within a single menu of options.** The objective should be to enable the best product fit with the particular circumstances of the client. Marketing staff from each institution need to be more familiar with the products of the other institutions to provide clients with a full menu of options. IFC's extensive business development infrastructure suggests an important IFC role in the marketing of WBG risk-mitigation products. It has the broadest relationship with private sector clients as well as commercial banks—key drivers of PRI demand. IFC's Client Relationship Management System might provide a channel for coordinating marketing efforts across the WBG for products that reach the private sector. For such coordination to be effective, however, it has to be based on clear management and

staff incentives in IFC, in particular, incentives to promote the products of the Bank and MIGA.

- **Establishing more systematic links between advisory services and the deployment of WBG PRM instruments and other products, particularly in infrastructure, while keeping in mind the need to manage potential conflicts of interest.** Greater upstream engagement of WBG PRM products might be enhanced with closer links to Bank/IFC advisory services that are engaged in helping governments establish an appropriate regulatory framework and developing specific PPP transactions. IFC's corporate advisory services, which are helping governments design concession agreements and privatizations, for example, represent a potentially important mechanism to more systematically introduce WBG PRM products earlier in a project's development, such as during the bidding stage. IFC's corporate advisory services could, for example, systematically include in bidding packages the option for the winning bidder to choose from a menu of WBG products such as IDA/IBRD PRG, MIGA PRI, and IFC investments. Moreover, enhancing client opportunities to choose from a menu of WBG PRM products needs to be accompanied by a consistent approach to pricing of political risk among the WBG institutions.
- **Following a consistent approach to pricing PRM across its guarantee instruments to avoid potential distortions.** At present, the Bank has a distinct pricing structure that does not reflect risk or market conditions. The Bank's Operating Principle 8.30 requires that in financial intermediary lending, on-lending occur at or near market rates. The same logic should be extended to the pricing of IDA and IBRD PRGs, which also reach private sector clients. A consistent approach to the pricing of comparable risks would reduce the potential for distortions and enable WBG private sector clients to make rational decisions as to which WBG instrument best fits their needs. Consistent pricing might also reduce the need for supply-side rationing of products through the hierarchy of instruments principle and instead allow the most appropriate product to be deployed. MIGA has developed a pricing system that reflects political risks as well as market conditions; this can serve as a basis for a more uniform pricing of political risk across the WBG.
- **Strengthening internal awareness of the guarantee instruments and the incentives and skills for their use and reducing transaction costs where possible, keeping in mind the importance of maintaining adequate processes and regulations for risk management.** Lack of staff incentives, inadequate skills, and poor familiarity with the products of the other institutions have prevented better exploitation of synergies downstream in marketing WBG products. Safeguards and fiduciary requirements in each of the three institutions generally add value and need to be maintained and strengthened, especially in light of their importance for mitigating financial, social, environmental, and ultimately political risks. But where feasible, inefficiencies and unnecessarily cumbersome procedures need to be reduced to minimize transaction costs for private sector clients.

3. **If a new organizational structure is developed and proposed, consider at least three alternative perspectives for organizational realignment (client, country, and product).**

- Under the client approach, all products for private sector clients, including guarantees and PRM instruments, would be offered through a single window.
- Under the country approach, the deployment of WBG guarantee and PRM products would be made according to country needs, under a management arrangement common for all three institutions.
- Under the product approach, the bulk of guarantee/insurance products would be managed under one institutional roof.

- Each of the organizational realignments may bring higher benefits than the existing structure in terms of lower transaction costs, better client focus, and higher efficiency, but each also entails significant uncertainties and risks in terms of loss or marginalization of some products, conflicts of interest, and reduced flexibility to respond to changes in the external environment. The assessment of alternatives for organizational realignment should take into account efficiency aspects, conflict-of-interest implications, effective coordination within the WBG, and responsiveness to private sector clients' and countries' needs.

4. **If the current organizational structure is maintained, direct management of each individual WBG institution to improve the delivery of its own guarantee/insurance products.**

### MIGA Management

- **Proposing to MIGA's shareholders amendments to its Convention to remain relevant and meet its market potential.** Constraints imposed on MIGA by its 1985 Convention need to be reconsidered so that MIGA can better serve its developing country members and clients. The most notable constraint is the inability to insure stand-alone debt (with no equity participation), and existing assets, and local and foreign investors among others. Although amending the Convention is likely to be a lengthy process involving shareholder approval and ratification from members, it would be important for MIGA to take the necessary steps now to retain its relevance in the future.
- **Considering, in the meantime, alleviating several constraints derived from its operational regulations and policies.** Several changes to MIGA's Operational Regulations to add new eligible investments and risks can help MIGA develop new products and meet evolving market demands. Several changes in policy and MIGA's Operational Regulations are being discussed internally.
- **Increasing its responsiveness to market demand by addressing internal weaknesses that reduce efficiency and slow responsiveness without lowering MIGA's financial, social, and environmental standards.** These include organizational issues in staffing, performance review, and incentives as well as consideration of matters such as inflexibility on guarantee contract terms and conditions. However, efficiency in its underwriting process must not come at the expense of quality, risk mitigation, safeguards, and development impacts of the projects it insures.
- **Improving its client relationship management, including aftercare, to enhance MIGA's value added and increase client retention.** Improving client relationships could be the most cost-effective marketing that MIGA could undertake to increase its business volume. Managing client relationships requires a focused and coherent business development plan implemented by a staff with expertise in the guarantee business and/or financial markets.

### Bank Management

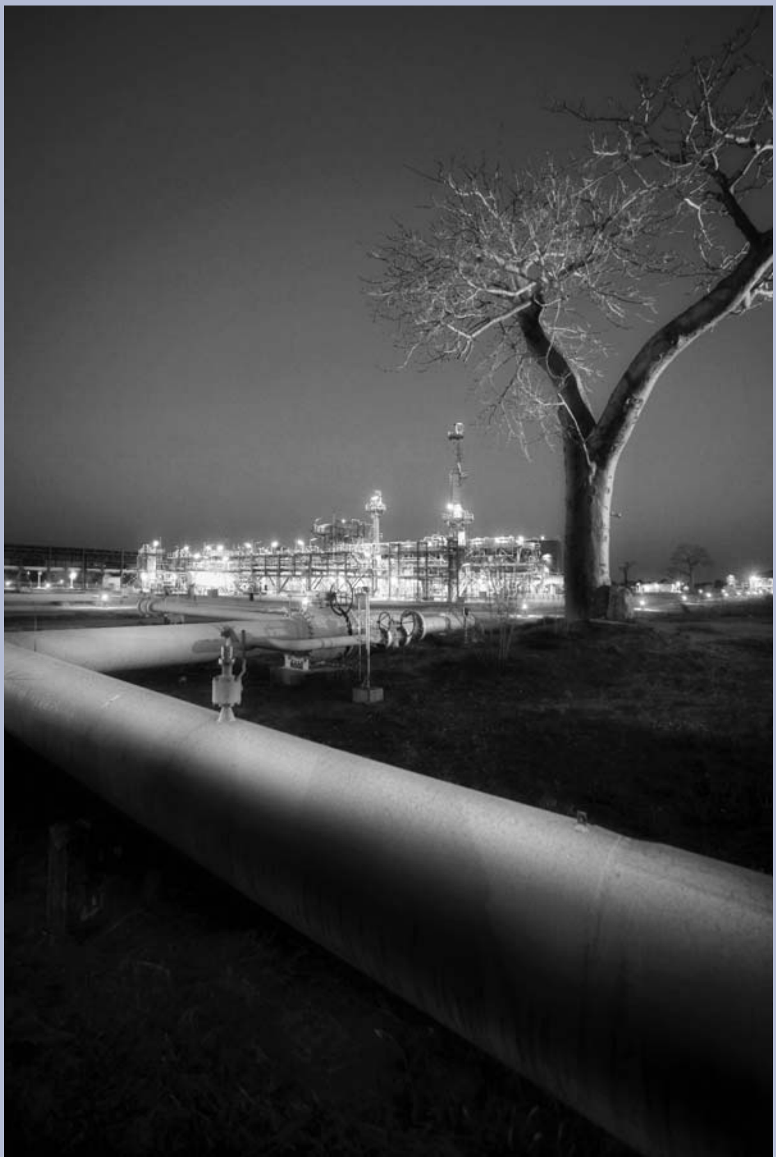
- **Maintaining and promoting the PCG instrument as a countercyclical tool to leverage government access to commercial funds and extending such access to IDA countries.** PCGs remain a potentially important instrument to help well-performing countries that do not have full access to commercial markets by introducing them to markets and improving the terms of initial transactions. They can also provide countercyclical assistance to countries whose access to markets is temporarily restricted. At the same time, PCGs can substitute for direct Bank lending and can reduce the Bank's leverage in some situations. More discussion and clearer guidance on the merits of PCGs vis-à-vis direct lending in various circumstances should be developed in the Bank. Given the growing number of IDA countries that fit the profile of well-performing countries with restricted access to markets, the option of a PCG instrument should be extended to IDA countries. Current incentives in the Bank promote direct Bank lending rather than leveraging of private commercial finance, yet PCGs can have significant development impact and additionality in the right circumstances. They should be more thoroughly considered in the CAS process.

- **Taking several measures to enhance the use of Bank PRGs.** Although the market for Bank PRGs will remain narrow because of the nature of the product, PRGs remain the only instrument the Bank has to directly support private investment projects, and Bank lending cannot substitute for them. They provide a unique means of PRM because of the Bank's close relationship with governments, sector knowledge, and policy dialogue on private sector development, and they can be deployed to enable transactions that would otherwise be perceived as too risky. Important measures for enhancing their use are creating awareness among Bank staff of the potential use and benefits of PRGs and building necessary skills; developing a marketing strategy that encompasses both governments and the private sector to better identify situations in which the role of a PRG can make a difference; and streamlining processing steps to reduce both internal disincentives to working on PRGs and transaction costs for private sector clients while ensuring that crucial measures for social and environmental safeguards and risk management are maintained and strengthened.

## IFC Management

- **Mainstreaming its guarantee products through its operations departments in the same manner that its equity and loan products are deployed.** IFC's Treasury has been instrumental in innovating and spreading innovation. The Treasury is decentralizing, beginning to put senior staff in the field. However, mainstreaming needs to be led by the industry and regional departments, which have the incentives and resources to scale up the use of the instruments in response to evolving client needs. IFC needs to develop the skills and capacity in its operational departments to offer a broad range of guarantee products.
- **Assessing the extent to which it can bring its guarantee products closer to meeting Basel II—and regulatory requirements in general—so that the guarantee beneficiaries can use IFC products more effectively for capital, provisioning, and exposure relief.** A great deal of the demand for guarantee-type instruments derives from financial institutions' needs for relief on capital, provisioning, and exposure requirements. In this context, IFC should review its guarantee products to assess the extent to which they can be tailored to better meet Basel II and regulatory requirements for the above purposes.
- **Revisiting its approach to RSFs to increase flexibility and improve the attractiveness of the product.** The rigid approach to structuring RSFs has limited IFC's ability to fully exploit the benefits of partnering with local and international financial institutions. This rigidity and high transaction costs have discouraged utilization of the instrument. More flexible structures should be considered to make the product more attractive to partner financial institutions. IFC has accumulated the data and the experience to give it the comfort needed to simplify processes and to give flexibility to partners to use their strengths while strengthening those processes intended for risk management and social and environmental safeguards.
- **Scaling up successful models in energy efficiency, education, and capital market development based on the use of guarantee structures**. IFC has developed models based on guarantee structures in the areas of energy efficiency, SME financing, education, and capital market development. Limited replication has taken place so far. IFC needs to assess its experience with these products, simplify, standardize, and bring them closer to market practices to enhance prospects for scaling up in line with its programmatic approach.

# Appendixes



Complex cross-border projects represent high-risk endeavors that can benefit from WBG guarantees. Photo courtesy of Sasol, a gas pipeline project guaranteed by MIGA and the World Bank.

# APPENDIX A: EVALUATION METHODOLOGY

The evaluation covers World Bank Group (WBG) guarantee operations from 1990 to 2007. The evaluation used the methods outlined here to gather evidence and compile the evaluation.

## Literature and Project Documentation Review

The Independent Evaluation Group (IEG) undertook a broad review of both internal and external literature on guarantees and political risk mitigation instruments. The IEG team reviewed a number of documents:

- All WBG policy documents related to the use of guarantee instruments since the late 1980s
- WBG analytical reports on guarantee instruments
- Relevant country and sector strategy documents
- Guarantee project approval, supervision, and completion/evaluation reports
- Administrative guidelines from the World Bank, the International Finance Corporation (IFC), and the Multilateral Investment Guarantee Agency (MIGA) that address the conditions and procedures relevant to the use of guarantees.

The external literature included major publications on political risk mitigation (PRM) and credit enhancement; journal articles; and research conducted by private sector practitioners, academics, and other multilateral and bilateral development agencies.

## Data Collection and Processing

The IEG team also extracted considerable internal data on the use of guarantee instruments from institutional databases such as IFC online databases, including the Management Information System and the Resource Management System. These included project information on all guarantee operations conducted in the WBG since 1990. These data were then matched against a range of criteria, including the WBG's lending eligibility criteria, host countries' income level classification, Institutional Investor Country Credit Rating country risk classifications, project size, project mobilization data, processing times and costs, and so forth.

Data on normal IFC lending operations and Bank infrastructure lending were also gathered to enable some comparison between the instruments. Data on joint projects were collected to assess cooperation among the three institutions. IEG also reviewed all IFC investment operations during a set sample period (fiscal 2005–07) to extract those in which PRM was identified as a primary rationale for IFC engagement in the project. The review also examined the eligibility criteria, nature of coverage extended, types of clients, and pricing structure used in political mitigation instruments across the WBG.

The evaluation also drew on external data sources. External data included LoanWare, market reports, and Berne Union data. Using data from the LoanWare database, an analysis of the market for loan guarantees was conducted that covered the period of 1993–2007 (during which period there are 113,661 deals recorded, of which approximately 8 percent were guaranteed.) A background report with this analysis is available on request.

## Staff Interviews

The IEG team interviewed some 50 staff from MIGA, IFC, and the Bank who were experienced in the use of WBG guarantee instruments.

IEG conducted a survey of WBG staff who have worked with guarantee instruments. The objective of the survey was to solicit staff views about the use and effectiveness of guarantee instruments. The survey questionnaire, which was e-mail based, was sent to 363 preselected staff on the basis of their current or previous experience with guarantees. Of those, 206 staff responded to the survey; responses included a range of comments that were used in the evaluation. The breakdown of survey response rates as well as an overview of key results is presented in appendix B.

### External Interviews

IEG interviewed several external stakeholders located in Washington, DC, London, Paris, Brussels, and Luxembourg. These included private companies and commercial banks that are clients of WBG guarantee instruments, the Berne Union (a consortium of other providers of political risk insurance), brokers of political risk insurance, other multilateral providers of guarantees, and national export credit agencies engaged in the provision of guarantees.

### Review of Other Multilateral/ National Providers of Guarantees

IEG undertook a desk review of the organizational structure and guarantee operations of several other providers of guarantees. These included both multilateral providers and export credit agencies. Among the multilaterals reviewed were the African Development Bank, European Investment Bank/Enhanced Integrated Framework, the European Bank for Reconstruction and Development, the Asian Development Bank, the Nordic Investment Bank, and in general terms Islamic Development Bank/Islamic Corporation for the Insurance of Investment and Export Credit, Ceylon Electricity Board, and African Trade Insurance Agency/ACA. Export credit agencies reviewed included Finnvera, Office Nationale du Ducroire (Belgian Export Credit Agency)/Delcredere, and the Commonwealth Development Corporation. In addition, some information was gathered on guarantee activities of the Groupe Agence Francaise de Developpement and its private sector arm, Proparco. A background report compiled during this review is available on request.

### External Reviews

The report benefited from external reviews. Three external experts provided comments and feedback on the evaluation: James Hanson, a former WBG staff and financial sector expert; Professor Marshall Meyer of the Wharton School of Business, who is an expert in organizational design; and Bob Chestnutt, a practitioner with long experience in developing infrastructure projects in Africa, including with the participation of the World Bank, IFC, and MIGA.

As part of the evaluation of WBG guarantee instruments, IEG conducted a survey of WBG expert staff between February 6 and 25, 2008 (see attachment on page 106). The objective of the survey was to solicit views about the use and effectiveness of guarantee instruments. The survey questionnaire, which was e-mail based, was sent to 363 preselected staff on the basis of their current or previous experience with guarantees. The total number of responding staff was 206. The breakdown of staff and their respective response rate is shown in table B.1.

**Table B.1: Staff Survey Responses**

| WBG | Total number of staff | Response rate (%) |
|---|---|---|
| World Bank | 61 | 45.9 |
| IFC | 243 | 52.6 |
| MIGA | 59 | 84.8 |
| Total | 363 | 56.4 |

*Source:* IEG survey.
*Note:* IFC = International Finance Corporation; MIGA = Multilateral Investment Guarantee Agency; WBG = World Bank Group.

*WBG staff are familiar with their own products but not with the guarantee products of other WBG institutions* (see table B.2). Most Bank staff were familiar with their own instruments as International Bank for Reconstruction and Development (IBRD)/International Development Association (IDA) Partial Risk Guarantees (PRGs), IBRD Partial Credit Guarantees (PCGs), and Policy-Based Guarantees. Bank staff were also familiar with MIGA political risk insurance (PRI) as much as their own products; however, except for IFC PCGs (a little less than half), less than one-third of staff were familiar with IFC guarantees. As reported, more than two-thirds of IFC staff were very familiar with many of their diversified products—PCGs, Risk-Sharing Facilities (RSFs), PRGs, and the Global Trade Finance Program (GTFP), but less than half knew about MIGA PRI. Only one-fifth of IFC staff were familiar with IBRD/IDA products. Compared with the Bank and IFC staff, MIGA staff were more familiar with the other two institutions' products, especially with Bank guarantees. However, less than half of MIGA staff reported being familiar with IFC guarantees. As is seen above, Bank and MIGA staff are familiar with products of the other institution, but not with those of IFC. In contrast, IFC staff are not familiar with products of either the Bank or MIGA.

*According to the WBG staff, the most critical benefits of the WBG guarantee instruments were enhanced image of financial soundness and improved financing terms (rates and tenors).* More than 85 percent of WBG staff felt that this was the case.

In addition to these two common benefits, staff also pointed out several other benefits. For IBRD/IDA PRGs and PCGs, most Bank staff reported that the WBG's role as an honest broker and IBRD/IDA's assistance in securing other investors and structuring finance were other critical benefits.

For IFC PRGs and PCGs, about 75 percent of IFC staff reported that IFC's technical and economic appraisal of the project and assistance in securing other investors and structuring finance were also important benefits. In MIGA, more than 70 percent of staff felt that the WBG's role as an honest broker and MIGA's assistance in securing other investors and structuring finance were additional benefits of their PRI product. Ability to provide

**Table B.2: Staff Familiarity with WBG Guarantee Instruments**

| | World Bank (%) | IFC (%) | MIGA (%) |
|---|---|---|---|
| Familiarity with the guarantee product of own institution | IBRD/IDA PRG (96.4)<br>IBRD PCG (85.7)<br>IBRD PBG (65.4) | IFC PCG (87.4)<br>IFC RSF (77.2)<br>IFC PRG (67.8)<br>IFC GTFP (64.8)<br>IFC CLG (48.3)<br>IFC GOLF (28.8) | PRI (100) |
| Familiarity with the guarantee product of another WBG institution | MIGA PRI (85.2)<br>IFC PCG (48)<br>IFC PRG (28)<br>IFC GTFP (20)<br>IFC RSF (16)<br>IFC CLG (15.4)<br>IFC GOLF (11.5) | MIGA PRI (45.8)<br>IBRD/IDA PRG (22.7)<br>IBRD PCG (12.7)<br>IBRD PBG (7.1) | IBRD/IDA PRG (83)<br>IBRD PCG (58.7)<br>IFC PCG (47.8)<br>IFC PRG (43.8)<br>IBRD PBG (41.3)<br>IFC GOLF (37)<br>IFC RSF (28.9)<br>IFC GTFP (26.1)<br>IFC CLG (22.7) |

*Source:* IEG survey.
*Note:* CLG = credit-linked guarantee; GOLF = Global Offshore Liquidity Facility; GTFP = Global Trade Finance Program; IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; MIGA = Multilateral Investment Guarantee Agency; PBG = Policy-Based Guarantee; PCG = Partial Credit Guarantee; PRG = Partial Risk Guarantee; PRI = political risk insurance; RSF = Risk-Sharing Facility; WBG = World Bank Group.

assistance in securing other investors and structuring finance were seen as additional critical benefits of WBG guarantee instruments by a majority of staff in all three institutions.

*Staff had varied views on which products could be substituted by another.* The survey results indicate that there is no clear consensus on which products can be substituted by the others across the institutions.

- **World Bank.** In the Bank, a significant number of opinions on substitutes were collected only for the PRG instrument. According to WBG staff who are most familiar with IBRD/IDA PRGs, this product can have as many as seven different substitutes within and outside its originating institution. Although about 30 percent of WBG staff responded that the product has no substitute, about 70 percent suggested substitutes. Here one-third reported that it can be substituted by IBRD/IDA lending, one-fourth by MIGA's PRI, and one-fifth by IBRD PCGs (table B.3).
- **IFC.** In IFC, staff suggested substitutability of several instruments. About 15 percent of staff familiar with this product felt that it had no substitute; more than 85 percent reported that it was substitutable. From those, about 40 percent felt that it can be substituted by IFC's direct investment and about one-fourth by RSFs. Though not significant, there were also views suggesting substitutability of IFC PCGs by IBRD PCGs, IFC CLGs, PRGs, Global Offensive Liquidity Facility, and GTFP, and IBRD/IDA lending. As for RSFs, though about 20 percent of staff reported that the product has no substitute, another 20 percent reported that it can be substituted by IFC's direct investment, and about one-third suggested its substitutability by IFC PCGs and PRGs. An insignificant proportion of staff suggested substitutability of RSFs by GTFP. As for IFC PRGs,

**Table B.3: Suggested Substitutes of WBG Guarantee Instruments**

| Suggested substitute | IBRD/IDA PRGs (%) | IFC PRGs (%) | IFC RSF (%) | IFC PRG (%) | IFC GTFP (%) | MIGA PRI (%) |
|---|---|---|---|---|---|---|
| IBRD/IDA lending | 37.5 | | | | 6.7 | |
| MIGA PRI | 25 | | | 12.5 | | |
| IBRD PCGs | 18.8 | 4.5 | | | | |
| IBRD/IDA PRGs | | | | 12.5 | 6.7 | 26.0 |
| IBRD PBGs | | | | | | 4.0 |
| IFC PCGs | 6.3 | | 33.3 | 12.5 | | 6.0 |
| IFC RSFs | 12.5 | 22.7 | | 25.0 | 6.7 | 4.0 |
| IFC PRGs | 12.5 | 15.9 | 28.6 | 12.5 | 6.7 | 14.0 |
| IFC direct investment | 12.5 | 36.4 | 19.0 | | 20.0 | 4.0 |
| IFC credit-linked guarantees | | 18.2 | | 25.0 | | 2.0 |
| IFC GOLF | | 6.8 | | | | |
| IFC GTFC | | | 4.8 | | | |
| None of the above | 18.8 | 11.4 | 19.0 | 0 | 53.3 | 44.0 |

*Source:* IEG survey.
*Note:* GOLF = Guaranteed Offshore Liquidity Facility; GTFC = Global Trade Facility Program; IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; IFC = International Finance Corporation; MIGA = Multilateral Investment Guarantee Agency; PBG = Policy-Based Guarantee; PCG = Partial Credit Guarantee; PRG = Partial Risk Guarantee; PRI = political risk insurance; RSF = Risk-Sharing Facility; WBG = World Bank Group.

about two-thirds of staff reported their substitutability by IFC's direct investment. Although there were views supporting their substitutability by RSF, CLG, IFC PCG, IBRD/IDA and IFC PRGs, and MIGA PRI, the rsponse was insignificant. In terms of GTFP, about half of staff most familiar with this instrument supported its nonsubstitutability, whereas an insignificant proportion of staff suggested that this product could be substituted by

**Table B.4: Percent of Surveyed Staff Who Reported That the Change Is Important**

| Important changes | IBRD/IDA (%) | IFC (%) | MIGA (%) |
|---|---|---|---|
| Improving coordination with other WBG institutions | 77.8 | 49.1 | 89.1 |
| Improving marketing of guarantees | 96.3 | 81.3 | 97.9 |
| Clarifying policies and guidelines, explaining when guarantees are appropriate | 82.1 | 82.3 | 80.9 |
| Offering more staff training | 77.8 | 90.3 | 71.1 |
| Reducing time and cost to process guarantees | 89.3 | 90.1 | 89.4 |
| Offering more flexible contract terms | 77.8 | 83.2 | 89.4 |
| Investing in new product development | 77.8 | 83.0 | 91.3 |

*Source:* IEG survey.
*Note:* IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; IFC = International Finance Corporation; MIGA = Multilateral Investment Guarantee Agency; WGB = World Bank Group.

**Table B.5: Reasons for Droppages of Guarantee Projects**

| Droppage reason | IBRD/IDA (%) | IFC (%) | MIGA (%) |
|---|---|---|---|
| Inadequate compliance with environmental or social guidelines | 16.7 | 1.9 | 5.0 |
| Another WBG agency provided the guarantee | 0.0 | 1.9 | 10.0 |
| Intermediate commercial banks withdrew from project | 11.1 | 20.8 | 10.0 |
| Underlying project technically or financially unsound | 16.7 | 15.1 | 15.0 |
| Government objected to the project | 0.0 | 7.5 | 17.5 |
| Another multilateral or bilateral agency provided the guarantee | 27.8 | 13.2 | 20.0 |
| A private firm provided the guarantee | 16.7 | 9.4 | 27.5 |
| Other | 33.3 | 18.9 | 35.0 |
| Processing time too long for client | 44.4 | 43.4 | 40.0 |
| Client proceeded with the project but without any guarantee involved | 66.7 | 41.5 | 47.5 |
| Cost of guarantee was too high for client | 11.1 | 81.1 | 50.0 |
| Client dropped the underlying project | 22.2 | 28.3 | 55.0 |

*Source:* IEG survey.

*Note:* IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; IFC = International Finance Corporation; MIGA = Multilateral Investment Guarantee Agency; WBG = World Bank Group.

IBRD/IDA PRGs and lending and IFC's PRGs, RSFs, and direct investment.

- **MIGA.** As for MIGA's PRI, about 40 percent of staff supported the product's nonsubstitutability. From those staff that felt that it had substitutes, one-fourth felt that it can be substituted by IBRD/IDA PRGs, and one-fifth felt that it is substitutable by IFC PRGs and the Global Offshore Liquidity Facility. Though there were other views supporting substitutability of PRI by IBRD policy-based guarantees, IFC PCGs, RSFs, CLGs, and direct investment, the significance was low.

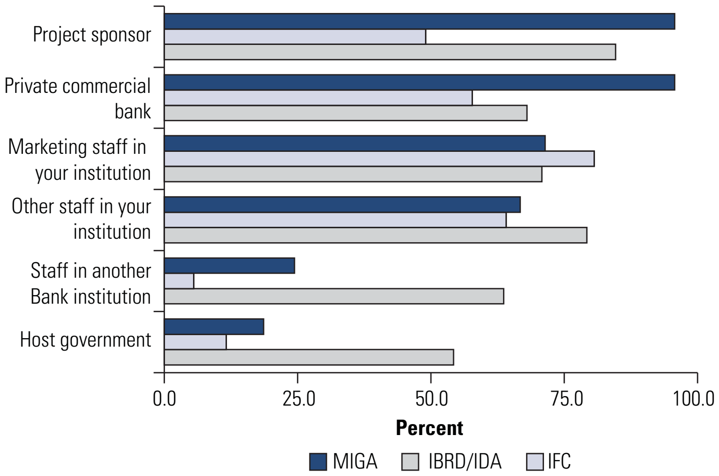
## Changes Needed to Improve Instruments

*A high proportion of staff felt that changes are needed to improve the WBG's guarantees instruments* (table B.4). Overall, most staff felt that reducing time and cost of processing guarantees and improving marketing are important for improving WBG guarantee instruments. Whereas these changes were supported by about 90 percent of overall surveyed staff, investing in new product development, offering more flexible contract terms, clarifying WBG policies and guidelines to explain when guarantees are appropriate, and offering more training to staff on guarantees were also strongly supported across institutions. In addition, MIGA and IBRD/IDA staff stressed the importance of improving the coordination within WBG institutions. Overall results suggest strong support for these changes in all three institutions.

*According to WBG staff with experience, clients proceeding with the project without a guarantee and long processing times were the main reasons for dropped guarantee projects.* About 65 percent of IBRD/IDA staff, 50 percent of IFC staff, and more than 80 percent of MIGA staff reported having experience with dropped guarantee projects (table B.5).

According to about one-third of IBRD/IDA staff, an involvement of another bilateral or multilateral agency in providing the guarantee was another decisive factor for the guarantee. About 40 percent of IFC staff took views in support of the two reasons mentioned, but about 80 percent reported that the droppages occurred because the cost of the guarantee was too high for the client. Moreover, clients dropping the underlying

**Figure B.1: Originator of Guarantees**




*Source:* IEG survey.
*Note:* IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; IFC = International Finance Corporation; MIGA = Multilateral Investment Guarantee Agency.

project and withdrawal of intermediate commercial banks from the project were reported by IFC staff as contributing reasons in one-fifth of dropped guarantee cases.

In MIGA more than 40 percent of staff shared views in support of the two common reasons, whereas 50 percent pointed out a too-high cost for the client and the client's droppage of the underlying project as reasons. About 20 percent of MIGA staff reported that the involvement of a private firm and a multilateral or bilateral agency in provision of guarantees was another reason for dropped guarantees.

*Bank and MIGA staff reported that project sponsors/investors most frequently originated the request of guarantees* (figure B.1). In contrast, in IFC, marketing staff were the ones to most frequently originate a guarantee. According to Bank staff, mostly project sponsors, its other staff, its marketing staff, and private commercial banks originated guarantees. Compared with products of other institutions, Bank guarantees were also relatively frequently originated by host government and staff of another WBG institution.

In IFC, as reported by about 80 percent and 60 percent of staff, respectively, its marketing staff and other staff play an important role in originating guarantees. Private commercial banks and project sponsors also approach IFC for a guarantee. As IFC staff reported, host government and staff in another Bank institution are the ones that are least likely to originate its guarantees.

In MIGA, as reported by about 90 percent of staff, project sponsors and private commercial banks first approach MIGA for a guarantee. According to staff, its marketing staff and other staff also play an important role in originating guarantees.

## Attachment: Survey Structure and Questions

The survey questions were structured to provide multiple choices as well as open-ended answers. All staff were asked the following questions:

**SURVEY**

1. **How familiar are you with the following WBG guarantee instruments? (Check all that apply.)**

**Answer Options**

IBRD Policy-Based Guarantees (PBG)
IBRD Partial Credit Guarantees (PCG)
IBRD/IDA Partial Risk Guarantee (PRG)
IFC Partial Credit Guarantee (PCG)
IFC Risk Sharing Facilities (RSF)
IFC Partial Risk Guarantees (PRG)
IFC Credit Linked Guarantees (CLG)
IFC Guaranteed Offshore Liquidity Facility (GOLF)
IFC Global Trade Facility Program (GTFP)
MIGA Political Risk Insurance (PRI)
Specify the level of familiarity: Not familiar / Barely familiar / Somewhat familiar / Very familiar

2. **Select the WBG guarantee instrument that you are most familiar with.**

**Answer Options**

IBRD Policy-Based Guarantees (PBG)
IBRD Partial Credit Guarantees (PCG)
IBRD/IDA Partial Risk Guarantee (PRG)
IFC Partial Credit Guarantee (PCG)
IFC Risk Sharing Facilities (RSF)
IFC Partial Risk Guarantees (PRG)
IFC Credit Linked Guarantees (CLG)
IFC Guaranteed Offshore Liquidity Facility (GOLF)
IFC Global Trade Facility Program (GTFP)
MIGA Political Risk Insurance (PRI)

3. **In your experience, how critical are the following benefits to clients for this guarantee instrument?**

**Answer Options**

WBG role as honest broker
Enhanced image of financial soundness
Compliance with environmental and social standards
Improved financing terms (rates and tenors)
Your institution's technical and economic appraisal of the project
Your institution's assistance in securing other investors and structuring finance
Specify the level: Extremely critical / Somewhat critical / Not very critical / Not at all critical / No opinion

4. **What other WBG instruments can substitute for this guarantee instrument?**

**Answer Options**

IBRD Policy-Based Guarantees (PBG)
IBRD Partial Credit Guarantees (PCG)
IBRD/IDA Partial Risk Guarantee (PRG)
IFC Partial Credit Guarantee (PCG)
IFC Risk Sharing Facilities (RSF)
IFC Partial Risk Guarantees (PRG)
IFC Credit Linked Guarantees (CLG)
IFC Guaranteed Offshore Liquidity Facility (GOLF)
IFC Global Trade Facility Program (GTFP)
MIGA Political Risk Insurance (PRI)
IBRD/IDA lending
IFC direct investment
None of the above

5. **How might the delivery of this instrument be improved?**

**Answer Options:** Open

6. **How important are the following changes for improving your institution's guarantee operations?**

**Answer Options**

Improving its coordination with other WBG institutions
Improving its marketing of guarantees
Clarifying its policies and guidelines, explaining when guarantees are appropriate
Offering more training to staff on guarantees
Reducing the time and cost to process its guarantees
Offering more flexible contract terms
Investing in new product development
Specify the level: Extremely important / Somewhat important / Not very important / Not at all important / No opinion

7. **Have you worked on a guarantee project that was dropped before becoming effective?**

8. **If you had a project dropped, identify which were the most likely reasons (select up to 5).**

Cost of guarantee was too high for client
Client proceeded with project but without any guarantee involved
Client dropped the underlying project
Processing time was too long for client
Intermediate commercial banks withdrew from project
Government objected to the project
Underlying project technically or financially unsound
Inadequate compliance with environmental or social guidelines
Another WBG agency provided the guarantee.

Another multilateral or bilateral agency provided the guarantee.
A private firm provided the guarantee.
Other reasons (please specify)

**9. Who typically first suggests that your institution's guarantees might be appropriate instruments for a project?**

**Answer Options**

Host government
Project sponsor
Private commercial bank
Marketing staff in your institution
Other staff in your institution
Staff in another World Bank institution
Specify frequency level: Frequently / Occasionally / Infrequently / Never / No opinion

**10. What immediate change would you make to improve the WBG's guarantee program?**

**Answer Options:** Open

**11. What risk mitigation needs of clients are not met by your institution's guarantee instruments?**

**Answer Options:** Open

Factory worker in Indian plant. Photo by Ray Witlin, courtesy of the World Bank Photo Library.

## Executive Summary

1. This study does not evaluate IFC's Global Trade Finance Program, which started in 2005.

## Chapter 1

1. As pointed out by Berger and Udell (1988), guarantees typically operate like external collateral, but they do not give control over specific assets. Instead, they represent a generic claim on the entire wealth of the guarantor, who thus has a large degree of freedom in using—and possibly neglecting—it.

2. The *New Oxford American Dictionary* defines insurance as "a practice or arrangement by which a company . . . provides a guarantee of compensation for specified loss . . . in return for payment of a premium" and, even more simply, as "a thing providing protection against a possible eventuality."

3. In determining which financial risk transfer services are insurance, five characteristics are typically identified: (1) the insured must have an "insurable risk" (such as the risk of a financial loss in the case of a disaster, theft, or credit event) with respect to a "fortuitous event" (defined as "any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party") that is capable of financial evaluation; (2) the insured must transfer its risk of loss to an insurance company under a contract that provides the insured with indemnity against the loss; (3) the insured must pay a premium to the insurance company for assuming the insured's insurable risk; (4) the insurance company typically assumes the risk as part of a larger program for managing loss by holding a large pool of contracts covering similar risks that is large enough for actual losses to fall within expected statistical benchmarks; and (5) before it can collect on an insurance contract, the insured must demonstrate that its injury was from an "insurable risk" as the result of an "insured event." In other words, the insured must demonstrate that it has actually suffered a loss that was covered in the contract (Culp 2003).

4. Finally, it is important to note that besides third-party guarantors, other potential issuers of asset insurance to the firm are the firm's stakeholders, including customers, debt holders, and shareholders (Merton and Perold 1998).

5. Referred to as "obsolescing bargain," which is defined as the propensity of host country authorities, mostly successors to signatories to the original investment agreements, to tighten the terms and conditions of investment contracts that were originally drawn to reward high early risk and uncertainty, after risk decreased and the project proved successful.

6. MIGA Convention, chapter X, Article 59: A vote of three-fifths of the governors exercising four-fifths of the total voting power is required for amendments in the Convention and its annexes.

7. Until fiscal year 1988, IFC issued three equity-related guarantees: a guarantee that insures a minimum return on notes issued in local stock markets, a guarantee insuring repatriation of equity principal, and a Guaranteed Recovery of Investment Principal (GRIP). IFC's GRIP program was designed to encourage private investors to participate in projects financed by IFC, even though the risk was considered quite high by the private investor. The program gave the investor a number of alternatives in participating with IFC. The private investor considering an equity investment in an IFC project gave the funds to the IFC and received a dollar-denominated certificate (GRIP), which IFC had to repay in some stipulated period—for example, 20 years. IFC then used the funds to make the equity investment in its own name. When the debt certificate or GRIP matured, the investor had the options of getting the funds returned with some profit included, buying the shares by cancelling the debt and paying a prearranged premium to the IFC, or extending the GRIP for an additional period. IFC stopped using equity-related guarantees in the late 1980s, in part not to compete with MIGA, which was established in 1988 with a special focus on promoting FDI through PRI.

8. GOLF is not a self-standing guarantee product and has been used only once.

9. Article 14 of the MIGA Convention limits its guarantee operations to investments made in the developing member country.

10. Article 12, §§ (a)–(c) of the MIGA Convention and MIGA's Operational Regulations set out the eligible investments that qualify for a MIGA guarantee. There was a deliberate effort in developing MIGA's Convention to avoid enumeration of eligible investments with an exclusive list of types of investments covered, in order to provide flexibility to MIGA's Board of Directors. MIGA's founding members recognized that the success of the guarantee program hinges on its ability to adapt to innovations in the marketplace (Shihata 1988, pp. 111–12).

11. Includes portfolio investments, which could be minority participations in joint ventures, preferred stock, and shares resulting from the conversion of debt instruments (per MIGA's Operational Regulations).

12. Includes production and profit-sharing contracts, management contracts, franchising and licensing agreements, turnkey contracts, operating leasing agreements and subordinated debentures issued by the project enterprise, and guarantees or other securities provided for loans to the project enterprise. Coverage must have terms of at least three years and depend substantially on the production, revenues, or profits of the investment project for repayment (per MIGA Operational Regulations, §§ 1.05 and 1.06).

13. Per MIGA Operational Regulations, §1.08. Refer also to the MIGA Convention, "Commentary on the Convention Establishing the Multilateral Investment Guarantee Agency." These provisions give the MIGA Board the flexibility to extend MIGA coverage to medium- or long-term investments, except for loans that are unrelated to a specific investment covered or to be covered by MIGA.

14. Loans and guarantees of less than three years may be eligible for cover if the Board so approves, provided that the investor demonstrates a long-term commitment to the project.

15. Value must be determined in terms of the currency in which the guarantee is to be issued (Shihata 1988, pp. 116–17).

16.Three reasons are given for IFC's focus on full-risk guarantees: (1) **Business Principle:** Because IFC acts as a full-risk partner in developing country investments, its guarantee activities cover all types of macroeconomic, commercial, and political risks where such guarantees are critical for the provision of additional funding from other sources and where IFC is best positioned to assess and price such risks because of its understanding of the players and/or its ability to divest the risk. (2) **Efficiency Reasons:** All-risk coverage helps avoid the ambiguity inherent in most investment situations, because different types of risks are often interrelated and difficult to disentangle. Also, all-risk coverage is more cost-effective because appraisal and supervision costs do not vary significantly with the number of risks assessed. (3) **Preferred Creditor Status and MIGA:** Providing PRGs may jeopardize IFC's preferred creditor status and impinge on MIGA's role. These are sound principles, but their validity can be limited to certain circumstances. For instance, risk sharing in terms of IFC guaranteeing certain types of risks and not others is perfectly in line with the Business Principle. In any event, IFC never takes exactly the same risks as the sponsor, and through the structuring of transaction risks and rewards are always apportioned in various ways among deal participants. The efficiency reasons can also be subject to limited validity. Certain kinds of risks often can be clearly isolated from others. Giving clients the option to trade certain types of risks should enhance efficiency. Assessing one or a few specific risks may also require fewer resources than a full appraisal.

17. For instance, when a full credit guarantee is cost-effective, IFC can perform its due diligence and supervision functions in a cost-effective way, and IFC is unlikely to fund in the same instrument, currency, and market, particularly in the local markets.

## Chapter 2

1. Note that the size of the total investment in the project can be above the limit, as long as the MIGA coverage does not exceed this ceiling.

2. IDA provided a $5 million credit and the ADB a $5 million concessional loan. The U.K. government support materialized as a $1 million grant from the Department for International Development.

3. Sixty-five of these claims were due to expropriations, with a total payout of $600 million (OPIC 2007).

4. According to the Berne Union Investment Insurance Database, total claims outstanding amounted to $337.1 million, $159.8 million, and $150.2 million for calendar years 2005, 2006, and 2007, respectively.

5. Cancellations of contracts are highest for the agribusiness, manufacturing, tourism, and services sec-

tors, followed by financial sector projects. Cancellations are below average for infrastructure projects, which usually have a longer gestation period, as well as for mining and oil and gas projects.

6. The mediation efforts were intended to resolve outstanding claims from the Menghistu government. In fiscal 2004, about 40 claims had moved toward resolution, with concrete settlement offers from the government.

7. In 2007 the Board approved the increase in MIGA's country limits from $420 million to $600 million and the individual project limit from $110 million to $180 million.

8. The United National Conference on Trade and Development reports an increasing internationalization of research and development and a growing share of FDI based on the transfer of intellectual property rights (UNCTAD 2005).

9. The MIGA Convention, Article 13(c), states that "the assets invested are transferred from outside the host country." The investor and the host country must jointly apply for Board approval.

10. See the MIGA Convention, Article 11(b), and MIGA Operational Regulations, paragraphs 1.53–1.57.

11. In 2007 Zurich Financial Services Group, a private insurer, launched its global climate initiative. Under this initiative, Zurich provides PRI for companies that invest in programs to limit greenhouse gas emissions.

12. FitchRatings uses the rating of the insurance company's insurer financial strength as a first step in the process of rating a structured finance with PRI coverage. For example, if OPIC or MIGA provides the PRI, an AAA insurer financial strength is assumed by Fitch because OPIC is a U.S. government agency and MIGA is a member of the WBG (FitchRatings 2005). Provision of PRI for structured finance and for capital markets is not new. OPIC provided its first capital markets transaction PRI coverage (transfer restriction and inconvertibility) in 1999 for the placement of $150 million of debt obligations of Otosan, the Ford-Koc Group joint venture automobile manufacturer domiciled in Turkey. Since then and through 2005, there have been 30 transactions issued by several providers, including Zurich U.S. Political Risk, Sovereign, and others, including MIGA.

13. Measured from the time the definitive application is submitted to MIGA until the guarantee contract is issued. This number excludes outliers.

14. Interview of underwriters and risk management officers for the IEG–MIGA fiscal 2007 *Annual Report*.

15. The reasonable period proviso of MIGA's Operational Regulations states that MIGA may deem the host country approval as given if the host country presents no objection within a reasonable period, which "shall in no case be less than 30 days from the date of the request for approval and shall be extended at the request of the host country."

16. All members conduct an analysis of the investors' (and, in a few cases, the local partners') bonafides. A few insurers require that the investor have a minimum number of years of experience in the sector where the investment is being made. Some insurers also require submission of financial statements after the contract of guarantee is issued.

17. MIGA's Council of Governors and Board of Directors set the maximum amount of contingent liability that may be assumed by MIGA as 350 percent of the sum of its unimpaired subscribed capital and reserves and retained earnings, 90 percent of reinsurance obtained by MIGA with private insurers, and 100 percent of reinsurance from public insurers. MIGA's maximum net exposure is therefore determined by the amount of available capital.

18. An internal review found that creditors would perceive an indirect extension of the Bank's preferred creditor status to the nonguaranteed portion of the debt, possibly pressure the Bank to lend in the event of financial distress of the borrower and reduce flexibility for the borrower in the event of debt rescheduling or restructuring; it also found that the market might implicitly overprice Bank credit based on its valuation of the guaranteed portion of the debt as well as the unguaranteed portion, thereby raising the cost of borrowing for the Bank.

19. Initial expectations were that although IBRD guarantees covered, on average, 20 percent of project financing, IDA guarantees would cover a higher proportion of project financing.

20. It should be noted that Nam Theun 2 was the first hydropower project to be approved in 10 years using the PPP format and also the first to be financed by the Bank after the publication of the findings of the World Commission on Dams. Thus, the project came under significant international scrutiny, and it is unlikely that the private sector would have gone ahead with the

project without a PRG. The Lao PDR Nam Theun 2 practices and lessons offer the private sector a new way of building better dams.

21. Structured finance operations have seen strong growth. Since 2000, when the Structured Finance unit was established, the compound growth rate of structured finance deals booked is 35 percent.

22. The African Enterprise Fund has discontinued use of guarantees to enhance single credit for SMEs in line with an overall shift in IFC away from direct support to SMEs.

23. All-in-costs include the spread, commission, interest payments, and any other fees resulting from the transaction.

24. Two IFC Korean Trade Facilities approved in the aftermath of the Asian crisis had the best utilization, at about 50 percent, and the Brazil 2002–03 trade facility was fully utilized.

25. The China Utility-Based Energy Efficiency Finance Program was started in 2006 with an RSF supporting a total portfolio of $100 million. As of March 2008, $65 million had been used. A follow-on to the program's RSF was approved by the Board to support another portfolio of $335 million. Development of similar RSFs has started in the Philippines, Vietnam, and Indonesia, all designed to support energy efficiency, renewable energy, and other types of investment whose implementation will lead to direct reduction of greenhouse gas emission. Of the original energy-efficiency RSFs in Hungary and Central Europe, about $67 million of $87 million approved was used by December 2007. The Commercializing Energy Efficiency Finance offspring project in Hungary is for up to $128 million, of which less than 10 percent has been used.

26. IFC has approved several carbon delivery guarantees, but the product is still at a development stage.

27. For instance, if IFC develops capacity to provide local currency financing, then the need for the traditional single-credit partial-credit guarantee will diminish. However, the demand for an RSF will be there until IFC develops the capacity to handle small investments.

28. The argument may not be based on funding costs, but on the unfunded nature of guarantees and on the fact that there are liquidity requirements on which Treasury returns are above the cost of funding.

## Chapter 3

1. In its sovereign-linked credit guarantee application by IFC, the instrument actually excludes certain political risks.

2. The functional approach is appropriate for small companies that offer one product and that need proprietary expertise and scale.

3. IFC's B-loans represent beneficial interests in a trust or direct participation in the loan only; therefore, they do not insure immediate payment in the event of a loss. Moreover, because IFC's loans are not guaranteed by the host government, there is far more risk embedded in its loans and guarantee portfolio despite its preferred creditor treatment (Standard & Poor's 2007). Also, IFC's B-loans do not substitute for coverage of risks such as expropriation, breach of contract, and war and civil disturbance.

4. An ADB evaluation of its PRG program also found that "if a choice is given to borrowers [within the $50 million per project guarantee limit], they will always prefer to receive ADB assistance in the form of a direct loan as opposed to a more time-consuming PRG-supported loan funded by commercial banks" (ADB 2000).

5. Based on MIGA estimates, MIGA derives 75 percent of its business directly or indirectly from commercial banks.

6. In cases where the Bank's PRG pricing would be higher than prices prescribed by the current approach, the difference might be transferred to the host government, thus reducing disincentives for governments to support PRGs with counter-guarantees.

7. The 2002 WBG Private Sector Strategy recommended explicitly to "unbundle subsidies from IFC financial products that support private firms and to allocate such subsidies more transparently to purposes that merit being supported with subsidies" (World Bank 2002b, p. 52).

8. International banks, which are MIGA's main beneficiaries, look at spreads when deciding whether to purchase PRI.

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