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Findings from Evaluations of Policy-Based Guarantees



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Findings from Evaluations of Policy-Based Guarantees

An IEG Learning Product

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Abbreviations

DPF	Development Policy Financing
DPL	Development Policy Lending
DPOs	Development Policy Operations
FSAL	Financial Sector Adjustment Loan
IBRD	International Bank for Reconstruction and Development
IDA	International Development Agency
IEG	Independent Evaluation Group
IMF	International Monetary Fund
PBGs	policy-based guarantees
PCGs	Partial Credit Guarantees
PPAR	Project Performance Assessment Report
PRSCs	Poverty Reduction Strategy Credit
SSAL	Special Structural Adjustment Loan

Overview

In 1999, the World Bank introduced policy-based guarantees (PBGs) to cover private lenders against the risk of default by sovereign borrowers. As a new instrument, the PBG expanded the menu of financing options through policy lending. PBGs were built on the World Bank's policy-based operations and existing guarantees, with the goal of leveraging the World Bank's resources to attract more private financing to enhance poverty reduction and growth.

The World Bank's early experience with PBGs was colored by its involvement with the first guarantee in Argentina, which was called in 2002. However, interest in using the instrument grew after the global financial crisis. Since 2011, the World Bank has issued eight PBGs with seven countries. In 2013, the operational framework was streamlined to make PBGs more accessible to clients by bringing the instrument fully under Operations Policy 8.60 that covers all development policy financing. Interest in PBGs now appears to be on the rise. Member countries are particularly attracted to the scale of financing and the market access under financial stress that PBGs have made possible.

This paper is a survey of practices and results that have been observed in the implementation of PBGs, drawing largely upon four in-depth Project Performance Assessment Reports

undertaken by IEG, in Serbia, Macedonia, and Montenegro. It also draws upon IEG's evaluations of Ghana's Poverty Reduction Support Credits, which provide background material on the 2015 Ghana PBG. A recent World Bank review of the Albania PBG was also taken into consideration. The report draws on IEG's technical analyses, coordinated with relevant units of the World Bank and, finally, interviews with a cross-section of World Bank staff. It therefore represents an initial step in building greater awareness of a relatively new and important tool in development finance. Based upon these experiences, the learning product offers the following lessons:

PBGs can represent an important instrument of development policy financing that can be used effectively to help members overcome difficult financing and reform challenges. The PBG approach brings a judicious combination of client benefits, private sector participation, and financial leveraging of World Bank resources. From the point of view of the Bank, through a PBG, World Bank capital is tied up for a much shorter period than for a standard policy loan. Additionally, the fact that only 25 percent of an issued guarantee counts toward the World Bank's country exposure limit creates an incentive for the use of the instrument,

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especially for clients with large financing needs. And the PBG provides an opportunity for the World Bank to leverage its own resources for the country's benefit. In parallel, benefits to World Bank clients include improved market access, potential diversification of the creditor base, longer maturity, and lower interest rates. IEG's review of PBGs found that, with World Bank support, borrowers were able to meet their financing needs during difficult market conditions.

A robust macroeconomic and fiscal policy framework is essential for sustaining benefits from improved access to private finance for deficit financing. As a development policy financing instrument, PBGs can facilitate a range of important policy reforms in client countries. Some of the PBG operations evaluated by IEG, however, would have benefited from a stronger focus on mitigating fiscal and macroeconomic risks. There are suggestions that in some cases, relatively large loans mobilized through PBGs might have created incentives for sub-optimal fiscal choices, particularly in the absence of an International Monetary Fund (IMF) program. The report highlights the importance of rigorous application of the World Bank's operational policy on the macroeconomic framework of development policy financing with a special focus on mitigating sovereign default risks through debt sustainability analysis. Incorporation of necessary

mitigating actions in the policy matrix is important if there are substantial macroeconomic risks. The World Bank's engagement through PBGs would also benefit from extended macroeconomic monitoring that extends beyond the programs' closing dates. This could be managed in the context of the World Bank's country partnership framework.

The impact of PBGs on borrowers' credit terms varied from one program to another. In all of the PBGs reviewed by IEG, the aggregate interest rates were lower than they would have been without guarantees. However, this fact alone may not be sufficient for assessing the effectiveness of PBGs in improving borrowers' credit terms. Estimating the implied interest rate on the non-guaranteed portion of PBG-supported loans and the extent of possible "erosion" in the value of a guarantee is important for more comprehensive assessment of PBGs. In this respect, the review finds that the financial benefits from improved credit terms varied across the five PBGs that supported commercial loans. The review therefore highlights the importance of maximizing the financial benefits for the borrowers from PBGs. Assessing the full extent of financial benefits using this metric in World Bank self-evaluation could further enhance understanding of the overall effectiveness of PBGs.

Greater attention to the modality for raising private finance is needed. The choice between bank loans and bond issuance in capital markets involves

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several trade-offs that need to be considered in light of a particular borrower's circumstances and lessons learned from previous operations. Most recent PBG transactions have been through negotiated deals in the international bank loan markets. For bank loan markets to ensure pricing efficiency, it is necessary for the World Bank and the borrower to ensure competitive bidding, transparency, and due diligence. The review also emphasizes that, in light of growing

interest in PBGs, there is need for more comprehensive Bank group wide corporate guidance on borrowing modalities and on the roles and responsibilities of relevant departments, that could perhaps be undertaken in the review of WBG guarantee instruments launched in July 2016. A supportive governance framework for operations that make use of PBGs is important for enhancing the overall effectiveness of this important instrument.

1. Introduction

In 1999, the World Bank introduced policy-based guarantees (PBGs) as a new financing instrument to expand the menu of financing options in support of clients' reform programs. PBGs cover private lenders against the risk of debt service default by the sovereign borrower. They are structurally the same as the existing "partial credit guarantees" of the World Bank, but they provide budget and balance of payments support and are not tied to any specific projects. Building on the World Bank's policy-based operations and existing guarantees, the World Bank created PBGs with the ambitious goal of leveraging its resources in policy lending operations to attract more private financing so as to enhance poverty reduction and growth, and to reduce its own capital charges and exposure limits.

With global financial markets regularly going through cycles of boom and bust, and given limited access to emerging markets and marginal borrowers, the World Bank saw PBGs as an instrument to enhance sovereign access to commercial financing, particularly during periods of market downturns. PBGs were expected to combine the financial role of credit enhancement with the developmental function of supporting reforms. They targeted a government's overall performance in macroeconomic management and structural reforms, rather than specific projects or specific risks, as was the case under partial credit guarantees (PCGs) and partial risk guarantees (PRGs).

The World Bank's early experience with PBGs was colored by Argentina's default on its guarantee in 2002. Following the call on Argentina's guarantee, the World Bank's appetite for providing PBGs dried up for almost a decade. However, the more recent experience with Western Balkan countries during 2011–14 and with Albania and Ghana in 2015, appears to have been more positive. With World Bank support through PBGs, these countries were able to meet their financing needs during adverse market conditions in the aftermath of the global financial crisis and during severe financial distress in Southern Europe.

In 2013, operations policy governing PBGs was reformed, bringing such operations under OP 8.60, which covers all development policy financing (DPF).¹ Today, the

¹ The report uses "DPF" or "development policy financing" when referring to the instrument. "DPL" or "development policy lending" was the previous name of the instrument before incorporation of guarantees under OP 8.60. The report uses "DPOs" or "development policy operations" when it refers to specific DPF operations.

CHAPTER 1 INTRODUCTION

interest in PBGs is on the rise. Member countries are particularly attracted to the scale of financing and the market access under financial stress that PBGs have made possible.

Recent Independent Evaluation Group (IEG) evaluations have generated a body of evidence and findings concerning completed PBGs. Four project performance assessment reports (PPARs) covering small Balkan economies (Serbia, the former Yugoslav Republic of Macedonia, and Montenegro) were completed in 2016.² Evaluations of Poverty Reduction Support Credits in Ghana provided background material on the 2015 Ghana PBG. A recent review of the Albania PBG conducted by the World Bank is also relevant. The present note also draws upon IEG's 2009 thematic evaluation reviewing all guarantees provided by the World Bank from 1990 to 2007.

This learning product assembles the information and findings from these sources. As such, the report represents a step toward building a greater awareness of this important tool of development finance. Section 2 provides an overview of the instrument and its evolution. Section 3 reviews prerequisites for such operations, and how they were applied in practice. Section 4 assesses completed PBGs on the degree of access to finance and resulting financial benefits. Section 5 reviews the extent to which the reform agenda has been applied to advance the objectives of PBGs and the scope for improvement. The final section draws preliminary lessons on the potential benefits and risks of PBGs.

² The four PBGs are: Serbia Private and Financial Sector Policy-Based Guarantee (February 2011); Former Yugoslav Republic (FYR) of Macedonia Policy-Based Guarantee (November 2011); Montenegro Financial Sector Policy-Based Guarantee (May 2012); and FYR Macedonian Public Expenditure Policy-Based Guarantee (January 2013)

2. The Evolution of PBGs

When they were launched in 1999, PBGs specifically targeted International Bank for Reconstruction and Development (IBRD)-eligible countries with a strong track record of performance, a satisfactory structural and macroeconomic framework, and a coherent strategy for gaining access to international financial markets.³ The PBGs for Argentina (1999) and Colombia (2001) were designed and implemented under these eligibility conditions. In addition, the World Bank added the enhancement of an innovative “rolling reinstatable” mechanism by which IBRD would reactivate the guarantee if the borrower fully reimbursed IBRD following a default and a call by the lender on the guarantee.

With a PBG from the World Bank, Argentina was able to borrow \$1.5 billion in the international markets, with a series of six \$250 million zero-coupon bonds maturing sequentially over the period 2000–04. Similarly, Colombia completed a notes issuance of \$1 billion, structured with mortgage-style, semi-annual amortizations. The World Bank provided a rolling guarantee on the first two debt service payments at a time when conditions were unfavorable. Both PBGs were undertaken concurrently with other policy-based operations, including the Special Structural Adjustment Loan (SSAL, 1998) in the case of Argentina, and the Financial Sector Adjustment Loan (FSAL, 1999) in the case of Colombia. No special adjustments in the macroeconomic framework and policy priorities were needed to meet the prerequisite of PBGs. The PBGs simply replaced the second tranche of existing development policy operations, with no change in the World Bank’s exposure to the countries.

When Argentina defaulted on its bonds in October 2002, the call on the World Bank’s guarantee marked a turning point in the use of PBGs. As a consequence, the World Bank made a payment of \$200 million to bondholders as stipulated under the PBG. Subsequently, Argentina also failed to reimburse the World Bank within the stipulated 60-day deadline to allow for the guarantee to be reinstated. Financial markets reacted negatively to Argentina’s default, with a spillover to the Colombia PBG-backed bonds.

The global financial crisis of 2007–09 and the Eurozone crisis in its aftermath created a new impetus for PBGs. As governments of the Eurozone experienced severe financial distress, with the market values of their debts suffering deep losses, major European banks which held the bulk of the troubled assets were suddenly threatened with insolvency. At the same time, more stringent regulatory requirements on capital and

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CHAPTER 2 THE EVOLUTION OF PBGS

liquidity under Basel III standards were taking effect. Investor sentiment turned sharply negative, even for debt instruments issued by reputable firms with a global franchise. The demand for securities issued by borrowers from emerging markets was low.

Box 2.1. PBGs in the Context of Evolving Bank Policy

Policy-Based Guarantees (PBGs) cover private lenders against the risk of debt service default by the sovereign government. Although they are structurally the same as Partial Credit Guarantees (PCGs), a project financing instrument, PBGs are offered for balance of payments and general budget support. PBGs can be used for any commercial debt instruments (loans, bonds) provided by any private institution. As in regular budget support loans, proceeds of the guaranteed debt can be used for any budgetary purposes.

Although PBGs fully count against the World Bank's capital, only 25 percent of an issued guarantee counts toward the World Bank's country exposure limit. For example, with \$50 million of credit available to a client, the World Bank could issue a PBG in the amount of \$200 million, thereby scaling up World Bank assistance substantially without changing the World Bank's exposure to the country. This provision creates an incentive for the use of the instrument, especially for clients with large financing needs.

When they were launched in 1999, PBGs specifically targeted International Bank for Reconstruction and Development (IBRD)-eligible countries with a strong track record of performance. Specific eligibility criteria included: criterion A – The country should have a strong track record of performance and its structural, social and macroeconomic policy package should be satisfactory; criterion B – The country should have a sustainable external financing plan; and criterion C – The country should have a coherent borrowing strategy, which will enable it to become a borrower in its own name without a guarantee in the medium term. These criteria were applied in addition to development policy financing (DPF) criteria on the macroeconomic framework of DPF per OP 8.60.

The operational guidance on PBGs was changed in 2013, fully incorporating PBGs under OP 8.60 which governs the World Bank's DPF. This resulted in a number of changes, including elimination of special eligibility criteria governing PBGs and making the instrument available for International Development Association countries. The treatment of the macroeconomic framework under PBGs is the same as for DPF loans except in one detail: PBGs can be extended to those IDA-only countries that have low or modest risk of debt distress. In 2015, with a waiver from the Board, the World Bank issued a guarantee for Ghana, a country with high risk of debt distress.

Source: IEG, World Bank <http://siteresources.worldbank.org/INTGUARANTEES/Resources/IBRDPBG.pdf>.

In this environment, many borrowers, including the governments of Eastern Europe and Africa, faced an extraordinary hardship. Unable to raise funds at home or abroad, many countries turned to the World Bank and the International Monetary Fund (IMF) for assistance. This gave rise to a new burst of activities involving the use of PBGs, including four operations in the Western Balkans (one each in Serbia and Montenegro and two in FYR Macedonia) between 2011 and 2013. Another batch of three followed in

2015, with PBGs extended to Albania, Angola, and Ghana. In 2016, the World Bank approved a PBG to Pakistan. PBGs to Angola and Pakistan were operational at the time of the completion of this report. Interviews with stakeholders conducted by IEG indicate growing interest in the instrument among operational staff. Thus a new generation of PBGs may be on the horizon.

The overall footprint of PBGs in the World Bank’s loan portfolio has been small, despite successive waves of financial turmoil and the growing scale of financing needs. With a cumulative guarantee amount of less than \$4 billion, as of July 2016 (Table 2.1), financing through PBGs pales in comparison with private capital flows to these countries and with the World Bank’s own operations.

Table 2.1. World Bank Policy-Based Guarantees, 1975–2016

Operation title	Country	Commitment (US\$ millions)	Status as of June 2016	Approval date
Competitiveness and Growth Development Policy Financing	Pakistan	420	Active	21-June-16
Macroeconomic Stability for Competitiveness and Growth Credit	Ghana	400	Active	30-Jun-15
First Fiscal Management Development Policy Financing Operation	Angola	200	Active	30-Jun-15
Albania Public Finance PBG	Albania	226.7	Active	27-Mar-15
FYR Macedonia Public Expenditure PBG	FYR Macedonia	201.5	Closed	8-Jan-13
Montenegro Financial Sector PBG	Montenegro	79.2	Closed	28-Jun-12
FYR Macedonia PBG	FYR Macedonia	134.9	Closed	10-Nov-11
Private and Financial Sector PBG	Serbia	400	Closed	10-Feb-11
Colombia PBG	Colombia	220.3	Closed	8-Mar-01
Argentina PBG	Argentina	250	Closed	16-Sep-99

Note: For active and closed projects, the commitment amount at Board approval is shown in U.S. dollars. These figures do not reflect any cancellations.

The PBGs that have been reviewed and evaluated by IEG (Serbia, Montenegro, and two guarantees with FYR Macedonia) were all designed and appraised under the old framework. More recent PBGs (Albania, Ghana, Angola, and Pakistan) were prepared under OP 8.60.

Box 2.2. Outcome Ratings of Completed and Evaluated PBGs

As of the end of FY16, IEG had validated and evaluated four PBGs. The outcome ratings are presented in the table below. Serbia's PBG was found to be successful in providing needed financing through the country's first commercial international borrowing, and supporting important sector specific reforms. A weak macroeconomic framework was the key reason behind the poor outcomes for Montenegro. The PBGs in FYR Macedonia were rated moderately satisfactory because of poor performance on public financial management (in the first PBG) and weaknesses in the macro framework (in the second).

	Outcome Rating
Serbia	Satisfactory
FYR Macedonia 1	Moderately Satisfactory
Montenegro	Moderately Unsatisfactory
FYR Macedonia 2	Moderately Satisfactory

Source: IEG.

3. The Quality of the Macro-Fiscal Framework of PBGs

Under the World Bank’s operational framework of DPF, PBGs are to be implemented in the context of a credible macro framework. OP 8.60 governing DPF also stipulates that, if macroeconomic instability remains a risk, the World Bank needs to require special macroeconomic and fiscal actions to be implemented as risk mitigation measures.

Data from six operations implemented since 2011 and reviewed by IEG indicate that because of the guarantee element, PBGs tend to mobilize larger financing compared to development policy loans (DPLs). On average, these PBGs provided close to 2.3 percent of gross domestic product in external financing – substantially higher than under regular DPLs (table 3.1).⁴ This phenomenon is explained not only by the fact that the financing requirements of borrowing countries were high at that time, but also because the magnitude of funding mobilized by PBGs would not, in most cases, have been possible under regular DPOs because of the World Bank’s country exposure limit.

Table 3.1. Financing Mobilized through World Bank Policy-Based Guarantees

Operation title	Country	PBG amount (US\$ millions)	Total Financing mobilized (US\$ millions)	Total Financing as percent of GDP
Macroeconomic Stability for Competitiveness and Growth Credit	Ghana	400	1,000	2.1
Albania Public Finance PBG	Albania	226.7	283.4	2
FYR Macedonia Public Expenditure PBG	FYR Macedonia	201.5	325	3.4
Montenegro Financial Sector PBG	Montenegro	79.2	132	3.2
FYR Macedonia PBG	FYR Macedonia	134.9	175	1.7
Private and Financial Sector PBG	Serbia	400	400	1

Source: IEG

The four PBGs evaluated by IEG were deployed in a challenging macroeconomic context with important fiscal imperatives. Despite the requirement and policy guidance,

⁴ The average size of preceding DPOs in Ghana, Albania, FYR Macedonia, Montenegro, and Serbia was 0.8 percent of GDP

CHAPTER 3
THE REQUIRED MACRO-FISCAL FRAMEWORK FOR PBGS

the quality of the macro framework supporting PBGs varied. Table 3.2 summarizes key features of the macro framework for the PBGs for which IEG has evaluative evidence.⁵

Table 3.2. Macro-Framework for Selected PBGs Reviewed and Evaluated by IEG

Country	Macro-Fiscal Framework
Serbia	IMF program
FYR Macedonia I	IMF program
Montenegro	No IMF program. Substantial macro risks, no specific objectives and policy content in the program to address those risks. The PPAR found that macro eligibility criteria might have not been fully met at the time of issuance of the guarantee.
FYR Macedonia II	Effectively no IMF program (program was set to expire shortly after the approval of PBG). The PPAR highlighted that the availability of PBG might have postponed adjustments and led to larger fiscal deficits.
Ghana	IMF program, strong macro-program to mitigate significant risks. Guarantee supported Eurobond issuance for refinancing of short-term domestic debt.

Source: IEG

The PBG for Serbia was implemented in parallel to an IMF program with high confidence in the underlying macro framework. That was also the case for the first PBG in FYR Macedonia and the one in Ghana. The situation was different with the second PBG in FYR Macedonia and the Montenegro PBG. In both cases, IEG evaluations found that the focus on the macro framework was not adequate.

In the case of FYR Macedonia, the PBG was implemented at a time when unauthorized capital expenditures and weakened fiscal control created substantial controversy. There were also legitimate concerns about some spending decisions that could undermine the fiscal framework, such as ad hoc increases in pensions. The PPAR found that the availability of a large loan through PBGs might have contributed to an expansion of the government’s spending program.⁶ Because the IMF program was scheduled to expire, it heightened the macro risks and put a special burden on the World Bank to ensure that the macro and fiscal framework remained adequate. The PPAR concluded that the second PBG in FYR Macedonia was not used effectively by the World Bank to secure a proper fiscal policy stance.

⁵ Evidence on Ghana PBGs is collected through an informal review of the macroeconomic framework of PBG as part of the PPAR on Ghana.

⁶ PPAR of PEPBG, FYR Macedonia, IEG, 2016.

In the case of Montenegro, IEG found that the fiscal projections underpinning the PBG were unrealistic, in contrast to independent projections available at the time, including those of the IMF.⁷

In contrast to Montenegro and FYR Macedonia II, the PBG in Ghana was strongly linked and complementary to an IMF program.⁸ In 2012, when Ghana was holding general elections and not implementing an adequate macro framework, the World Bank stopped the provision of budget support. However, in 2015, with the return of the IMF program, the World Bank resumed its adjustment lending, and introduced a PBG to help address the exceptionally large financing needs. The underlying macro framework was adequate and was endorsed by the IMF. The PBG supported the issuance of Eurobonds in 2015, with the proceeds earmarked for refinancing and buying back high-interest debt. No additional spending resulted from the large proceeds made possible by the PBG. On the contrary, the authorities appeared motivated to implement difficult adjustments because of the PBG.⁹

Based on evidence from these IEG PPAR evaluations, this report highlights that the requirement of an adequate macro framework for World Bank DPFs is especially important in the context of large policy loans supported by PBGs. Under a comprehensive and robust macro framework, PBGs, as a DPF instrument, can facilitate and serve as important leverage for policy reforms in support of fiscal sustainability and other important policy areas. In the absence of such a framework, PBGs may create risks of fiscal overspending as a result of the availability of large-size financing. Evidence gathered by IEG indicates that, in some contexts, the availability of large financing without an adequate macro framework may dilute the incentive of the borrower to uphold fiscal discipline. Large financing operations, especially those magnified by the addition of PBGs, should be avoided if the World Bank is not able to fully address the existing macro risks through policy lending and dialogue. In the absence of a parallel IMF program, there is a particular need to pay attention to such macroeconomic risks.

It is thus imperative, for all policy-based lending, and even more so for such leveraged operations, that before granting a PBG, the World Bank ensures the integrity of the macro framework and supports additional corrective measures as needed. Moreover,

⁷ PPAR of PBG, Montenegro, IEG, 2016.

⁸ “Macroeconomic Stability for Competitiveness and Growth Credit” Program Document, World Bank, 2015.

⁹ Ghana’s case has been used only for assessing the underlying macro framework - this report does not examine the borrowing modality used by the Government under this PBG.

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the World Bank is required to monitor the program up to the closing date, which is typically less than a year from approval date, typically covering only a fraction of a guarantee's duration. It is essential to monitor the actions of the borrower during the entire period while the guarantee is in effect. This can perhaps be done as part of the World Bank's country partnership strategy with relevant clients.

For these reasons a question may be raised about whether the current operational framework of DPF adequately ensures a sound macro framework for PBGs. Eligibility criteria for PBGs prior to 2013 were more demanding, because they were built around assumptions about a downward public and external debt trajectory. That said, the Montenegro PBG illustrates that even those criteria alone could not guarantee a satisfactory macroeconomic framework. An IEG review in 2015 found that most DPOs are underpinned by an adequate macro framework, and OP 8.60 provides the necessary guidance on acceptable treatment of macroeconomic issues in World Bank DPF.¹⁰ With a stronger focus on these issues in PBGs, the World Bank should be able to address macro and fiscal risks and further promote important reforms in fiscal and debt institutions. Rigorous debt sustainability analysis would be key to ensuring quality macro and fiscal frameworks for PBGs under OP 8.60. These suggestions could be reviewed together with the overall re-appraisal of the World Bank Group's guarantee instruments, launched in FY17.

¹⁰ "The Quality of DPOs' Macroeconomic Framework" IEG Learning Product, 2015.

4. Did PBGs Improve Access to Private Finance and Credit Terms?

Access to commercial finance with improved credit terms is the key motivation and an objective in all PBGs, which support not only a particular debt transaction, but also may pave the way for the regular presence of the borrower in international markets.¹¹ The definition of “access to finance” has evolved since the introduction of PBGs in the late 90s. Whereas initially the focus of the instrument was to help clients lacking access to international markets, the emphasis has recently shifted to a broader definition of access to market, which includes the volume of private financing, maturity, and financial terms. This enabled provision of PBGs to countries that already have some level of market access.¹²

PBGs may be assessed on the criteria of the amount of commercial financing raised and improvements in financial terms that includes both maturity and interest rates. Though difficult to measure precisely, these criteria help capture the value of PBGs in terms of both attracting private creditors and securing advantageous terms, given the prevailing market conditions and investor sentiment.

Table 4.1. Summary Terms of Commercial Loans Supported by PBGs

	Serbia	FYR Macedonia I	Montenegro	FYR Macedonia II	Albania
Effective Date	February, 28, 2011	December 2011	July 2012	January 2013	March 2015
Amount	EUR 293 million	EUR 130 million	EUR 100 million	EUR 250 million	EUR 250 million
Coverage	100% of principal at maturity	76% of principal at maturity	60% of principal at maturity	62% of principal at maturity	80% of principal at maturity
Maturity	6 years	5 years	7 years guaranteed portion and 5 years the rest	7 years guaranteed portion and 5 years the rest	10 years
Interest	Euro Swap plus 100 basis points	4.25 percent	350 basis points spread over 12-month Euribor	3.9 percent	130 basis points spread over 12-month Euribor

¹¹ Some PBGs had explicit “financial” objectives in the policy matrix (Serbia and FYR Macedonia), though these objectives were related to the terms of subsequent independent borrowing rather than the terms of the instruments supported by PBGs.

¹² “Modernizing the World Bank’s Operational Policy on Guarantees,” Operational Policy and Country Services.

CHAPTER 4

DO PBGS IMPROVE ACCESS TO PRIVATE FINANCE AND FINANCIAL TERMS?

Source: IEG

Effects on market access. In practice, PBGs helped secure financing that could otherwise be out of reach when market conditions were unfavorable. The four PBGs reviewed by IEG opened a pathway to private finance at a time of global financial distress. Shocked by the exceptional turmoil in major financial centers and crises in Southern Europe, investors were not receptive to small Eastern European emerging economies. The four PBGs in the Balkans met their objectives of helping governments raise the desired volume of private finance at terms that were acceptable. The guarantees secured total commercial bank credit of EUR 780 million with maturities of five to seven years.

For Serbia, the PBG facilitated the country's first external sovereign borrowing transaction and secured a relatively large loan of long maturity. The loan was extended by Société Générale in 2011 through competitive bidding. The principal amount was EUR 296.2 million, fully covered by the World Bank's guarantee and priced at a 100 basis point spread above the EURIBOR. The maturity of six years was particularly attractive, given Serbia's heavy reliance on more expensive short-term local market funding in the past. Following the PBG, Serbia went back several times to international markets independently between 2012 and 2015, raising \$5 billion through bond issues with maturities of five to 20 years.

In the case of FYR Macedonia, the first PBG helped the government regain access to international markets in 2011. Designed as a standalone PBG, the operation allowed the government to borrow EUR 130 million from Deutsche Bank and Citibank. In January 2013, FYR Macedonia received a second PBG from the World Bank to raise EUR 250 million from Deutsche Bank under somewhat more favorable market conditions than the first. The second PBG helped cover the government's large fiscal gap. Between the two loans supported by PBGs, FYR Macedonia was able to independently tap the international loan markets in July 2012, although the amount involved was much lower than expected. The PBGs for FYR Macedonia, especially the second one, were more important in raising the volume of finance rather than opening access to markets.

The experience of neighboring **Montenegro** underlines the critical role played by the World Bank guarantee in overcoming credit constraints during times of financial distress. Having suffered one of the deepest downturns in the aftermath of the recent global financial crisis, Montenegro was in a financial straitjacket. The EUR 60 million PBG helped the government borrow EUR 100 million from Credit Suisse to cover a large part of its budget deficits in 2012. Montenegro was able to contract a commercial loan two months prior to the approval of the PBG, but it also needed to provide gold as partial collateral and to accept a relatively high rate.

Effects on maturity. PBGs also helped extend the maturity of loans. The improved tenor, however, is mostly confined to the guaranteed portion of the loans and not to the non-guaranteed portion. This result is clear from the loans to FYR Macedonia and Montenegro, which were split into guaranteed and non-guaranteed portions. The guaranteed portion of the loans enjoyed an extended maturity. The non-guaranteed portion did not see an increase in maturity compared to earlier non-guaranteed loans.

Effects on subsequent borrowing. The role of PBGs in improving the terms of credit on subsequent and non-guaranteed loans is more difficult to determine. In some cases, when a PBG was followed by an independent debt issuance, the terms were reasonable and better than those obtainable before or without the PBG. These cases, however, occurred when market conditions were benign, including the years 2014 and 2015. The role of PBGs in strengthening the borrower's position is noticeable in the case of Serbia. In this case, there were substantial capacity development and knowledge transfers from the World Bank with respect to debt management. By contrast, FYR Macedonia and Montenegro already had established a presence in the international markets prior to PBGs.

Effects on interest rates. The key contribution of the instrument is its effect on interest rates. To the extent that the World Bank is perceived to have a lower credit risk than the borrower, the guaranteed loans should carry a lower rate than independent loans as a result of better credit terms. The standard method used in the World Bank of showing these benefits is to compare the actual interest rates with hypothetical (counterfactual) rates that the borrower would have paid for a similar loan without a guarantee. For some PBGs, the World Bank provided such estimates of the reduction in interest rates as a result of World Bank guarantees. This is normally presented in program documents or implementation completion and results reports. Deriving good counterfactuals, however, is challenging and requires sophisticated market tests, which are not always possible.

These analyses, while very useful, do not give the full picture of financial benefits. The difference between the counterfactual and the actual interest rate is not amenable to straightforward interpretation. How large does the difference need to be to make it a success? A higher percentage of the loan covered by the guarantee would lead to a larger reduction in interest rates. For example, the interest rate on an instrument that is 90 percent guaranteed by the World Bank should be lower compared to an instrument that is 50 percent guaranteed, if other factors are held constant.

An elegant way of determining the PBG's contribution to the borrower's credit terms is to derive the implicit interest rate on the non-guaranteed portion of the PBG-supported loan. This is based on the premise that the actual borrowing rate of the PBG-supported

CHAPTER 4

DO PBGS IMPROVE ACCESS TO PRIVATE FINANCE AND FINANCIAL TERMS?

loan is the weighted average of the rate on the guaranteed portion and the rate on the non-guaranteed portion. The guaranteed portion should carry a rate that is the same or close to the borrowing cost of the World Bank. The rate on the non-guaranteed portion reflects the borrower's creditworthiness. This approach was articulated in an Operations Policy and Country Services (OPCS) paper on enhancing the effectiveness of PBGs (Box 4.1).

Box 4.1. An OPCS Metric of Improvements in Financial Terms - 2012

According to a note on PBGs provided by Operations Policy and Country Services to the Bank's Board for discussion, in 2012, "Improved financial terms refers to the implied spread on the unguaranteed portion of the borrowing (which thereby adjusts for the effects of the protection that the [World] Bank guarantee provides) being equal to or lower than a comparable reference spread on nonguaranteed borrowing. Even with the broadened definition of improved market access, at a minimum the implied spread on the unguaranteed portion of the borrowing is expected to be equal to a comparable reference spread."

Source: World Bank, 2012. "Modernizing the World Bank's Operational Policy on Guarantees," Operational Policy and Country Services. URL: <http://siteresources.worldbank.org/EXTRESLENDING/Resources/1-5-12-Guarantee-AP-post-CODE-clean.pdf>.

This implicit rate shows the *sovereign risk premium* associated with the debt instrument supported by PBGs. Financial benefits from PBG will fully materialize, or in other words, the value of PBG will be preserved if the interest rate of the non-guaranteed component is in line with the sovereign risk premium in the market. The difference between these two rates can point to the extent of "erosion" of the value of PBG as a result of structuring of the debt instrument, which can be driven by a number of factors, including possible additional premium demanded by the markets and other inefficiencies.¹³

For the purpose of this learning product, IEG worked in cooperation with relevant World Bank units to identify the extent to which the implied interest rates for the five commercial loans supported by PBGs (four evaluated PBGs and the Albania PBG) were

¹³ There is a hypothetical possibility that as a result of increased investor confidence, the implied interest rate can be lower than sovereign risks premium in the market. This "halo" effect of PBGs is possible especially for marginal borrowers that are not well known and monitored closely by large international lenders. For these borrowers, the World Bank can serve as an honest broker to alleviate information asymmetry between lenders and borrowers. This effect, however, is very difficult to detect. Possible changes in market perceptions resulting from PBGs are more likely to occur at the outset of the program, when markets first learn about World Bank support, and to be gradually factored in, rather than at the end of the process when the deal is signed.

different from relevant yields in the market, which would point to the extent of erosion of the value of the guarantee. (The appendix to this report illustrates the methodological approach).

Overall, there was a variation across the five loans supported by PBGs. In one case, no erosion in the value of the PBG was detected. In two PBGs, the observed erosion was quite low, while in the remaining two operations, the observed erosion was higher.¹⁴ In terms of factors explaining why structuring of a debt instrument could result in a loss in the value of a guarantee and, subsequently, less than expected benefit for the borrower, the review highlights that in one case, a substantial improvement in market conditions took place in the period between the borrower's commitment to the loan and actual signing, making the agreed interest rate less favorable compared to market conditions at the time of signing. There is also evidence that for bank-loan markets to yield pricing efficiency, competitive bidding, transparency, and due diligence on the part of the borrower and the World Bank are essential.

It could be a useful exercise for PBG teams to work with clients on the decomposition and benchmarking of interest rates of debt instruments supported by PBGs to allow for better assessment of the extent of improvements in credit terms. World Bank self-evaluation of PBGs through implementation completion and results reports can serve as an appropriate platform for such analysis.

Based on the cases reviewed, greater attention is also needed to the modality for raising private finance for maximizing financial benefits for the clients. The choice between bank loans and bond issuance involves several trade-offs that need to be considered in light of a particular borrower's circumstances. Most recent PBG transactions have been through negotiated deals in the international bank loan markets. For such markets to ensure pricing efficiency, it is necessary for the World Bank and the borrower to ensure competitive bidding, transparency, and due diligence. The review also emphasizes that, in light of growing interest in PBGs, there is need for more comprehensive World Bank-wide corporate guidance on borrowing modalities and on the roles and responsibilities of relevant units in the World Bank. Such guidance could be reviewed in the light of the ongoing Bank Group-wide review of guarantee instruments¹⁵. Such a supportive governance framework for PBGs in the World Bank is essential for enhancing the overall effectiveness of this important instrument.

¹⁴ Specific PBGs are not mentioned due to market sensitivities.

¹⁵ "Steering Committee on Guarantees," An internal World Bank document.

5. Reform Agenda under PBGs

IEG reviews indicate that the reform content of PBGs is not materially different from that of non-guarantee DPOs, and reflect greater or lesser degrees of macroeconomic stringency, as do other DPOs. Furthermore, nothing in the World Bank's operational policy suggests that the reform content of PBGs should be different from other policy-based operations. As emphasized by the World Bank, for DPOs backed by PBGs, access to private finance is only one side of the coin. The principal agenda is for the implementation of policy and institutional reforms.

The reforms underlying all four PBGs in Balkan countries built on previous World Bank-supported operations and represented part of a broader reform agenda consistent with current country partnership strategies. For example, FYR Macedonia's reform program, supported by its first PBG, was originally designed as the second operation of a series of programmatic DPLs. At the request of the government in early 2011, the World Bank converted DPL2 into a standalone PBG, retaining largely the same policy matrix as was envisaged for DPL1.

Box 5.1. Summary of Reform Contents under Selected PBGs

Envisaged reforms in Serbia under its PBG were associated with: (i) improving the business environment for the private sector, and (ii) making the financial sector more stable and efficient.

The key policy objectives under the FYR Macedonia first PBG were to: (i) strengthen sustainability of public finances and functioning of labor markets; (ii) strengthen social safety nets, and (iii) improve resilience of financial sector.

In many respects, FYR Macedonia's second PBG – the Public Expenditure Policy-Based Guarantee – was, for all intents and purposes, a crisis-related assistance aimed at mitigating the impact of the renewed Euro zone turmoil and difficult financial market access. The focus of policy measures under the PBG was on improving the efficiency of public expenditures and public financial management along with strengthening health systems and improving the targeting of social assistance and social inclusion.

Finally, in the case of Montenegro, FSPBG was designed to support the authorities' efforts to strengthen the banking system and increase its resilience to possible future shocks by continuing to undertake sectoral policy reforms and system restructuring.

Source: IEG

According to OP8.60, the size of financial assistance in the World Bank's policy-based operations is irrelevant for the determination of an appropriate reform agenda. The

choice of lending instruments, as well as the size of assistance, is dictated by macroeconomic considerations and by the World Bank's risk management requirements. And the reform agenda depends on a different set of variables, including government priorities, political support, and capacity.

Some stakeholders, however, find that the reform agenda for PBGs should be more demanding because they tend to give proportionally larger financial support due to increased leverage. The increase should also be used as leverage for promoting more difficult actions. Adding a PBG to a DPL offers greater financial support but may merit attaching deeper reforms. Otherwise, they may represent an opportunity lost, according to this perspective.

In practice, as IEG's reviews of PPARs and some other available information illustrate, World Bank operations have involved both of these approaches. There are cases of "performance-based" determination of the amount of financing.¹⁶ By the same token, an increase in funding could be provided for strong performance and perhaps for agreement to a stronger reform program.

IEG finds that the World Bank may have missed an opportunity in some PBGs by not negotiating a deeper reform agenda when the size of financial support was significantly increased. In the case of Montenegro, for example, IEG finds that by the time the PBG was being prepared there was evidence that resolution of nonperforming loans was moving much slower than expected, and that could have been addressed through the PBG. In the second FYR Macedonia PBG, IEG finds that at the time of preparation urgent policy issues had emerged with respect to public financial management. The conversion of an existing DPL into PBG with much larger funding gave the World Bank an opportunity to address those issues more comprehensively, which, according to the PPARs, was not fully used.

The policy content of PBGs should be seen as an important tool to strengthen market perceptions of debt sustainability and facilitate improvement of financing terms for clients. The demand for PBGs has been strongest when governments face severe fiscal needs, sometimes without the support of the IMF. Strong measures, including actions that the IMF may have called for, are needed to mitigate the underlying risks. With PBGs, the World Bank hopes to bring about attractive financial terms from private commercial lenders. The underlying reform program needs to be credible and capable of standing up to scrutiny by independent parties. And last, there is an element of elevated risk of financial loss to the World Bank that needs to be mitigated. Therefore,

¹⁶ For example, downsizing of support under Tanzania's PRCs due to the failure to comply with important triggers.

CHAPTER 5
REFORM AGENDA UNDER PBGS

the reform agenda should be geared toward ensuring sound macro and fiscal frameworks through incorporation of fiscal reforms and other structural reforms with important implications for fiscal sustainability in the policy matrix.

6. Lessons

This learning product offers the following lessons.

PBGs represent an important instrument of development policy financing that can be used effectively to help members overcome difficult financing and reform challenges.

The PBG approach brings a potentially powerful combination of client benefits, private sector participation, and financial leveraging of World Bank resources. Through a PBG, World Bank capital is tied up for a much shorter period than for a standard policy loan. The fact that only 25 percent of an issued guarantee counts toward the World Bank's country exposure limit creates an incentive for the use of the instrument, especially for clients with large financing needs. The benefits to World Bank clients include improved market access, potential diversification of the creditor base, longer maturity, and lower interest rates. IEG's review of PBGs found that, with World Bank support, borrowers were able to meet their financing needs during difficult market conditions.

A robust macroeconomic and fiscal policy framework is essential for sustaining benefits from improved access to private finance for deficit financing. As a DPF instrument, PBGs can facilitate a range of important policy reforms in client countries. Some of the PBGs evaluated by IEG, however, would have benefited from a stronger focus on mitigating fiscal and macroeconomic risks. Evidence suggests that, in some cases, relatively large loans mobilized through PBGs might have created incentives for suboptimal fiscal choices, particularly in the absence of an IMF program. The report highlights the importance of rigorous application of the World Bank's operational policy on the macroeconomic framework of DPF with a special focus on mitigating sovereign default risks through debt sustainability analysis. Incorporation of necessary mitigating actions in the policy matrix is especially important for PBGs. Close collaboration with IMF is likely to be valuable. The World Bank's engagement through large DPOs backed by PBGs will also benefit from extended macroeconomic monitoring that goes beyond a program's closing date. This can be managed in the context of the World Bank's country partnership framework.

The impact of PBGs on borrowers' credit terms varied from one program to another. In all of the PBGs reviewed by IEG, the aggregate interest rates were lower than they would have been without guarantees. However, this fact alone may not be sufficient for assessing the effectiveness of PBGs in improving borrowers' credit terms. Estimating the implied interest rate on the non-guaranteed portion of PBG-supported loans and the extent of possible "erosion" in the value of a guarantee is important for more comprehensive assessment of PBGs. In this respect, the review finds that the financial benefits from improved credit terms varied across the five PBGs that supported

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commercial loans. The review therefore highlights the importance of maximizing the financial benefits from PBGs. Assessing the full extent of financial benefits using this metric in World Bank self-evaluation could further enhance understanding of the overall effectiveness of PBGs.

Based on the cases reviewed, greater attention is needed to the modality for raising private finance. Whether or not to add a PBG to a DPL, as well as the choice between bank loans and bond issuance, involves several trade-offs that need to be considered in light of a particular borrower's circumstances. Most recent PBG transactions have been through negotiated deals in the international bank loan markets. For such markets to ensure pricing efficiency, it is necessary for the World Bank and the borrower to ensure competitive bidding, transparency, and due diligence. The review also emphasizes that, in light of growing interest in PBGs, there is need for more comprehensive World Bank-wide corporate guidance on borrowing modalities and on the roles and responsibilities of relevant units in the World Bank. Such guidance could be reviewed in the light of the ongoing Bank Group-wide review of guarantee instruments. Such a supportive governance framework for PBGs in the World Bank is essential for enhancing the overall effectiveness of this important instrument.

Appendix A: Assessing the Implied Interest Rate of Non-guaranteed Instruments and the Value of Guarantees: A Methodological Approach

Commercial loans or bonds partly guaranteed by the World Bank can be seen as a “bundle” combining two distinct credit risks. “Unbundling” of the instrument and deriving the implied interest rate on the non-guaranteed portion of the instrument would therefore allow to observe the sovereign risk premium associated with the particular transaction. It would also allow to assess the value of guarantee or the extent of losses from structuring of the instrument by comparing the implied rate with comparable rates on sovereign’s other borrowing instruments.

For the purpose of this learning product IEG has developed a framework to derive upper and lower bounds of the implied interest rates associated with PBG-supported transactions. In addition, some calculations of the “value” of guarantee for commercial loans were available at the Bank based on the approach outlined in a guide for potential investors titled “Pricing partially guaranteed bonds” (Financial Solution occasional Paper 001/16, February 2016¹⁷). Although somewhat different in their approaches, these two sets of estimates pointed generally to the same direction in terms of the extent of financial benefits from guarantees in individual operations.

It should be noted that IEG’s approach does not depend on assumptions about sovereign yields, but comparing the results with other instruments does depend on availability of comparator instruments. Bank’s approach in deriving the actual value of guarantee is based on assumptions about sovereign risks premium. As sovereign yields for many of Bank’s clients cannot be easily observed both approaches have limitations and should be interpreted with a caution.

In IEG approach, it is first assumed that the implicit interest rate for the guaranteed portion of the loan should be equal to the yields on IBRD bonds, and that there is no erosion in the value of guarantee as a result of structuring of debt instrument (markets do not require additional premium). The implied interest rate of non-guaranteed portion can be derived using the formula below.

¹⁷ <http://documents.worldbank.org/curated/en/723281467998238063/pdf/103282-v1-WP-Occasional-Paper-001-Partially-guaranteed-bond-valuation-final-Box394864B-PUBLIC-Volume-1.pdf>

APPENDIX A:

ASSESSING THE IMPLIED INTEREST RATE OF NON-GUARANTEED INSTRUMENT: AN IEG APPROACH

$$I_{NG} = (AI - W_G * I_{IBRD}) / W_{NG}$$

Where I_{NG} is the implied interest rate on nonguaranteed portion of the loan; AI is the aggregate interest rate on the bundle; W_G and W_{NG} are the weights of guaranteed and nonguaranteed components of the loan based on principle amount respectively derived from present values of exposure; and I_{IBRD} – is the IBRD bond rate in euros of similar maturity. The formula captures cases when the maturity of guaranteed and nonguaranteed components is different, as in the case of the loans reviewed by IEG¹⁸.

The formula above will give the lower bound of the implied interest rate of non-guaranteed portion of the instrument as markets may seek additional premium, for a range of reasons, on guaranteed component of the instrument in addition to the risk premium of the reputable guarantor. Due to the fact that the loan to Serbia supported by PBG was fully guaranteed (based on principle amount), it is the only case where the difference between IBRD bond rates and spreads on the guaranteed instrument can be observed. The difference, however, does not appear material: the interest rate on guaranteed instrument (Euro Swap rate plus 100 basis points) was largely in line with the IBRD bond rate of comparable maturity. Based on this and available other information on the extent of possible market fluctuations, IEG uses a 0.5 percentage point (50 basis points) difference to derive an upper bound for the risk premium for non-guaranteed component of the instrument with the equation below.

$$I_{NG} = (AI - W_G * (I_{IBRD} + P)) / W_{NG}$$

Where P is an estimate of empirically observed maximum difference between the guaranteed component of IBRD guaranteed instrument and comparable IBRD bond rates.

With these two equations a range for the interest rate of non-guaranteed components of the instruments guaranteed by the World Bank can be estimated. Comparing this rates with the interest rates of comparator debt instrument would point to the extent of efficiencies in structuring of Bank-supported instruments. Identical or similar rates would indicate that there was no loss in the value of guarantee and, accordingly, financial benefits were larger. If the implied rate on the non-guaranteed portion of the loan is higher than it would indicate on possible erosion in the value of guarantee and smaller financial benefits from PBGs.

¹⁸ An alternative approach could have been to derive the weights based on cash flows, but for this exercise the weights based on principle amount were found as more appropriate.

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