

MIGA's Financial Sector Guarantees in a Strategic Context



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Abbreviations and Acronyms

ABS	Asset-backed security	LICUS	Low Income Countries Under Stress
ADB	Asian Development Bank	MATR	Management Action Track Record
AIG	American International Group, Inc.	M&E	Monitoring and evaluation
AMS	Agribusiness, manufacturing, and services sector	MIGA	Multilateral Investment Guarantee Agency
ARDE	Annual Report on Development Effectiveness	MIGOP	MIGA Operations Department
BP	Bank Procedure	NEXI	Nippon Export and Investment Insurance
BPR	Business Process Review	NGO	Non-governmental organization
BU	Berne Union	OeKB	Oesterreichische Kontrollbank Aktiengesellschaft (Austrian PRI Agency)
CABEI	Central American Bank for Economic Integration	OGM	Oil, gas, and mining sector
CAS	Country Assistance Strategy	OP	Operational Policy
CODE	Committee on Development Effectiveness	Op Regs	Operational Regulations
DA	Definitive Application	OPIC	Overseas Private Investment Corporation
DFID	Department for International Development (UK)	PA	Preliminary Application
DIFC	Dubai International Finance Corporation	PER	Project Evaluation Report
EC	European Commission	PCR	Project Completion Report
ECA	Europe and Central Asia Region	PFG	Project Finance and Guarantee (WB)
ECG	Evaluation Cooperation Group	PPP	Public-private partnership
EIA	Environmental impact assessment	PRC	Project Review Committee
EIB	European Investment Bank	PRG	Partial Risk Guarantee
EMS	Environmental management systems	PRI	Political risk insurance
EROIC	Economic return on invested capital	PSD	Private sector development
ERR	Economic rate of return	PU	Project Underwriting
EVP	Executive Vice President	PwC	PricewaterhouseCoopers
FDI	Foreign direct investment	ROC/ROOC	Return on operating capital
FIAS	Foreign Investment Advisory Service	ROE	2003 Report on Operations Evaluation in MIGA (OEU)
FRR	Financial rate of return	SIP	Small Investment Program
FY	Fiscal year	SME	Small and medium-sized enterprise
GDP	Gross domestic product	SMI	Small and medium-sized investor
IBRD	International Bank for Reconstruction and Development	SINOSURE	China Export and Credit Insurance Corporation
IFC	International Finance Cooperation	TA	Technical Assistance
IDA	International Development Association	TAAS	Technical Assistance and Advisory Services
IEDR	Independent Evaluation of IFC's Development Results	UNCTAD	United Nations Conference on Trade and Development
IFC	International Finance Corporation	WBG	World Bank Group
IPA	Investment Promotion Agency	WCD	War and Civil Disturbance (coverage)
JBIC	Japan Bank for International Cooperation	XPSR	Expanded Project Supervision Report
KEIC	Korean Export Insurance Corporation		
KPI	Key performance indicator		

Foreword

The Independent Evaluation Group's (IEG) evaluation draws lessons from recent experience with one of the Multilateral Investment Guarantee Agency's (MIGA) main pillars, financial sector guarantees – its most important business area today – to inform the design and implementation of MIGA's new *Strategic Directions*. The challenge of the new strategy – the first in the *post*-Convention change era – is to enable MIGA to better exploit its original mandate and take full advantage of the new opportunities opened up by the changes to its Convention, at a time of continuing uncertainties about the global post-crisis recovery.

MIGA is on track to meet some, but not all of its key performance targets for the current strategy period. In particular, while MIGA met its target of being "overweight" in International Development Association countries, "growing the business" has been a significant challenge, and MIGA's capital utilization has accordingly been low (31 percent at end-FY11) in IEG's assessment and by also MIGA's own reports. Similarly, aligning operations with strategic goals and demonstrating the development effectiveness of operations have remained challenging.

IEG found that MIGA's financial sector guarantees were strategically relevant and developmentally impactful, particularly in transition economies whose banking systems that have not completed their reforms. Their development outcome performance is high – 80 percent were rated "satisfactory" or better, compared to 48 percent of non-financial sector projects. However, financial sector guarantees are only weakly aligned to MIGA's strategic priority areas – they typically support projects in International Bank for Reconstruction and Development countries and are absent in Africa. At the same time their alignment to the World Bank Group's goal of responding to the global financial crisis is strong. IEG estimates that financial sector guarantees have not contributed positively to MIGA's financial results in the past decade as their profitability was undercut by high levels of reinsurance. Finally, MIGA still faces challenges in improving the quality of its underwriting, although financial sector projects perform better than other sectors (60 percent are rated less than satisfactory compared to 71 percent of all of evaluated projects.)

Several lessons for the design and implementation of MIGA's new strategy emerge from this evaluation, which confirm and complement earlier IEG findings on MIGA's institutional and development effectiveness. First, the report reconfirms the need for MIGA to articulate a fundamental value proposition and make this the basis for its next strategy; in this context, reviewing eligibility policies and practices, pricing, and economic capital models appears essential to support greater product flexibility, as does measuring project-level financial results. Second, it will be important for MIGA to strengthen its approach to track strategy implementation, development effectiveness and institutional performance, including by measuring project development outcomes and reporting "dis-

connects” between IEG’s independently validated project results and MIGA’s own self-assessed project ratings. Finally, MIGA could improve the Quality of Underwriting of financial sector projects – and also of other sectors – by institutionalizing a culture of learning by distilling lessons from evaluation and self-evaluation and applying them to new operations.

A handwritten signature in dark ink, appearing to read "Vinod Thomas". The signature is fluid and cursive, with a small horizontal line underneath it.

Vinod Thomas
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This report was written by an IEG team led by Stefan Apfalter and including Aurora Medina Siy, Marianne Anderson, Sayuri Inoue and Ronald Johannes, under the supervision of Christine I. Wallich, Director, Independent Evaluation Group. Valuable analytic inputs were prepared by Ian Webb; Khaliun Yadamsuren handled desk-top publishing. The authors would like to thank peer reviewers Nils Fostvedt and Luis Dodero for valuable comments, and the many Multilateral Investment Guarantee Agency staff who provided valuable information and feedback during the evaluation.

Executive Summary

With the advent of the Independent Evaluation Group (IEG)-wide annual report on the *Results and Performance of the World Bank Group* that addresses the evaluation of performance and institutional effectiveness of all three World Bank Group institutions in a single report, IEG's evaluations of the Multilateral Investment Guarantee Agency (MIGA) are taking a more thematic focus.

The aim of this report, *MIGA's Financial Sector Guarantees in a Strategic Context*, is to inform the design and the implementation of MIGA's new *Strategic Directions FY12–14* by drawing lessons from recent experience with one of MIGA's main pillars, financial sector guarantees, the fastest growing business area for MIGA. The new strategy coincides with the beginning of the *post-Convention* change era. Its key challenge will be to enable the Agency to better exploit its original mandate and take full advantage of the new opportunities opened up by the changes to MIGA's Convention. That the strategy is being developed at a time when the global post-crisis economic recovery is not fully in sight only heightens the challenge for MIGA's strategy.

The report begins by looking at the *implementation* of MIGA's current strategy, *Operational Directions FY09–11*, and assesses MIGA's performance over the strategy period in relation to the strategy's objectives. MIGA's ability to monitor strategy implementation is assessed in light of MIGA's efforts to introduce key performance indicators over the last three years. The report also presents a conceptual framework for assessing the *design* of MIGA's upcoming FY12–14 strategy – its completeness, its internal consistency and logic for achieving its strategic objectives, based on IEG's report *Evaluating MIGA's FY05–08 Strategic Directions*.

The evaluation provides then an in-depth assessment of MIGA's financial sector guarantees. Financial sector guarantees have the potential to play an important role in development. They may contribute positively to the deepening and broadening of financial markets. Positive development impacts can also ensue from MIGA's support for the entry of foreign banks into developing country financial systems that accelerate the introduction of new technologies and management approaches. With financial sector guarantees being MIGA's most important business segment in terms of volume of newly issued guarantees and their role in the World Bank Group's response to the global financial crisis, they are at the center stage of MIGA's strategy and operations. The evaluation distills findings about the development effectiveness of projects in this sector and MIGA's effectiveness in underwriting them, and considers issues of financial sector guarantees' alignment with MIGA's strategic priorities.

The report concludes by discussing possible factors for strategy implementation, and identifies issues aimed at strengthening MIGA's ability to implement its new strategy going forward.

Lessons for MIGA's Strategic Directions

MIGA has successfully removed the most important external constraint to its effectiveness with the change in its Convention and the amendment of its Operational Regulations.

The *Strategic Directions FY12–14* and its implementation will be instrumental in getting the most out of MIGA's broadened mandate and potential developmental reach. The opportunity to support private sector investment in the post-crisis recovery only heightens this challenge.

In parallel with its now-broader mandate, MIGA also needs to exploit more fully the flexibility and range of eligible investments that have been allowed all along by its charter. IEG's analysis shows that MIGA has substantial unused leeway available within its original scope of operations—and has even more so now.

This evaluation reviews and assesses the achievement of MIGA's strategic objectives in the previous strategy period. The Operational Directions FY09–11 reconfirmed MIGA's priority areas—projects in IDA countries, especially Africa, conflict-affected environments, complex infrastructure projects, and South-South investments—and identified targets that MIGA would meet in key areas. MIGA also took steps to clarify its mission and strategy, to align its organizational structure and enhance tracking of its strategic progress.

The ultimate test of a strategy lies in its results. MIGA was on track in meeting several but not all of its key performance targets for the strategy period, FY09–11:

- ***MIGA's guarantee volume*** (new guarantees issued) initially fell short of the strategy's target of \$1.8–\$2.2 billion a year, subsequently revised to \$1.4–\$1.8 billion. With guarantee issuance of \$1.4 billion (FY09), \$1.5 billion (FY10) and \$2.1 billion (FY11), MIGA's guarantee issuance met its target in the last year of the strategy period, but was at the lower end of its revised target range during the beginning of the strategy period.
- ***MIGA's outstanding portfolio of guarantees***—a measure of its total coverage

outstanding even though not a formal key performance target – reached an all-time high of \$7.7 billion in gross exposure as of 30 June 2010, as cancellations dropped sharply during the crisis period.

- ***The number of new guarantee projects*** met the strategic targets of 20–30 new projects a year in two years out of three: MIGA supported 20 new projects in FY09, 16 projects in FY10, and 38 in FY11.
- MIGA met its target of being “***overweight***” in IDA countries, with 23 percent of its new guarantee issuance going to IDA countries, compared to the 5 percent of all foreign direct investment (FDI) flows flowing to IDA countries. Similarly MIGA's ***outstanding portfolio was “overweight” in IDA countries***, with 26 percent of gross exposure in IDA countries in the strategy period, far more than IDA countries' share in the stock of FDI flows to developing countries.
- At the same time, ***the share of guarantees in areas outside its strategic priorities remained above 50 percent***. Guarantees aligned to priority areas rose from 16 percent in FY09 to 30 percent in FY10 and 50 percent for the first half of FY11. This follows the sharp decline in the previous strategy period, largely as a result of MIGA's financial sector guarantees in the Europe and Central Asia (ECA) Region. While financial sector guarantees are part of MIGA's crisis response and can be considered strategic in the crisis period, the growing dominance of financial guarantees in non-IDA countries predated the crisis by several years and was apparent starting in FY05.
- ***MIGA's administrative expenses in relation to premium income*** remained below the targeted threshold of 85 percent. However the ratio has increased from 74.6 percent in FY08 to 68.3 percent in FY09 and 78.7 in FY10.
- ***MIGA's return on operating capital*** was well below its target range of 7–10 percent (before provisions) during the strategy period to date. The return on operating capital was 1.4 percent in FY10.

Guarantee volume and the number of projects matter, but development effectiveness is the fundamental measure of success, consistent with MIGA’s emphasis on “value-driven-volume.” IEG’s analysis of development effectiveness revealed that project performance was broadly unchanged during FY00 and FY08—the last year sampled—with 64 percent of IEG-evaluated projects rated “satisfactory” or better on development outcome. The performance of MIGA guarantees issued before FY00 was substantially weaker, with fewer than 50 percent of evaluated projects rated “satisfactory” or better. As projects can only be evaluated when they are operationally mature (for example, three years after their issuance), the performance of projects issued during the current strategy period could not be evaluated as they are too “young.” (These project performance ratings cannot be extrapolated to MIGA’s portfolio as a whole, since MIGA’s universe of projects is too small for any sample of guarantees to allow for statistical inference at the portfolio level.)

MIGA’s capital is a significant resource – and an indicator of MIGA’s risk-bearing capacity. MIGA capital utilization stood at 31.3 percent as of June 30, 2010—a low value not only by IEG’s assessment but by also MIGA’s own reports (economic capital of \$323 million over operating capital of \$1.036 billion).

The upcoming strategy should take into account the lessons of past strategies and their implementation. The current strategy presented for the first time a single, integrated framework linking business performance, development results, and risk-exposure aspects of MIGA’s future directions. This report outlines critical questions for MIGA’s upcoming Strategic Directions to be conceptually complete, and identifies key lessons on monitoring, financial sustainability and implementation of MIGA’s strategy.

Monitoring Strategy Implementation

MIGA’s initiative to develop KPIs to track institutional performance and strategy implementation is an important step in the right direction. Key Performance Indicators (KPIs) were introduced in FY09 with a view to enhancing MIGA’s ability to track strategy implementation.

However, the proposed metrics need further enhancement to adequately track progress in achieving strategic and operational objectives and provide management with sufficient information for strategic decision making. Going forward:

- The five KPIs introduced in FY09 need to be mainstreamed and more systematically monitored on a rolling basis.
- New KPIs need to include at least one KPI to track the alignment of new guarantees to strategic priorities and indicators that monitor client satisfaction—tracking the number of repeat clients and findings of client satisfaction surveys would be particularly relevant.
- There is scope for also improving the current KPIs that track internal productivity, for example, staff productivity (deals per underwriter), costs per transaction in relation to norms, and so forth.
- Most importantly, MIGA needs to track systematically the development outcomes of its projects by reporting the “disconnect” between IEG’s independently validated project ratings and MIGA’s own self-assessed project ratings.
- Finally, MIGA needs to refine its currently proposed approach for tracking development effectiveness by means of “development reach indicators,” as they are only partial measures of MIGA’s development footprint and—without the independently validated projects ratings—also potentially misleading.

Financial Sustainability of MIGA’s Strategy

MIGA’s guarantee portfolio is profitable overall. MIGA currently focuses only on financial results at the overall portfolio level, and does not calculate individual projects’ all-in costs or their contribution to MIGA’s income. As a result, MIGA cannot know how different strategic priorities will affect its overall income from guarantees. As an insurer, MIGA operates on margins that are much thinner than those of a lender/investor such as the International Finance Corporation (IFC): spreads in the PRI industry are about one fifth of a lender’s. Hence knowing how much income MIGA’s projects generate is essential.

Project contributions to MIGA's financial results vary greatly. IEG's analysis shows that project contributions to financial results are largely determined by a guarantee's size, duration, "administrative intensity," and reinsurance. A project's financial contribution will be reduced if MIGA cedes a portion of its premium income to the reinsurer. IEG estimates that projects having less than \$45 million in guarantee coverage contribute negatively to MIGA's financial results: large projects, such as infrastructure projects, have tended to contribute positively to MIGA's bottom line, whereas smaller projects, such as in Agriculture, Manufacturing and Services, do not. As a result, most projects in the priority areas of MIGA's FY09–11 strategy as well as guarantees issued under the Small Investment Program (SIP), contribute negatively to MIGA's financial results because of their size. Financial sector guarantees, despite being generally of large size, are also estimated to have contributed negatively to MIGA's aggregate financial results in the period since FY01, because of high levels of reinsurance.

Issuance of guarantees with negative financial returns is entirely warranted to the extent that they support projects with positive development impacts. These findings do not imply that MIGA should focus on more profitable business lines. Rather, measuring financial results at the project level can help MIGA determine the implications of its strategic directions for financial sustainability—MIGA needs to find the right project mix for impact and financial sustainability. However, cross-subsidization within the portfolio does imply a significant burden of proof to demonstrate strong development impact based on rigorous ex ante assessment during underwriting. Underwriting projects that contribute negatively to MIGA's profitability and have poor development results would be a "lose-lose" combination.

MIGA can improve its financial results and its strategic relevance by being more selective with respect to which projects it underwrites. IEG estimated that MIGA could have improved its financial results without compromising on its strategic priorities by being more selective about the projects underwritten. And going forward, informed by project-level financial results, MIGA could steer its underwriting away from non-strategic projects that generate negative financial

results toward strategic priority area projects—whether they generate positive financial results or not.

Project-level profitability metrics also are an important input to strategy development. At present, MIGA does not incorporate project-level financial results considerations into its strategy. With projects in three out of MIGA's four priority areas estimated by IEG to have underwriting costs exceeding the premium income received—either due to their size, their duration, early cancellation or reinsurance—there is substantial basis to conclude that project-level profitability matters for strategy development.

Factors Affecting Strategy Implementation

During the current strategy period, MIGA has made progress in addressing issues relating to its institutional and developmental effectiveness, to consolidate its long-term viability and strengthen its operational and development results. MIGA has changed its business model to align its operations with the Bank's country assistance strategies and collaborate at the project level—a significant improvement compared with past practice. More effort is being made to assess projects' expected development impacts as a part of underwriting due diligence, although the practice is not consistent and there are issues with the quality of the development impact analysis. MIGA has improved the risk and finance analytics underpinning its decision making on guarantee pricing, provisioning, reinsurance, and capital deployment. MIGA is piloting self-evaluation of its guarantee projects, and completed its first three self-evaluations as of December 2010 with IEG support. Several innovative projects have been underwritten, although systematic development of innovative product lines is still lacking. Business development efforts have been strengthened including the Joint Business Development Agreement signed with IFC and MIGA's recently established Asia Hub in Hong Kong SAR, China. But it is too early to assess actual impacts on MIGA's business.

Product innovation, in particular adaptation of existing products, remains a substantial challenge for MIGA. As highlighted in IEG's Guarantees Report, MIGA did not make use of its

ability to offer a wider range of guarantee products and terms allowed within the scope of its then-prevailing Convention and Operational Regulations. Narrow interpretations and internal "soft policies" and practices led MIGA to offer a rigid and limited product mix in an industry whose products are flexible and customized. The scope for innovation is even greater now and it is essential for MIGA to introduce more innovative products by taking advantage of the space allowed by its amended Convention and Operational Regulations.

MIGA's pricing and economic capital models need further strengthening. Introducing product innovation and greater flexibility in the terms of its coverages will require MIGA to strengthen its models to better support managerial decision making and ensure that new products and more flexible terms are appropriately priced for risk. But not only the pricing, MIGA's entire underwriting process should become more responsive to clients' requests for modification in existing coverage terms. MIGA needs hence to review its pricing model and make the necessary refinements needed to support these changes, including revision of its pricing model.

Financial Sector Guarantees and MIGA's Strategy

This evaluation provides an in-depth assessment of MIGA's financial sector guarantees as an illustration of strategy implementation. The financial sector has been MIGA's most important business segment in terms of volume of newly issued guarantees since FY08 and throughout the implementation period of the FY09–11 strategy.

Financial sector guarantees are now the most important business segment in terms of volume of newly issued guarantees. FY09 was a peak year, when 89 percent of MIGA's guarantees were in the financial sector. This share was 64 percent in FY10, demonstrating the continued importance of the financial sector in the overall business volume. Financial sector guarantees also make up the largest share of the outstanding portfolio, accounting for about 43 percent of the outstanding portfolio (net exposure) as of June 2010. Infrastructure was the next highest, at 34 percent.

MIGA's support to the financial sector in developing countries has significant potential for development impact. It can contribute positively to the deepening and broadening of financial markets and thereby to growth and investment, as well as to macroeconomic stabilization and financial access for small and medium-sized enterprises and poorer segments. For example, when banks seek political risk insurance coverage from MIGA for shareholder loans to their subsidiaries to increase their capacity to lend to local businesses, this contributes to "broadening" the financial sector in the host country. When foreign investors seek PRI coverage for their equity investment in a newly privatized state-owned bank, this increases competition, widens the array of financial instruments in the local market, and improves the market's ability to price and settle transactions, contributing to financial "deepening" in the host country.

MIGA's support for the activity of foreign banks in host country financial systems is associated with important development impacts. Entry of foreign banks has accelerated the introduction of new technologies and management approaches, and has also been a way of "importing" home country regulatory standards and raising the standards of domestic banks by competitive pressure. MIGA's support for mortgage banking through securitization helped to create more diversified financial systems, able to finance long term assets such as housing. At the same time, the role of foreign banks in developing countries has not always been an unalloyed gain, as for example, fragile and relatively new, open financial systems may become over-exposed to global shocks, as happened in some regions.

The alignment of financial sector guarantees to MIGA's strategic priorities is rather weak. Financial sector guarantees typically support projects in IBRD countries and are strikingly absent in Africa. Financial sector guarantees were less associated with South-South investments than guarantees in other sectors. As a result of the growing importance of financial sector guarantees and their weak alignment with strategic priorities, projects in MIGA's priority areas declined to 16 percent of guarantee volume in FY09 and 30 percent in FY10, from a high of 91 percent in FY06. For the first half of FY11, the share of projects in priority areas was 22 percent.

MIGA's financial sector activities are aligned to the World Bank Group's goal of responding to the global financial crisis. MIGA adopted the Financial Sector Initiative in March 2009, a MIGA-specific, crisis-response effort that is part of the wider, internationally coordinated Joint International Financial Institution Action Plan supported by the European Bank for Reconstruction and Development, the European Investment Bank, and the World Bank Group. MIGA's total cumulative support (gross exposure) under the Financial Sector Initiative to date is \$1.5 billion. While financial sector guarantees are part of the World Bank Group's crisis response and can be considered strategic during the crisis period, their growing importance in the ECA Region was apparent starting FY05, predating the crisis by several years.

Financial sector guarantees have some interesting characteristics. First, they are ***substantially larger*** on average than the average non-financial sector guarantee (\$96 million versus \$43 million). ***Second***, they have a ***shorter tenor at inception*** than guarantees in other sectors (7 versus 11 years). Cancellations bring this down to a *de facto* tenor of 5 years, compared to 7 years for the average guarantee in the portfolio. ***Thirdly***, financial sector guarantees are also ***more regionally concentrated*** than guarantees in the other sectors. Fully 95 percent of financial sector guarantees were issued in one single region, ECA, compared to 48 percent in a single region for the next highest sector, oil, gas and mining. ***Fourth***, financial sector guarantees ***are concentrated in a few host countries***, with fully 80 percent issued in only five host countries over the past five years. They have also been "client concentrated," with 93 percent going to five clients in FY06–10. ***Finally***, IEG estimates that financial sector guarantees ***do not contribute positively to MIGA's financial results***. Despite the high business volume, the profitability of MIGA's financial sector projects appears to have been negative, due to high levels of reinsurance.

MIGA's new Strategic Directions FY12–14 needs to articulate how to manage the issuance of financial sector guarantees in a more strategic fashion. The dominance of financial sector guarantees in the portfolio, their weak alignment with priority areas, and their nega-

tive contribution to financial results suggest the need for the FY12–14 Strategy to ensure that its operational activities are in line both with its strategic objectives and with its financial goals.

Performance and Findings from Evaluated Financial Sector Projects

The findings of this section are based on IEG's project evaluation database, which comprises 41 ex post evaluations of MIGA guarantee projects. Included in the database are 10 financial sector projects, of which 50 percent are rather recent guarantees, that is, all but one underwritten by MIGA between FY06 and FY08, and the other half underwritten between FY98 and FY02. Project-level findings thus reflect MIGA's experience with financial sector guarantee projects issued since FY98. Even though most of the evaluated projects were underwritten before the start of MIGA's last strategy period, many are still active and under implementation at the current time, and the report gives special emphasis to those issued in FY06–08. Several striking results emerge from an analysis of these financial sector projects.

It is important to remember that project performance ratings cannot be extrapolated to MIGA's portfolio as a whole, since MIGA's universe of projects is too small for any sample of guarantees to allow for statistical inference at the portfolio level. Therefore, the project-related findings in this report do not only draw on quantitative analysis of aggregate project-level ratings, but also on qualitative analysis of ex post project evaluation findings, using content analysis to identify "common patterns," "enabling conditions," and "success factors."

Evaluated financial sector projects have high development outcome ratings. Fully 80 percent of evaluated financial sector projects were rated "Satisfactory" or better on development outcomes—far higher than non-financial sector projects (48 percent). Financial sector projects performed better in this regard than projects in any other sector, outperforming, for example, Agriculture, Manufacturing and Services (47 percent), and Infrastructure, including Oil, Gas and Mining (50 percent).

MIGA’s financial sector guarantees were strategically relevant at the country level. Project-level findings indicate that most guarantees in the financial sector are consistent with the Country Assistance Strategy and Bank sector strategies. Fully 90 percent of the evaluated financial sector projects were rated satisfactory or better with regard to Strategic Relevance. Financial sector guarantees in transition economies stand out in terms of supporting the modernization of the host countries’ financial markets.

In ECA’s transition economies in particular, MIGA’s support to foreign-owned banks has been strategically relevant and developmentally impactful in those banking systems that have not completed their reforms. IEG also found that the foreign bank subsidiaries supported by MIGA competed effectively in this environment, and contributed positively in upgrading the host countries’ banking sectors. Many introduced financial products and services that were not available from domestic banks, and transferred their know-how in delivering the new products and services by partnering with local banks.

Financial sector projects rated “satisfactory” or better on development outcome had several interesting features in common. *First*, all successful evaluated financial sector projects had sponsors with long operating experience as global financial institutions or in the respective host country or both. Several successful projects were supported by IFC, either as a shareholder/investor or a lender. *Second*, the financial intermediaries tended to be strategically selective, focusing their lending activities on a narrow but profitable niche.

Quality of Underwriting is a less positive story. The Quality of Underwriting indicator measures MIGA’s work quality in underwriting the project—not the performance of the project itself. Quality of Underwriting was rated less than “satisfactory” in 60 percent of evaluated financial sector projects. Still, financial sector projects perform better on Quality of Underwriting than other sectors. More generally, MIGA faces a challenge in improving the quality of its underwriting which IEG rated as less than satisfactory in 71 percent of all of MIGA’s evaluated projects taken together,

and in 74 percent of evaluated non-financial sector projects.

To address these Quality of Underwriting issues and improve its development effectiveness, MIGA needs to ensure that lessons distilled in project evaluations and self evaluations are applied to new operations.

Even though MIGA has made progress with its self-evaluation program, it remains a work in progress. The quality of MIGA’s self evaluations varies, consistent with being on a learning curve. Moreover, MIGA needs to develop a feedback loop for lessons identified in Project Evaluation Reports to be considered by underwriters in their day-to-day work and senior management when reviewing projects or taking more strategic project decisions. Going forward, it will be important for MIGA to disseminate findings from evaluations for institutional learning, and to establish mechanisms that systematically integrate evaluative learning into MIGA’s underwriting and decision-making processes.

Conclusions and Issues Going Forward

The aim of this report, *MIGA’s Financial Sector Guarantees in a Strategic Context*, has been to inform the design and the implementation of MIGA’s new *Strategic Directions FY12–14* by drawing lessons from recent experience with one of MIGA’s main pillars, financial sector guarantees—the fastest growing business area for MIGA.

This evaluation underscores the relevance of several recommendations issued previously in the IEG report *MIGA Development Results and Institutional Effectiveness – 2010: Achieving Value Driven Volume*. This report confirms the need for MIGA to articulate a fundamental value proposition and make this the basis for its next strategy, and presents broader evidence on the need to measure project-level financial results, also recommended by IEG in 2010. Furthermore, the report confirmed that product innovation and adaptation of existing products remains a substantial challenge for MIGA. Going forward, it will be essential for MIGA to take fuller advantage of the space allowed by its amended Convention and Operational Regulations. Reviewing MIGA’s eligibility policies and practices (including “soft policies”) and

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its Pricing model and Economic capital modes appears essential in this context.

Based on new evaluative evidence and analysis presented in this report, IEG found that MIGA's approach to track strategy implementation, development effectiveness, and institutional performance can be further enhanced. To this end, it will be important for MIGA to refine its current strategy monitoring to systematically track the development outcome performance of its projects and report any "disconnect" between IEG's independently validated project ratings and MIGA's own self-assessed project ratings.

With regard to financial sector guarantees this report found that they have an important role to

play in development—not only in crisis response. MIGA's financial sector guarantees were strategically relevant at the country level. In particular in ECA's transition economies MIGA's support to foreign-owned banks has been strategically relevant and developmentally impactful in those banking systems that had not completed their reforms. Evaluated financial sector projects had also better Development Outcomes than projects in any other sectors. Finally, to improve on the Quality of Underwriting of financial sector projects—and also of all MIGA sectors—institutionalizing a culture of learning by distilling lessons from project evaluations and self evaluations and applying them to new operations will be essential.

1. Introduction to the Report

1.1 The aim of this report is to inform the design and the implementation of MIGA's new *Strategic Directions FY12-14* by drawing lessons from recent experience with one of the main pillars of the Multilateral Investment Guarantee Agency (MIGA), financial sector guarantees, the fastest growing business area for MIGA.

1.2 The Independent Evaluation Group (IEG) has submitted evaluation reports to the Committee on Development Effectiveness (CODE) and the Board annually since 2003, with past reports examining themes such as the development effectiveness of guarantee projects (2006); MIGA's "Quality of Underwriting" (2007), and the design and implementation of MIGA's Small Investment Project (SIP) Program (2007).

1.3 IEG last evaluated MIGA's strategy in 2008, when it reviewed MIGA's Strategic Directions for FY05-08.¹ That evaluation made recommendations aimed at strengthening MIGA's institutional effectiveness, based on the need for MIGA to consolidate its long-term financial viability; improve operational efficiency, responsiveness and quality; and strengthen its development results.

1.4 With the advent of the IEG annual report on *Results and Performance of the World Bank Group*² that evaluates the performance and institutional effectiveness of all three World Bank Group institutions in a single report, IEG's evaluations are now taking a more thematic focus.

TOPICS COVERED IN THE EVALUATION

1.5 *The focus of this report is MIGA's financial sector guarantees.*³ Financial sector guarantees have the potential to play an impor-

¹ IEG-MIGA 2008 Annual Report: *Evaluating MIGA's Strategic Directions FY05-08*.

² IEG Annual Report 2010: *Results and Performance of the World Bank Group*.

³ Regarding the definition of financial sector guarantees, this evaluation follows MIGA's own sectoral classification of guarantee projects which is based on the SIC system (Standard Industrial Classification). Thus MIGA's *financial sector guarantees*, MIGA's support for the *financial sector*, and *financial intermediaries* include *only* MIGA guarantee projects that support general bank-

tant role in development. They may contribute positively to the deepening and broadening of financial markets. The financial sector has been MIGA's most important business sector in terms of volume of newly issued guarantees since FY08 and remains so today. In FY09, 90 percent of MIGA's guarantee issuance was in the financial sector, followed by 64 percent in FY10 and 65 percent FY11 to date.⁴ The recent financial crisis highlighted the importance of MIGA's financial sector guarantees even further. This evaluation considers issues of alignment with MIGA's strategic priorities and distills findings about the development effectiveness of projects in this sector and MIGA's effectiveness in underwriting them.

1.6 To inform the design and the implementation of MIGA's new *Strategic Directions FY12–14*, the report opens with an analysis of MIGA's institutional effectiveness, with special emphasis on strategy implementation capabilities and institutional impediments. The challenge of MIGA's new strategy for FY12–14 will be to better exploit its original mandate and take full advantage of the new opportunities opened up by the changes to MIGA's Convention. That the strategy is being developed at a time when the global post-crisis economic recovery is not fully in sight only heightens the challenge ahead.

1.7 The report presents a forward-looking analysis aimed to inform the development and implementation of MIGA's new strategic direction framework for FY12–14. It looks at the implementation of the current strategy, *Operational Directions FY09–11*, and assesses performance over the strategy period with respect to its Key Performance Indicators (KPIs) and other indicators. It also includes an updated assessment of MIGA's institutional and operational effectiveness in those areas that are most relevant to strategy implementation.⁵

ORGANIZATION OF THE EVALUATION

1.8 The report is organized as follows: Chapter 2 first looks at MIGA's institutional effectiveness, starting out with an analysis of MIGA's opportunities in the *post*-Convention Change era as the context for MIGA's strategy going forward. It then reviews MIGA's achievements in the current strategy period in relation to the strate-

ing operations, leasing, mortgage lending, investment funds, pension funds, and the like. This classification thus *excludes* guarantee projects intermediated through banks that support infrastructure or other end-industries.

⁴ The cut-off date for all data in this evaluation is December 2010, unless otherwise specified. Thus the FY11 data cover the first half of FY11.

⁵ IEG has provided similar updates on MIGA's institutional effectiveness since 2008, as requested by CODE following its discussion of IEG-MIGA 2008 Annual Report, *Evaluating MIGA's FY05–08 Strategic Directions*.

gy's objectives, and analyzes some of the factors that may have contributed to the outcomes observed. In addition, to inform the discussion of MIGA's upcoming strategy, the report presents a conceptual framework for assessing the strategy's completeness, its internal consistency and logic for achieving its strategic objectives, including financial sustainability dimensions and monitoring of strategy implementation. The chapter concludes with an assessment of efforts to strengthen institutional and operational effectiveness, with particular focus on monitoring, financial sustainability and implementation – factors that are key to the success of any strategy.

1.9 Chapter 3 focuses on the effectiveness of financial sector guarantee projects from the perspective of MIGA's strategy and strategy implementation. It looks at effectiveness in underwriting guarantees in this sector, analyzes their strategic relevance and development outcomes, identifies key drivers of project performance, and presents lessons learned from the evaluated projects that MIGA can apply to future operations. IEG's findings on the profitability of MIGA's financial sector guarantees are also presented, as financial sustainability is a key aspect of any strategy. Conclusions and issues going forward are presented in Chapter 4.

1.10 A summary of the methodology used in this report is provided in Appendix A, and Appendixes D–F contain more detailed descriptions of IEG's project evaluation methodology, the database of evaluated projects, and the methodology for calculating projects' contribution to MIGA's financial results. Definitions of MIGA guarantee and insurance-related terms are in Appendix B. Appendix C provides a comprehensive listing of MIGA's Risk Coverages.

2. Lessons for MIGA's Strategic Directions FY12–14

2.1 This chapter looks at challenges and opportunities in the post-Convention Change era as the context for MIGA's strategy going forward. It reviews achievements in the last strategy period and analyzes some of the factors that may have contributed to the outcomes observed, with the objective to inform the development of MIGA's upcoming strategy. This chapter also presents a conceptual framework for assessing the strategy's completeness, internal consistency, and logic for achieving its strategic objectives, including financial sustainability dimensions and monitoring of strategy implementation. The chapter concludes with an assessment of efforts to strengthen institutional and operational effectiveness, with particular focus on monitoring, financial sustainability and implementation – factors that are key to the success of any strategy. These strategic elements will also provide the context for the evaluation of financial sector guarantees in Chapter 3.

I. The Post-Convention Change Era

2.2 MIGA has successfully addressed its most important external constraints with the changes in its Convention and Operational Regulations. These changes give MIGA an important opportunity to enhance its role, with several new coverages and a broader definition of eligible investments. In particular, they enable MIGA to insure free-standing debt and existing assets - removing two of the biggest constraints on MIGA's effectiveness in the marketplace. A project making use of these new authorities – the Otogar-Bağcılar-İkitelli-Olimpik Village metro project in Istanbul – was approved within a month of the Convention change becoming effective and, by December 2010, two further transactions have been approved and several Definitive Applications have since been registered that make use of the new coverages.

2.3 MIGA's *Strategic Directions FY12–14* and its implementation will be instrumental in getting the most out of MIGA's now-broadened mandate and potential developmental reach. With a potential post-crisis recovery on the horizon, this challenge is only heightened. MIGA's strategy needs to clearly articulate how it will

Evaluation Essentials

- ❖ During the previous strategy period FY09–11, MIGA was on track in meeting some but not all of its targets.
- ❖ MIGA's upcoming *Strategic Directions FY12–14* will be instrumental in getting the most out of MIGA's now-broadened mandate.
- ❖ To be conceptually complete, MIGA's *Strategic Directions FY12–14* needs to address MIGA's developmental role; its financial sustainability; and the customer, internal, and resource perspectives.
- ❖ MIGA's initiative to monitor strategy implementation through KPIs was an important step, but the concept needs further improvement.
- ❖ Greater selectivity with respect to supporting projects in MIGA's strategic priorities areas would enable MIGA to improve its financial results and its strategic relevance.
- ❖ Product innovation, in particular adaptation of existing products, is still a challenge for MIGA.

reap the fruits from the amended Operational Regulations (Op Regs) and Convention.

2.4 *Exploiting more fully the flexibility and range of eligible investments already allowed by its charter will be as important.* IEG earlier found that MIGA had not taken full advantage of the opportunities already available before the Convention change (Box 1). For example, guarantees of production-sharing agreements and management agreements or similar investments have been a miniscule share of MIGA's guarantees.⁶ While this may have reflected sporadic demand, it also points to an unexploited opportunity. MIGA has only covered performance bonds as the underlying investment in two projects, production-sharing agreements in one project, and management agreements in two projects. These represent an untapped opportunity, especially with the growth of public-private partnership (PPP) and extractive industries. An additional example regards the coverage to nonprofit, nongovernmental organizations (NGOs), which has always been provided for in the Convention and is another unexploited opportunity – one that the Overseas Private Investment Corporation (OPIC) has been offering for some time.⁷

ACHIEVING STRATEGIC GOALS – A RETROSPECTIVE

2.5 *The global crisis reduced capital flows and heightened risk perceptions.* The past five years have seen foreign capital flows to developing countries soar to record highs – and then drop. In both cases these flows have been highly concentrated, and political risk has been a factor in determining the direction and level of these flows. Political risk insurance (PRI) has been an important instrument to mitigate the aversion to investing in difficult settings, and global demand for PRI has increased significantly. Much of this increase has been met by private insurers and national insurance agencies.

⁶ MIGA's eligible investments, investors, and allowable risk coverages as well as MIGA's portfolio of guarantees were comprehensively analyzed in IEG's 2008 Guarantees Report.

⁷ OPIC's PRI is available to protect NGO assets such as vehicles, equipment, inventory, supplies or other property that are deployed on the ground against War and Civil Disturbance and/or expropriation. Recently OPIC has insured NGOs supporting reconstruction and relief efforts following the earthquakes in Haiti and Pakistan.

<http://www.opic.gov/www.opic.gov/news/press-releases/2010/pr021710>.

Box 1. Available Risk Coverages and Eligible Assets of MIGA PRI			
Comprehensive risk	No	Underlying Assets Insurable by MIGA	
Commercial risks only	No	Equity, Portfolio equity, Quasi-equity	Yes
Political risks, including:	Yes	<i>Subordinated Loan – w/o equity link</i>	Yes
Transfer and Convertibility	Yes	<i>Senior Loan – w/o equity link</i>	Yes
Breach of Contract	Yes	<i>Bonds/debt instrument - without equity link</i>	Yes
Expropriation	Yes	First loss tranche	No
Political Violence	Yes	Mezzanine tranche	Yes
Conventional Terrorism ^a	Yes	Trade credit	No
<i>Non-honoring of Sovereign Obligation</i>	Yes	Portfolio of assets	No
Non-honoring of Arbitration Award	Yes	Production sharing contracts	Yes
Wrongful Calling of Guarantee	Yes	Profit-sharing contracts	Yes
License Cancellations	Yes	Management contracts	Yes
Sovereign default	Yes	Franchising agreements	Yes
Beneficiary (Project) Type		Licensing agreements	Yes
Greenfield Assets	Yes	Turn-key contracts	Yes
Assets for Expansion/Modernization		Operating leasing agreements	Yes
<i>Existing Assets</i>	Yes	Subordinated Bonds	Yes
Privately-owned	Yes	Guarantees of Securities	Yes
Government-owned	Yes	Percentage of investment covered	
Client (Guarantee-holder) Type		Partial ^d	Yes
Privately-owned	Yes	Other	
Government ^b incl.	Yes	Gov't Counter-guarantee needed?	No
Subnational	Yes	In kind contribution ^e	Yes
Parastatal	Yes	Local currency	Yes
Non-Profit Organization ^c	Yes	Reinsurance (PRI risk only)	Yes

Note: Coverages that are newly permitted by the amended OpRegs (June 2009) or Convention (Nov. 2010) are shown in italics.
a. This is covered under MIGA's War and Civil Disturbance risk coverage.
b. Provided that the government-owned investor operates on a commercial basis.
c. Provided that the specific investment to be covered will be carried out in a commercial manner.
d. The portion of loss covered by MIGA shall not exceed 99% for loans and 95% for all other investments.
e. Defined as tangible or intangible assets having monetary value, such as machinery, patents, processes, techniques, managerial know-how, trademarks and marketing channels.

2.6 *MIGA's market share of new investment insurance to developing countries has been hovering around 2.4 percent since 2008, compared to 3.6 percent on average during 2005-07.*⁸ In terms of

⁸ Berne Union data do not easily lend themselves to comparing MIGA's share of PRI with that of other PRI providers because the Berne Union reports only aggregate exposures and are not broken down by type of cover. Since MIGA cannot provide many of the covers provided by private PRI insurers (such as short term receivables, trade credit, kidnapping, and so forth), Berne Union aggregates are not fully representative of MIGA's actual market. By January 2011, only data for half of the year 2010 are available from Berne Union. Volatility and the relatively small number of projects MIGA issued per year during the referred period and the subsequent strong impact of individual projects on market share figures make the interpretation of trends in market share difficult.

rank order, MIGA's ranking has remained stable at sixth place out of 35 Berne Union insurers since 2005. MIGA's business has been faced, on the one hand, with heightened political risk over concerns that host governments may respond to stress in public finances or reserves by revisiting their contractual commitments or by imposing transfer and convertibility restrictions; and on the other hand, with investors pulling back or delaying projects, due, for example, to the difficulty of arranging project finance. MIGA has felt the latter of these effects, especially in its infrastructure business.

2.7 *MIGA's Operational Directions FY09-11 spelled out four priority areas* – projects in International Development Association (IDA) countries, especially Africa, conflict-affected environments, complex infrastructure projects,⁹ and South-South investments, consistent with its previous strategy.¹⁰ KPIs were also introduced in order to track strategy implementation.¹¹ These KPIs relate to the volume of guarantees issued, the number of projects supported, guarantees in IDA countries, MIGA's return on operating capital, and its administrative expense/net premium income ratio. MIGA has used these indicators since 2009 to measure and report on progress.

2.8 When taking a retrospective look at performance over the last strategy period, MIGA was on track in meeting several, but not all of its KPI targets.

- i. *MIGA's guarantee volume* (new guarantees issued) initially fell short of the strategy's target of \$1.8–\$2.2 billion a year, subsequently revised to \$1.4–\$1.8 billion. With guarantee issuance of \$1.4 billion (FY09), \$1.5 billion (FY10) and \$2.1 billion (FY11), MIGA's guarantee issuance met its target in the last year of the strategy period, but was at the lower end of its revised target range during the beginning of the strategy period. *MIGA's outstanding portfolio of guarantees*—a measure of its total coverage outstanding even though not a formal key performance target—reached an all-time high of \$7.7 billion in gross exposure as of 30 June 2010, as cancellations dropped sharply during the crisis period.

⁹ MIGA defines “complex infrastructure” as infrastructure and extractive industry projects involving project finance, environment, or social issues.

¹⁰ These four strategic priority areas were outlined in MIGA's *Strategic Directions for FY05–FY08*, and revalidated in MIGA's *Operational Directions FY09–FY11*.

¹¹ This was recommended in IEG-MIGA's 2008 Annual Report, *Evaluating MIGA's Strategic Directions*.

- ii. *The number of new guarantee projects* met the strategic targets of 20-30 new projects a year in two years out of three: MIGA supported 20 new projects in FY09, 16 projects in FY10 and 38 in FY11.
- iii. MIGA met its target of being **“overweight” in IDA countries**, with 23 percent of its new guarantee issuance going IDA countries, compared to the 5 percent of all foreign direct investment (FDI) flows flowing to IDA countries. Similarly, MIGA's *outstanding portfolio was “overweight” in IDA countries*, with 26 percent of gross exposure in IDA countries in the strategy period, far more than IDA countries' share in the stock of FDI flows to developing countries. At the same time, *the share of guarantees in areas outside its strategic priorities remained above 50 percent*. Guarantees aligned to priority areas rose from 16 percent in FY09 to 30 percent in FY10 and 50 percent for the first half of FY11. This follows the sharp decline in the previous strategy period, largely as a result of MIGA's financial sector guarantees in the ECA Region. While financial sector guarantees are part of MIGA's crisis response and can be considered strategic in the crisis period, the growing dominance of financial guarantees in non-IDA countries predated the crisis by several years and was apparent starting in FY05.
- iv. *MIGA's administrative expenses in relation to premium income* remained below the targeted threshold of 85 percent. However the ratio has increased from 74.6 percent in FY08 to 68.3 percent in FY09 and 78.7 in FY10.
- v. *MIGA's return on operating capital* was well below its target range of 7-10 percent (before provisions) during the strategy period to date. The return on operating capital was 1.4 percent in FY10.

2.9 *To better capture MIGA's goal of delivering “value-driven-volume”* it is important, therefore, to complement the above analysis by looking at indicators of development effectiveness and effective use of capital.

2.10 *Developmental effectiveness of MIGA's projects has been broadly unchanged in recent years.* As in the International Finance Corporation (IFC) and the World Bank, IEG assesses the development performance of projects using a CODE-endorsed methodology.¹² Two-thirds (64 percent) of IEG-evaluated projects issued between FY00-FY04 had “satisfactory” or better development outcome ratings, compared to 64 percent of evaluated projects issued between FY05-

¹² See Appendix for details of IEG's CODE-endorsed Ex Post Project Evaluation Methodology.

FY08, the last year sampled.¹³ (It is important to remember that these numbers cannot be extrapolated to MIGA's portfolio as a whole, since MIGA's project evaluation sample will always be too small for statistical inference.)

2.11 *MIGA's capital is a significant resource that has been underutilized during the period under review.* MIGA's capital is an indicator of its risk bearing capacity, and MIGA monitors the level of economic capital used by its outstanding guarantees (see Appendix F). MIGA's economic capital utilized stood at \$323 million compared to its operating capital of \$1.036 billion.¹⁴ This means that the risk inherent in the guarantee portfolio "consumed" about 31 percent of MIGA's available capital. This can be interpreted as a strong capital position and MIGA's clients and competitors view it as such. At the same time it can also be interpreted as an underutilization of the capital that MIGA could use to maximize its development impact.

II. Considerations for MIGA's New Strategic Directions

2.12 An organization's success in achieving its strategic goals depends on the actions it takes and the external and internal contexts for those actions. The strategy development process for FY12–14 is an opportunity for MIGA and its stakeholders to consider its strategic directions framework in light of findings on the implementation of MIGA's previous strategy, new developments in the PRI market and changes in the global economy.

2.13 As MIGA again reviews its experience with its strategic directions and formulates new directions and operational priorities, Box 2 outlines key questions for MIGA's upcoming Strategic Directions.

2.14 The upcoming strategy should take into account the experience of past strategies and their implementation. To this end, key lessons on monitoring, financial sustainability and implementation are drawn from recent evidence and previous IEG evaluations.

¹³ These project evaluation findings do not include projects underwritten in the FY09-11 strategy period, which will only be evaluated in FY12–15. This is because, in IEG's CODE-approved evaluation methodology, projects must be operationally mature – for example, three years into implementation – to be evaluated. See Appendix for details of IEG's database of evaluated projects used for this evaluation, and Appendix for a description of IEG's project evaluation methodology for MIGA projects.

¹⁴ As of June 2010. Operating capital includes paid-in-capital, retained earnings, other comprehensive income, and the net insurance portfolio reserve.

Box 2. Key Questions for MIGA's Strategic Directions FY12-14

To be conceptually complete, MIGA's upcoming *Strategic Directions FY12-14* needs to address MIGA's developmental role; its financial sustainability; and the customer, internal and resource perspectives.

- **Development Outcome Aspects:**
- **Does the strategy clearly articulate how MIGA will deliver on its development mandate?**
- Does it explain how development impact considerations feature in decision-making? How development outcomes affect staff rewards? Does it explain how MIGA will assess ex ante projects' expected development outcomes? How MIGA will be selective in supporting only those assessed as positive ex ante? Does it explain how MIGA will track the development impact of its projects? Does it define goals for project development outcomes?
- **Financial Sustainability:**
- **Is the strategy credible on how MIGA will grow its business while remaining financially sustainable as a development insurer?**
- Does it elaborate a consistency framework linking the strategy's operational priorities (sectors, countries, thematic priorities) with business volume growth, project and investment financial returns and MIGA's risk-bearing capacity? Does this framework incorporate the dynamics of MIGA's pricing model, provisioning policies, and reinsurance decisions?
- **Customer Value Perspective:**
- **Does the strategy clearly define its clients? Does it present a customer value proposition for them that plays to MIGA's strengths compared to other PRI providers?**
- Does the strategy clearly define roles and responsibilities for business development? Does it indicate how this will be incentivized and aligned to MIGA's operational priorities? Do the strategy's product offerings reflect the product innovation demanded by clients and needed to meet the strategy's business targets? Has it demonstrated that MIGA's pricing model is refined enough to respond to customer demands for product flexibility?
- **Internal Perspective:**
- **Is the strategy realistic about the internal capabilities, processes and initiatives needed to deliver MIGA's customer value proposition, target development outcomes and financial goals?**
- Does it indicate how MIGA's core business functions will be aligned to support implementation of the strategy? Are internal organization functions aligned? Is the strategy persuasive that MIGA's business and decision-making processes are consistent with delivering its strategic targets for business volume and development impact? With client expectations of MIGA's responsiveness? Is it convincing about the alignment of resources to strategy implementation?
- **Resource Perspective:**
- **Does the strategy outline how MIGA would use its resources (staff and budget) to enable delivery of the various components of its strategy?** Does the strategy clearly lay out the connections between MIGA's budget and its areas of planned business growth? Does it articulate a human resources strategy and consider whether MIGA's staffing, capabilities, skills and technology applications are appropriate to deliver the strategy?
- **Implementation:**
- **Does the strategy have the right KPIs to know if it is on track?**

MONITORING THE IMPLEMENTATION OF MIGA'S STRATEGY

2.15 *MIGA has enhanced its ability to track strategy implementation.* The *Operational Directions FY09-11* initially stipulated a set of three KPIs focused mostly on guarantee volume. These were subsequently broadened to the five KPIs reported quarterly in MIGA's Executive Vice President (EVP) Reports, which were assessed earlier in this Chapter. The KPIs introduced in 2008 have been important to enable MIGA to measure progress towards its goals, and also to support the Board in carrying out its accountability function.

2.16 MIGA has indicated that, going forward, it plans to track a more complete set of financial and operational performance indicators on a pilot basis, including KPIs for (a) business development, (b) underwriting efficiency, (c) the sector composition of guarantees issued in relation to targets, and importantly, (d) project development outcomes. This is an important step and clearly signals accountability for supporting developmentally sound projects and a willingness to be measured in delivering on this commitment. Using independently validated project ratings as the basis for MIGA's KPI on development outcome would meet good practice standards, and provide substantial credibility to progress reported on this basis.^{15 16}

2.17 *Complementing its development outcome KPI, MIGA is tracking six "development effectiveness indicators" for each project, namely investment mobilized, taxes and fees paid, local procurement of goods, direct employment, training outlays, and community development outlays, based on information reported by guarantee-holders.*¹⁷

¹⁵ For the Bank, IEG also reports the "disconnect" between the final validated ratings and the self-reported ratings in the ICRs. This disconnect is tracked as an indicator of how well the Bank is supervising its projects. Similarly, IFC reports (unvalidated) DOTS ratings together with IEG's independently validated Expanded Project Supervision Report ratings, and analyzes any resulting "disconnects." IFC has a long track record of self-evaluation, and Expanded Project Supervision Report and IEG final validated ratings differ only 2-6 percent of the time.

See: http://www.ifc.org/ifcext/disclosure.nsf/Content/Annual_Portfolio_Performance_Review_FY09.

¹⁶ Another concern is that because MIGA is small, projects may be evaluated by staff who themselves helped to underwrite the project. While positive from a learning perspective, the objectivity of the ratings and of a KPI based on them can be questioned.

¹⁷ See Annex 3B "Development Effectiveness Indicators" in MIGA's Contract of Guarantee for Equity Investments template (2010 Forms, September 1, 2010). Loan and shareholder loan contracts also include this Annex. As of

2.18 *MIGA's "development effectiveness" indicators are very different from development outcome indicators.* They are akin to IFC's "development reach indicators" which have been useful to illustrate aspects of projects' "footprint" in the local economy. Using these indicators, MIGA would be able to tally the number of people trained and employed by MIGA projects, the volume of project purchases in the local economy, and taxes and fees paid and the like. However, these are partial measures of development effectiveness and potentially misleading: simply because a project mobilizes investment, pays taxes and fees, procures locally, employs and trains people and contributes to the community, does not mean it has a positive development outcome. For that, it needs also to be financially sound, economically sustainable, and to have no negative environmental or social effects.

EVALUATING MIGA'S STRATEGY FROM THE PERSPECTIVE OF FINANCIAL SUSTAINABILITY

2.19 As a development insurer, MIGA aims to underwrite developmentally impactful projects while maintaining its financial sustainability. MIGA can only fulfill its mandate if it is able to remain financially sustainable over the long term. Thus, while MIGA does not underwrite projects with profitability foremost in mind, managing expected underwriting income remains important. Broadly, this means being able to recover the costs of underwriting and monitoring guarantees from its net premium income on a portfolio level.¹⁸

2.20 *Ideally MIGA's projects should have positive development outcomes and contribute to MIGA's financial sustainability.* MIGA may also wish to support projects expected to have high expected development returns, even though the financial return to MIGA from underwriting them is minimal or even negative. Either objective requires being able to distinguish which projects are likely to contribute to MIGA's profitability, and which are not.

2.21 At present, MIGA does not incorporate project-level financial results considerations into its operational decisions or strategy. MIGA's business income is currently operated on a portfolio basis, so that collectively, all premium revenues received cover all the costs

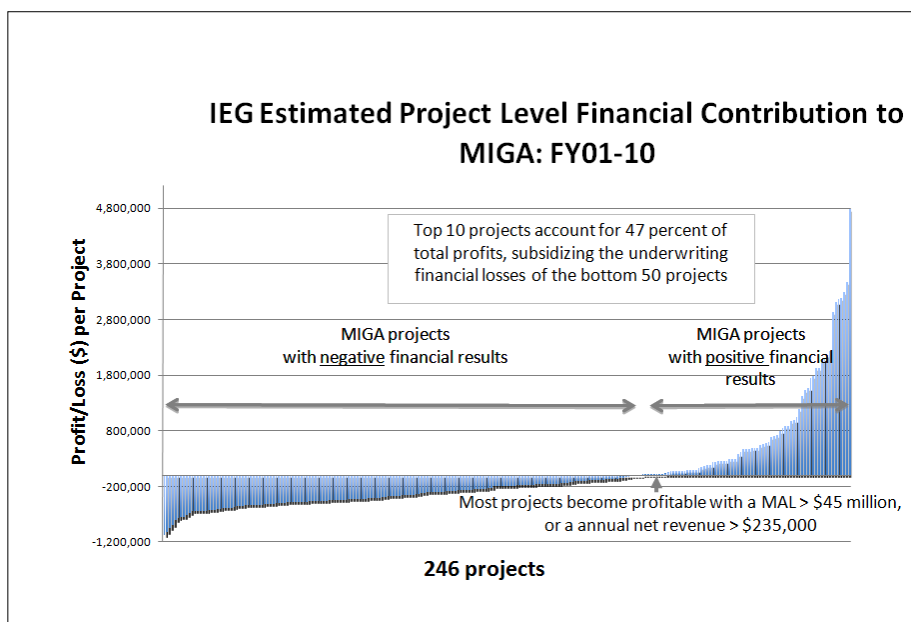
January 2011, 28 contracts with this new reporting requirement had been signed.

¹⁸ IEG's CODE-approved evaluation framework calls for assessing guarantee projects' contribution to MIGA's financial results, in addition to their development outcome and MIGA's effectiveness. Measuring guarantees' contribution to MIGA's financial results has been constrained until recently because data on underwriting costs at the project level was not available. Appendix 7 describes the methodology used by IEG to estimate project-level contributions.

expended. Information on projects' expected contribution to financial results is not used to steer business development, nor to inform its operational decisions or strategy.

2.22 Project contributions to MIGA's financial results are largely determined by the size, duration, and administrative intensity of a project, plus the level of reinsurance used for a project. The dynamic and interactions of these five key drivers for project-level profitability were discussed in detail in the IEG report 2010 "MIGA's Development Results and Institutional Effectiveness – Achieving Value Driven Volume." For example, IEG's report found that, for projects to contribute positively to MIGA's financial results, they need to be large in terms of MIGA's exposure, or in terms of its annual net revenue to MIGA.¹⁹ IEG estimates that the "break even size" of a project is approximately \$45 million, or a "break-even annual net revenue" of approximately \$235,000.

Figure 1. A Few Large Projects Contribute Positively to MIGA's Financial Results



Source: IEG estimates based on MIGA data.
 Note: MAL= maximum aggregated liability.

2.23 *MIGA's guarantee portfolio is profitable, but not all guarantees contribute to its profitability.* IEG estimated the contributions to

¹⁹ Annual net revenue equals premium due less reinsurance plus ceding commission. For purposes of IEG's analysis, these amounts were annualized by summing up all the net revenue cash flow streams from different contracts within a project, and dividing the total by the number of years the project was active.

MIGA's financial results from projects of different types between FY01-FY10. Seventy percent of projects underwritten by MIGA in this period – 171 out of the 246 total projects – contributed negatively to MIGA's financial results (Figure 1) During the same period, about a third of MIGA's projects fell outside MIGA's four strategic priority areas (71 projects out of 246), and almost two-thirds of these non-strategic projects (46 out of 71) are estimated to have contributed negatively to MIGA's financial results. Taken together, IEG estimates these 46 non-strategic projects made a negative contribution of -\$16.5 million to MIGA's financial results. This compares to the aggregate project-level contribution of \$2.8 million to MIGA's financial results from all 246 projects together over the same period (Table 1).

Table 1. IEG-Estimated Financial Contribution to MIGA's Financial Results, FY01–10

	<i>Number of MIGA projects</i>	<i>IEG-Estimated Financial Results (\$ millions)</i>
Projects meeting one or more MIGA strategic priorities	175, of which: 50 projects generate positive financial results 125 projects generate negative financial results	+\$8.2 +\$53.3 -\$45.1
Projects meeting none of MIGA's strategic priorities:	71, of which: 25 projects generate positive financial results 46 projects generate negative financial results	-\$ 5.4 + \$ 11.1 -\$ 16.5
Total	246	+ \$2.8m

Source: IEG estimates based on MIGA data.

Note: IEG's findings do not represent the actual "financial results" of individual projects, but rather reasonable estimates that allow robust conclusions about profitability patterns.

2.24 Few sectors or strategic priority areas contribute positively to MIGA's financial results. Complex infrastructure projects contribute positively to MIGA's financial results, due to their large premium size and longer tenor of 9 years, compared to 6 years for the portfolio as a whole. For the same reasons, oil, gas, and mining projects also generate positive financial contributions for MIGA.

2.25 By contrast, three of MIGA's four strategic priority areas were "loss-making" business lines, due to projects in these areas being smaller. Primarily due to their small premium size, projects in the priority areas of South-South, IDA, and conflict-affected countries are estimated to have made generally low or negative financial contributions to MIGA. For example, the overall financial contribution of MIGA's 52 South-South projects was estimated at -\$2.2 million over the 10-year period 2001–10. Projects in IDA-eligible and conflict-affected countries also generated large negative returns for MIGA (Table 2). These negative financial contributions are not related to sector characteristics, but in the projects' generally smaller size and annual net revenue to MIGA.

Table 2. IEG-Estimated Contributions of MIGA's Strategic Priorities and SIP, FY01–10

<i>Category</i>	<i>Number of Projects</i>	<i>Estimated Financial Contribution (\$ millions)</i>
Complex Infrastructure	81	+ \$33.4
South-south	52	(-\$2.2)
IDA	113	(-\$4.6)
Conflict-affected	71	(-\$8.6)
Financial Sector	89	(-\$12.0) ^a
Small Investor Program	29	(-\$12.6)
Total	246	2.8m

Source: IEG calculations based on MIGA data. Categories overlap and do not sum up to total.

a. Adjusting the profitability calculations of financial sector guarantees for a high share of repeat clients and assuming that they are easy to underwrite can *conceivably* reduce administrative costs associated with underwriting them. Still the overall contribution of financial sector guarantees are negative: -\$6.4 million.

Box 3. SIP Projects Contribute Negatively to MIGA's Financial Results

The *Small Investment Program (SIP)* is MIGA's vehicle for targeting small and medium enterprises (SMEs). Guarantees of up to \$10 million are underwritten on a streamlined basis and approval is delegated to MIGA management. Premiums are set to recover only variable underwriting costs, a subsidy of 50 percent of MIGA's regular premium. In FY10, one-fifth (4 out of 19 projects) of MIGA's projects were SIPs.

While SIP projects themselves are small, the investors benefiting from the premium subsidy can be very large. SIP beneficiaries (guarantee-holders) include wholly-owned subsidiaries of DaimlerChrysler, Societe Generale de Surveillance SA (SGS SA) and large state-owned enterprises such as the Industrial Development Corporation of South Africa and the Developpement Agro-Industries Sud, SA of France.

SIP projects contribute negatively to MIGA's financial results. Collectively, SIP projects cost MIGA an estimated -\$12.6 million between FY01–10 (Table 2). This is not surprising, since projects are inherently small (maximum size is \$10 million)²⁰ and SIP premiums are explicitly set to recover only part of MIGA's underwriting costs. This subsidy is intended to make MIGA's PRI attractive and affordable for SMEs.

IEG questioned SIP's premium subsidy in 2007 and recommended that MIGA refine the program to focus the subsidy on SIP's intended beneficiaries, small investors and SMEs. SIPs negative financial contribution is otherwise hard to justify.

Few SIP projects have been evaluated and their development results are not yet known. IEG plans to evaluate SIPs development outcome performance for a future report. IFC's experience with a Washington-based retail model of direct lending to SMEs was not successful, and led IFC to switch to a business model of supporting SMEs through credit intermediaries. This model may also be relevant for MIGA.

²⁰ MIGA's 2007 SIP Policy requires that the guarantee coverage must not exceed \$10 million; the SME investee company may have a maximum of 300 employees and an asset value of \$15 million; and the investor company (guarantee-holder) may have a maximum of \$50 million in assets and total sales of \$100 million. Eligible sectors include finance, agribusiness, manufacturing, and services—infrastructure is ruled due to environmental and social risks. Only B and C category projects are eligible for SIP.

2.26 *Both premium size and project duration have decreased over the decade, lowering MIGA's overall underwriting profitability.* The existence of large-premium and long-duration projects is what matters for how much financial surplus MIGA generates from a given year of underwriting operations—not the volume of guarantees or number of projects. As the average duration for MIGA's portfolio fell by 31 percent, from 4.9 years to 3.0 years between FY01-10, average net revenue²¹ dropped by 16 percent, from \$277,000 to \$149,000. The trends in these profitability drivers have combined to substantially lower MIGA's overall profitability over the decade.²²

2.27 MIGA can improve its financial performances and its strategic relevance by being more selective about the projects it underwrites, informed by project-level financial results. For example, MIGA can turn down some projects in order to influence the composition of its guarantee issuance, even though it is operating well below capacity.²³ The estimates above indicate that MIGA could have improved its financial results by up to \$16.5 million without compromising on its strategic priorities, by being more selective about the projects underwritten.

2.28 MIGA can also exert substantial influence on the composition of its prospective pipeline through proactive business development efforts targeted at certain sectors. Recent business development efforts have clearly demonstrated that effectively targeted efforts can yield fruit, even when the overall demand for PRI is influenced by market factors. The Business Development Partnership with IFC has yielded three guarantee approvals and added four projects to the pipeline of potential projects,²⁴ while the Asia Hub has added seven, as of mid-FY11. "Client management"—the level of service and attention paid to clients in the application process and during contract administration—is another way to influence the direction of future business. In short,

²¹ Annual net revenue = premium due *less* reinsurance *plus* ceding commission.

²² Profitability of projects in a given year is calculated as the total net premium income less underwriting and administrative costs over the lifetime of all projects issued in that fiscal year.

²³ As an example, MIGA delivered 16 projects in FY10, compared to 43 in FY06, while having more underwriting staff in FY10 (23) than in FY06 (17). MIGA also has substantial unused risk-bearing capacity, with only 31 percent of its operating capital used. While MIGA's fixed costs are high and it is operating below capacity, this analysis shows that it is not a sufficient criterion to underwrite projects as long as they cover their variable underwriting costs and make some contribution to MIGA's fixed costs.

²⁴ Projects in the pipeline are those for which MIGA has received a Definitive Application from the investor.

MIGA is not a passive market taker—it can and does influence the types of clients and projects it supports.

2.29 *These findings do not imply that MIGA should focus on more profitable business lines.* They do imply that MIGA should rigorously assess the strategic relevance and expected development outcome of the projects it is considering to underwrite and determined they are positive. Underwriting projects that contribute negatively to MIGA's profitability, are non-strategic, and have negative development results would be a lose-lose combination. In addition, measuring financial results at the project level would help MIGA determine the implications of its strategic directions for its financial viability.

INSTITUTIONAL FACTORS AFFECTING STRATEGY IMPLEMENTATION

2.30 *MIGA has made progress in addressing issues relating to its institutional and developmental effectiveness.* Its operations are now better aligned with Bank country strategies—a significant gap in the past. More effort is being made to assess projects' expected development impacts as part of underwriting due diligence, although there are quality and consistency issues. The risk analysis underpinning MIGA's pricing, provisioning, reinsurance and capital allocation decisions has been refined.

2.31 *MIGA's Action Plan for Strategic Progress* in FY09 was designed to address internal constraints such as underwriting and decision-making processes, and MIGA's business development and client relationship function. MIGA introduced the goal of "value-driven volume" for its operations and defined its comparative advantage as supporting "smart projects in difficult environments." Having piloted a self-evaluation program in FY09, MIGA has completed its first three project self-evaluations as of December 2010, with IEG support. IEG views this initiative as key to improving MIGA's project quality and operational performance, through institutional learning.

2.32 *MIGA now has several new business development initiatives under way.* Responsibility for business development was assigned to MIGA's Operations Department in FY09 and a variety of business development efforts have been launched linked to sector strategies. In addition to enhancing its Agent and Finder Program, MIGA has launched the Business Development Partnership with IFC to leverage IFC's global network of staff and contact, and has recently established an Asian Hub—initiatives that have already yielded positive results, as noted earlier in this Chapter. To date it is, however, too early to assess in a comprehensive manner the effectiveness of these business development initiatives for MIGA's strategy as the development of a richer more diversified and more strategic pipeline of prospective MIGA guarantees takes time.

2.33 *Product innovation, in particular adaptation of existing products, continues to be a major challenge for MIGA.* As noted earlier in this Chapter, MIGA has supported a relatively narrow mix of investments even though there was substantial scope allowed by its charter and Operational Regulations (Op Regs). In addition, within a PRI market characterized by tailor-made rather than standard contracts, MIGA is perceived as unusual in offering not only a fixed menu of risk coverages (as defined by the Convention and Op Regs) but also very *standard* coverage terms and conditions. An example is MIGA's coverage against loss of income due to temporary business interruption. MIGA's standard contract suggests that a complete shutdown for a 30 day period (given in brackets on the standard) is required, despite the Op Regs being silent on the length and extent of the business interruption.^{25 26} A private PRI provider would be able to price the additional risk implied by an interruption of less than 30 days or by a partial shutdown and tailor (and price) the contract on that basis.

2.34 *MIGA hinders itself from responding to requests for adjustments to standard contract terms* because it has neither a systematic process nor a standing authorization for a Director or Senior Manager to consider and approve such requests. Even small exceptions are referred to MIGA's Management Team and up to the EVP for decision. This lack of process and clarity about what will get endorsed in the end, what will not, and why appears to discourage underwriters, according to IEG interviews, from bringing innovations forward and finding solutions to client needs. This is not to say that MIGA has not on occasion considered slight modifications to coverage terms to suit projects and clients.

2.35 *There are instances where contract language is more rigid now than three or four years ago.* Until 2004 MIGA's contract of guarantee allowed investors to choose a specific amount of coverage for each risk. An investor might want to get transfer risk coverage of one amount to facilitate the repatriation of funds and a higher amount for War and Civil Disturbance and Expropriation to cover assets at risk.²⁷ Currently, MIGA's contracts suggest the same dollar amount of coverage on all risks covered; given the above described lack of a clear and explicit approval process for deviations from these standard

²⁵ Source: *MIGAs Operational Regulations* (as amended on 14 April 2009), Part I, Section IV: Eligible Risks, page 23.

²⁶ Source: MIGA Contract of Guarantee forms.

²⁷ When the contract of guarantee was redrafted there was no accompanying statement of policy or explanation of the change.

terms, staff members feel discouraged to offer greater flexibility, that is, different dollar amounts of coverage on the different risks covered.

2.36 These narrow interpretations and lack of flexibility in tailoring contracts seem to stem from numerous "soft policies" and a tendency to follow existing practices – they do not relate to charter or Op Reg restrictions. The impact of "soft policies" is exacerbated by a striking lack of "official guidance" to underwriters and other staff in the form of Policy- or Operations manuals. A tool such as the World Bank's Operational Manual containing Operational Policies, Bank Procedures, and interim instructions to staff, such as Operational Memoranda on the conduct of Bank operations does not exist. For MIGA underwriters looking for guidance on what is allowed versus what is ruled out by policy, the practice is often to ask colleagues, typically legal staff. By this means, what was intended as a business decision by management may be conflated into a (soft) policy on the matter. These soft policies thus affect innovation and client responsiveness.

2.37 Less influence of "soft policies" will require a substantial effort by MIGA to articulate what it considers actual policies (and what are not its actual policies) and to communicate the difference in an effective way. MIGA is starting to recognize the hold these unwritten norms have on the institution and has recently started to review some of them, with a view to determining the original underlying rationale of the norms, practices, and unwritten rules that drive behavior, and whether they are still valid. Progress in this area through a rigorous and comprehensive review of such soft policies (and of some of the longer-standing formal policies as well) would be important for strategy implementation.

2.38 *Product innovation and greater product flexibility requires the ability to price risk.* MIGA's pricing will have to become more sophisticated to support the introduction of new products and flexible coverages and terms. MIGA's pricing is currently driven by the administrative cost and risk cost associated with the coverage, as well as by market competition and conditions. This mirrors the PRI market where political risk insurance rates are fundamentally driven by the risk costs of offering such coverage, including expected losses, administrative costs, required return on capital and a number of market-based factors. The latter include primarily the availability and price of international reinsurance capacity and price competition between PRI providers.

2.39 MIGA's current pricing model calculates a pricing band which provides substantial range for pricing discretion. This enables MIGA to respond to both market pressures and to client-specific negotiations. Nonetheless, for MIGA to introduce new products and greater

flexibility in the terms of its coverages, it must carefully consider the pricing consequences. When potential clients request modification in standard contract coverage, for example, 25 day business interruption instead of the standard 30 days, the underlying risk and thus expected losses (and also client behavior) may change. This may have to be reflected in MIGA's price quote.

2.40 *MIGA's pricing model was last fine-tuned in FY07 and needs further refinement to support the demands of MIGA's business.* This model will need to be fine-tuned further so that MIGA can appropriately price the risk embodied in its new products and flexible coverages. This will involve also fine-tuning MIGA's economic capital model, since the economic capital (value-at-risk) estimates are the main driver of the "risk cost" element of MIGA's pricing.

III. Summary

2.41 *MIGA's Strategic Directions FY12-14 and its implementation will be instrumental* in getting the most out of MIGA's broadened mandate and potential developmental reach. The opportunity to support private sector investment in the post crisis recovery only heightens this challenge.

2.42 A retrospective analysis of the strategy period FY09-11 revealed that MIGA was on track in meeting several, but not all of its key performance targets for the strategy period FY09-11. In terms of guarantee volume, MIGA's guarantee issuance (new guarantees issued) initially fell short of the strategy's target of \$1.8-\$2.2 billion a year, but met its target in the last year of the strategy period (FY11). MIGA's outstanding portfolio of guarantees reached an all-time high of \$7.7 billion in gross exposure as of 30 June 2010, as cancellations dropped sharply during the crisis period. The number of new guarantee projects met the strategic targets of 20-30 new projects a year in two years out of three. When looking at the portfolio composition, MIGA met its target of being "overweight" in IDA countries. At the same time, MIGA issued a growing share of its guarantees in areas outside its strategic priorities. MIGA was able to contain its administrative expenses below the set threshold of 85 percent of net premium income, even though this ratio has increased in the recent past. MIGA's return on operating capital was at 1.4 percent – well below its target range of 7-10 percent (before provisions). Complementing the above analysis of strategy implementation with development effectiveness indicators shows that project performance is broadly unchanged over the last ten years.

2.43 *MIGA's capital is a significant resource – and an indicator of MIGA's risk bearing capacity.* MIGA's capital utilization, however, stood at 31.3 percent as of June 30, 2010 – a low value not only by IEG's assessment but by also MIGA's own reports (economic capital of \$323 million over operating capital of \$1.036 billion).

2.44 *The upcoming strategy should take into account the lessons of past strategies and their implementation.* To be conceptually complete, MIGA's upcoming Strategic Directions needs to address MIGA's developmental role; its financial sustainability; and the customer, internal, and resource perspectives.

2.45 *MIGA's initiative to develop* KPIs to track institutional performance and strategy implementation is an important step in the right direction. KPIs were introduced in FY09 with a view to enhancing MIGA's ability to track strategy implementation. However, the proposed metrics need further enhancement to adequately track progress in achieving strategic and operational objectives and provide management with sufficient information for strategic decision-making.

2.46 *With regard to financial sustainability, MIGA can improve its financial results and its strategic relevance* by being more selective with respect to which project it underwrites. IEG estimated that MIGA could have improved its financial results without compromising on its strategic priorities, by being more selective about the projects underwritten. And going forward, informed by project-level financial results, MIGA could steer its underwriting away from non-strategic projects that generate negative financial results toward strategic priority area projects—whether they generate positive financial results or not.

2.47 *These findings do not imply that MIGA should focus on more profitable business lines.* Rather, measuring financial results at the project level can help MIGA determine the implications of its strategic directions for financial sustainability – MIGA needs to find the right project mix for impact and financial sustainability. However, cross-subsidization within the portfolio does imply a significant burden of proof to demonstrate strong development impact based on rigorous ex ante assessment during underwriting. Underwriting projects that contribute negatively to MIGA's profitability and have poor development results would be a “lose-lose” combination.

2.48 *Looking at factors affecting strategy implementation, MIGA* has made progress in addressing issues relating to its institutional and developmental effectiveness, including the strengthening of its business development efforts. However, product innovation, in par-

ticular adaptation of existing products, remains a substantial challenge for MIGA.

3. Financial Sector Guarantees and MIGA's Strategy

3.1 This chapter takes a closer look at MIGA's financial sector guarantees, MIGA's most important business segment in terms of volume of newly issued guarantees. Given their importance in the current strategy period and their important role in development, financial sector guarantees were selected as a case in point to analyze MIGA's experience in implementing its strategy. Section I reviews trends and characteristics of financial sector guarantees, followed by an assessment of the strategic relevance of financial sector guarantees (Section II). Development outcomes of financial sector guarantees are discussed next in Section III. MIGA's quality of underwriting in this sector is discussed in Section IV. The Chapter concludes with a summary (Section V).

I. Financial Sector Guarantees and Strategy Implementation

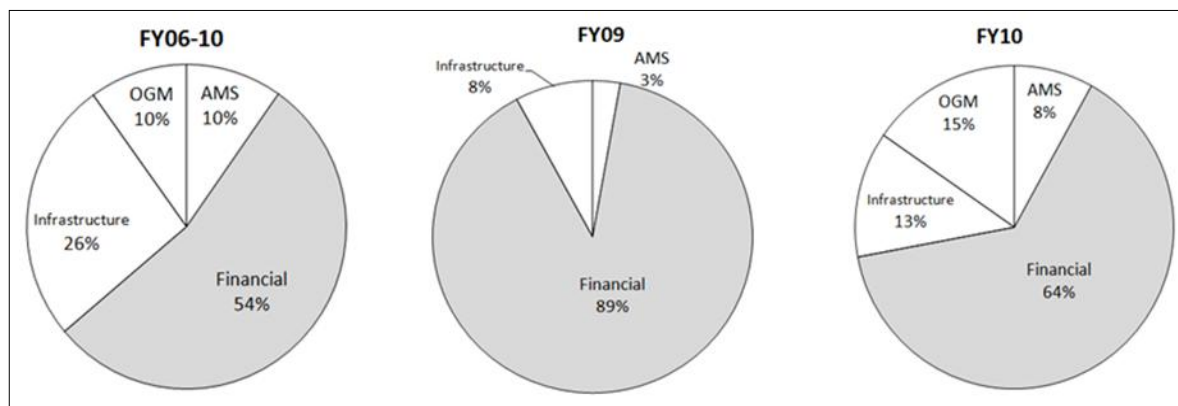
RECENT TRENDS IN FINANCIAL SECTOR GUARANTEES

3.2 *Financial sector guarantees were MIGA's most important business segment* in the strategy period in terms of volume of newly issued guarantees. Over the past five years, financial sector guarantees comprised 54 percent of MIGA's guarantee volume (FY06–10), up from 39 percent in the preceding five year period (FY01–05). The issuance of financial sector guarantees reached a peak in FY09, the first year of the strategy period, when 89 percent of MIGA-issued guarantees were in the financial sector. Their predominance in MIGA's business volume continued in FY10 at 64 percent of MIGA's total issuance that year (Figure 2). As of mid FY11, the strategy period's last year, financial sector guarantees accounted for 65 percent of guarantees issued.

Evaluation Essentials

- ❖ Financial sector guarantees were MIGA's most important business segment.
- ❖ MIGA's engagement in the crisis response through financial sector guarantees highlights the agency's potential to contribute countercyclically, albeit in limited amounts.
- ❖ Except during the last two crisis years, the dominance of financial sector guarantees in MIGA's issuance, however, does not align well to MIGA's strategy.
- ❖ MIGA's financial sector guarantees were strategically relevant at the country level, in particular in Europe and Central Asia's transition economies.
- ❖ Evaluated financial sector projects had better development outcome ratings than projects in other sectors.
- ❖ MIGA's Quality of Underwriting is better for financial sector projects than other sectors, but generally remains weak.
- ❖ To improve its development effectiveness, MIGA needs to ensure that lessons distilled in evaluations and self evaluations are applied to new operations.

Figure 2. Sector Composition of Guarantees Issued (by Volume), FY06–FY10, FY09 and FY10



Source: MIGA.

3.3 *Infrastructure guarantees have declined as a share of MIGA's guarantee issuance, pari passu with the growth of financial sector guarantees.* Infrastructure fell to 26 percent of guarantees issued in FY06–FY10, compared to 40 percent in FY01–FY05. Similarly, the share of guarantees issued in Agriculture, Manufacturing and Services (AMS) fell to 10 percent of guarantee volume, from 12 percent in FY01–05, while the share of volume in Oil, Gas, and Mining (OGM) stayed fairly even (9 percent compared to 10 percent of total volume).

3.4 *In terms of guarantees outstanding, financial sector guarantees make up the largest sectoral share of MIGA's guarantee portfolio.* Financial sector guarantees represented 43 percent of MIGA's outstanding portfolio (net exposure)²⁸ as of FY10, the highest of any sector. Infrastructure represented 34 percent of the guarantees outstanding, followed by guarantees in AMS (13 percent) and OGM with 10 percent.

3.5 *Given these patterns, it is striking that the financial sector was not one of MIGA's operational priority areas* identified in MIGA's Strategic Directions FY05–FY08 and revalidated in its Operational Directions FY09–FY11²⁹. The weight of financial sector guarantees in MIGA's portfolio and in its share of guarantees issued in recent years suggests that the sector is of high overall strategic importance to MIGA, and to the Agency's operational and financial/business performance. Moreover, the growth in importance of

²⁸ "Outstanding portfolio" is a stock concept that refers to total net portfolio exposure outstanding at a given time (for example, gross exposure less cancellations, terminations, expirations, and reinsurance).

²⁹ MIGA 2005 Review for FY00–FY04 and Strategic Directions for FY05–FY08 and MIGA Operational Directions FY09–11.

this sector was visible starting in FY06, the middle of the previous strategy period. This contrasts with IFC, where "developing financial markets" is one of its strategic priorities.

3.6 *MIGA's financial sector activities are aligned to the World Bank Group's goal of responding to the global financial crisis.* While financial sector guarantees are part of MIGA's crisis response and can be considered strategic in the crisis period, the growing dominance of financial guarantees in the Europe and Central Asia Region was apparent starting FY05, predating the crisis by several years.

3.7 *Most MIGA's financial sector guarantees did not fall into any of MIGA's formal strategic priority areas.* Since FY06, six percent of MIGA's \$3.9 billion in financial sector guarantees supported projects in IDA countries,³⁰ compared to 43 percent for guarantees in all other sectors. One percent of MIGA's financial sector guarantees were in Africa, compared to 31 percent for guarantees in all other sectors. By contrast, some 0.4 percent of MIGA's financial sector guarantees were in conflict-affected countries, compared to 15 percent for guarantees in all other sectors. One percent of financial sector guarantees supported South-South investments, compared to 25 percent for guarantees in all other sectors (Table 3).³¹ When looking at these trends, however, one has to bear in mind that MIGA depends on investors to come forward with projects – it cannot make projects happen.

Table 3. Guarantees in MIGA Priority Areas (FY06–FY10)

Guarantees:	IDA (%)	Africa (%)	Conflict-affected (%)	South-South (%)	Non-priority (%)
Financial sector	6	1	0.4	1	94
All other sectors	43	31	15	25	21

Source: IEG-MIGA analysis based on MIGA data as percent of guarantees issued.

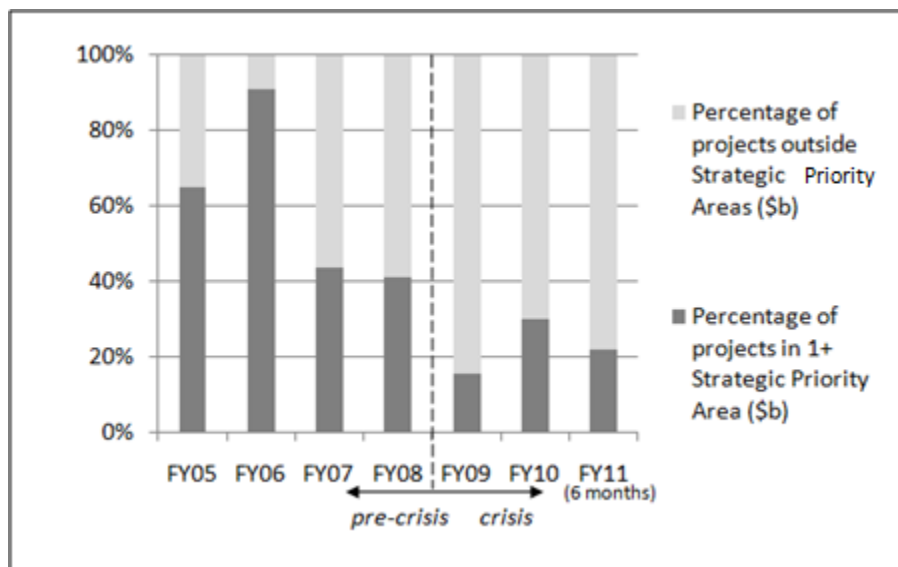
3.8 *The alignment of MIGA's financial sector guarantees' to MIGA's strategic directions is rather weak.* Financial sector guarantees have lent themselves more to support IBRD countries and are strikingly absent in Africa. In general, financial sector guarantees lent themselves less to South-South investments than guarantees in other sectors. The flip side of the growing preponderance of financial sector guarantees is MIGA's declining issuance of guarantees in priority areas. Projects in MIGA's priority areas declined to 16 percent of

³⁰ As percentage of guarantees issued. Includes IDA and blend countries.

³¹ Note that there is substantial scope for overlap in these categories, that is, a guarantee may be in a conflict-affected IDA country, and cover a South-based investor. Such guarantees would be counted under all categories that apply.

guarantee volume in FY09 and 30 percent in FY10, compared to 91 percent in FY06. By the first half of FY11, the proportion was 22 percent. (Figure 3)

Figure 3. MIGA Guarantee Projects in at Least One Strategic Priority Area, FY05–11



Source: IEG-MIGA analysis based on MIGA data.

CHARACTERISTICS OF MIGA'S FINANCIAL SECTOR GUARANTEES

3.9 *Financial sector guarantees are substantially larger on average than guarantees in other sectors.* The average size of MIGA's financial sector guarantees was \$96 million between FY06–10, compared to \$43 million for guarantees in other sectors, and \$61 million for the average of the portfolio as a whole.³² This is a striking contrast to the FY01–05 period when financial sector and non-financial sector guarantees were similar in size, \$37 million and \$38 million, respectively.

3.10 *Financial sector guarantees have a shorter tenor at inception than guarantees in other sectors.* MIGA's financial sector guarantees had an average tenor of 7 years over the period FY01–FY10, compared to 11 years for other sectors and 10 years for the portfolio as a whole.

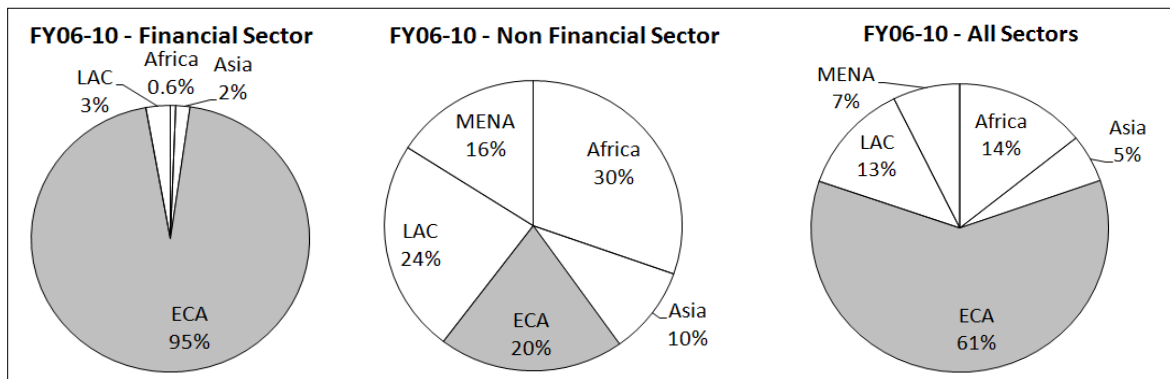
³² The larger size of financial sector guarantees does not necessarily translate into supporting larger "projects." With financial sector guarantees, the face value of the guarantee typically corresponds to the entire "project" being financed (for example, a shareholder loan or line of credit.) In other sectors, the guarantee may cover only part of the financing (that is, the foreign equity slice or cross-border loan) for a much larger "project."

3.11 *Cancellations reduce the de facto tenor to 5 years, compared to 7 years for the average guarantee in the portfolio.*³³ Cancellations hence diminished guarantees' original tenor by about 30 percent on average, for both financial and non-financial sector projects.

FINANCIAL SECTOR GUARANTEES ARE CONCENTRATED IN VARIOUS WAYS

3.12 *MIGA's financial sector guarantees have been more regionally concentrated than guarantees in the other sectors.* Ninety-five percent of financial sector guarantees were issued in one single region, Europe and Central Asia, between FY06–10, compared to 48 percent for the next highest sector (OGM).³⁴ In general, the issuance of non-financial sector projects has been more evenly distributed across all regions, with Europe and Central Asia accounting only for 20 percent (Figure 4).

Figure 4. Regional Composition of Guarantees Issued (by volume), FY06–10



Source: MIGA.

Note: Regions: ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa.

3.13 *Financial sector guarantees are concentrated in a few host countries.* Eighty percent of all financial sector guarantees supported projects in only five host countries over the past five years— compared to non-financial sector guarantees, where the top five host

³³ Guarantees are often cancelled prior to their expiration. Cancellations take place for many reasons including changes in investor risk perceptions relative to guarantee cost, improved country performance, sale or transfer of the project company, or of the guarantee-holder company, to name but a few.

³⁴ Looking at the sector-wise regional concentration from the perspective of outstanding net exposure gives a similar picture: Eighty-eight percent of MIGA's outstanding financial sector guarantees (net exposure) were in Europe and Central Asia (as of June 30, 2010) compared to guarantees outstanding in other sectors, which were distributed in a relatively balanced manner across the five regions.

countries accounted for only 45 percent of projects supported by MIGA guarantees.

3.14 *Financial sector guarantees have also been “client concentrated”,* that is, with respect to guarantee-holders. Five top clients (guarantee-holders) purchased 93 percent of MIGA's financial sector guarantees (by volume) in FY06–10. By comparison, in all other sectors the top five clients accounted for 39 percent of all guarantees.

MIGA'S FINANCIAL SECTOR GUARANTEES CAN BE SEEN IN THE CONTEXT OF CRISIS-RESPONSE

3.15 *MIGA has supported investments made by foreign banks during several financial crises,* including the Asian crisis of 1997, Russia, Brazil, and Turkey in the late 1990s, and Argentina in the early 2000s.

Box 4. MIGA's Crisis Response Deepened its Engagement in the Finance Sector

The current global financial crisis has heightened attention to MIGA's financial sector guarantees. Beyond its already significant build-up of exposure to the financial sector, MIGA adopted the Financial Sector Initiative in March 2009, a MIGA-specific crisis response effort focused on supporting financial institutions in Europe and Central Asia. It is part of the wider, internationally coordinated Joint International Financial Institution (IFI) Action Plan agreed to by the European Bank for Reconstruction and Development, the European Investment Bank, and the World Bank Group.

Under the Joint IFI Action Plan, MIGA agreed to commit up to \$2 billion-\$3 billion in gross exposure for political risk insurance on cross-border investments by financial institutions to recapitalize or provide liquidity to subsidiaries. In FY10, guarantees totaling \$918 million were issued under the initiative (six contracts issued in Serbia, Croatia, Latvia, and Kazakhstan), bringing MIGA's total cumulative support under the Financial Sector Initiative to \$1.5 billion in gross guarantee coverage. This highlights MIGA's potential to contribute countercyclically, albeit in limited amounts.

3.16 MIGA's growing activity in support of projects in Europe and Central Asia followed the wave of financial sector reform, bank privatization and entry of foreign banks into that region, much of it supported by the World Bank Group. The acceleration of MIGA's issuance in Europe and Central Asia (which grew 14 percent per annum in terms of net exposure between FY00–10) can be linked to European banks' support to their subsidiaries in European Union accession countries and other countries in the region.³⁵

³⁵ Financial liberalization in the Latin American and Caribbean region in the early 1990's provided a similar impetus for the steady growth in MIGA's

THE DROP IN CANCELLATIONS UNDERSCORES MIGA'S IMPORTANT ROLE IN CRISIS PERIODS

3.17 *MIGA guarantees are often cancelled prior to their expiration* due to changes in investor risk perceptions relative to MIGA's pricing, improved country performance, or a change in ownership of the project or guarantee-holder among others. Such cancellations lead to the shrinking of MIGA's outstanding portfolio, that is, a "runoff," which is usually measured in terms of annual runoff of the outstanding portfolio (net exposure). The annual runoff due to cancellations amounted to 8 percent³⁶ between FY06-10, with MIGA's financial sector guarantees canceling about as frequently as guarantees in other sectors.

3.18 During the crisis, cancellations of guarantees declined in general, with cancellations of financial sector guarantees declining even more sharply. The FY09 -FY10 pattern of cancellations changed abruptly during the global economic crisis. In FY09 and FY10, cancellations led to a much smaller runoff in the outstanding portfolio of just 1.5 percent and 2.9 percent, respectively. In particular, cancellations of financial sector guarantees were very low in FY09 and FY10, resulting in a runoff of only 0.2 percent and 1.1 percent, compared to 2.3 and 4.3 percent for non-financial sector guarantees.

3.19 *The decline in cancellations can be attributed to the heightened risk perception of investors during crisis times.* Investors tend to hold onto their guarantees significantly longer during crisis periods. This points to the important role that MIGA has in providing investor comfort during such a crisis – a service particularly appreciated by financial sector clients as cancellation patterns revealed.

WITH REGARD TO THE FINANCIAL SUSTAINABILITY OF FINANCIAL SECTOR GUARANTEE

3.20 *Financial sector guarantees do not contribute positively to MIGA's financial results, according to IEG estimates.* MIGA issued some \$2.8 billion of guarantees in the financial sector over the 10 year period FY01-10, but despite this high business volume, the sector did not contribute positively to MIGA's overall financial results. Financial

business volume in an earlier decade, as U.S. and European financial intermediaries opened bank branches or acquired local banks in the region. ABN-AMRO, ING, and Citibank were among the important players at the time. Between FY90 and FY99, MIGA's issuance of financial sector guarantees was concentrated in the Latin America and the Caribbean Region (51 percent by volume).

³⁶ These 8 percent only represent the effect of *cancellations* on the shrinking of the outstanding portfolio, that is, on the "runoff." Runoff can also be caused by, for example, reductions, expiries, translation adjustments, and so forth. Their effect is not included in this figure.

sector projects contributed negatively in 8 out of the 10 years, with a total estimated negative contribution of -\$12 million.³⁷ Factoring in a high share of repeat clients and assuming that financial sector guarantees are easy to underwrite *conceivably* reduces administrative costs associated with underwriting financial sector guarantees. Still, they still produce a negative financial result of -\$6.4 million, according to IEG's estimations. In comparison, infrastructure—a sector in which MIGA issued about \$2.7 billion in guarantees—yielded an estimated positive contribution of about \$26 million over the same period³⁸ (Table 4).

Table 4. Project Contributions to MIGA's Financial Results, FY01–10

<i>Sector</i>	<i>Net Exposure [\$ billions]</i>	<i>Contribution to Financial Results [\$ millions]</i>
Infrastructure	\$2.67	+ \$26.1
OGM	\$0.64	+ \$7.3
Finance	\$2.76	(-\$12.0)/(-\$6.4) ^a
AMS	\$0.99	(-\$18.6)

Source: IEG estimates based on MIGA data.

a. Adjusting the profitability calculations of financial sector guarantees for a high share of repeat clients and assuming that they are easy to underwrite can conceivably reduce administrative costs associated with underwriting them. Still the overall contribution of financial sector guarantees are negative: -\$6.4 million.

3.21 *High reinsurance was the reason for financial sector projects' negative contribution to MIGA's financial results.* To limit its exposure, MIGA reinsures certain exposures through private PRI providers. The share of financial sector guarantees that was reinsured was much higher than other sectors over this period.³⁹ Thus MIGA lost a large share of potential revenue from financial projects to reinsurance. Reinsurance of financial sector projects reduced this sector's profitability by almost \$29.7 million (168 percent), according to IEG's estima-

³⁷ Assuming that financial sector guarantees are of low complexity with a relatively high share of repeat clients, a recalculation of the profitability of financial sector projects was carried out. In this recalculation, it was assumed that finance projects were universally simple projects to underwrite, and so were assigned the *lowest possible* initial year underwriting cost, \$130,000. The results of this re-calculation put the financial sector total still at a loss of \$6.4 million. Hence, adjusting for repeat clients and low complexity in underwriting does not significantly change the overall conclusions. Indeed, it reveals that the administrative cost component actually has a relatively smaller impact upon the total profit/loss result than other drivers, such as average size of net revenue.

³⁸ For a detailed description of the methodology, see Appendix 7.

³⁹ This may have been related to the country exposures associated with financial sector guarantees in this period.

tions.⁴⁰ OGM and AMS projects experienced less drain from reinsurance, losing \$7.1 and \$7.8 million respectively (49 and 74 percent).

3.22 *Concentration trends were not the only cause for the high reinsurance level.* MIGA's exposure was well within its own country and projects limits, even during the crisis, and exposures were reinsured even though limits were not close.⁴¹ MIGA could have put the additional risk on its own balance sheet. Reinsurance decisions thus led to MIGA using its capital less effectively, and also to loss of potential revenue from its dominant sector of issuance over the past and current strategy periods.

3.23 This choice was even more conservative than it looks at first glance. MIGA's overall country and project limits are only reviewed by the Board at discrete intervals, with MIGA authorized to increase the approved exposure limits by ten percent a year, automatically.⁴² MIGA has not made use of its authority to adjust exposure limits since the last increase in limits was approved by the Board in April 2007. MIGA's per country and per project limits could therefore have been 30 percent higher than they are now, that is, at \$799 million instead of \$600 million for country limits and at \$240 million instead of \$180 million for project limits. *These country and projects limits, MIGA's reinsurance policy, and the use of its risk-bearing capacity deserve a thorough treatment in the upcoming Strategic Directions FY12-FY14.*

IMPLICATIONS FOR MIGA'S STRATEGY

3.24 *The dominance of financial sector guarantees in MIGA's issuance does not align to MIGA's strategy.* Financial sector guarantees have become MIGA's most important business segment in terms of volume of newly issued guarantees. While financial sector guarantees are part of MIGA's crisis response during the last two years – and may hence be called strategic – the buildup of the financial sector in

⁴⁰ The profitability for financial sector projects changed more than 100 percent due to reinsurance because of the leverage effect that reinsurance can have upon profitability. Although reinsurance can only theoretically extend up to 100 percent of gross revenue, when expenses are very high and so just a little bit lower than the value of revenues, then a reduction of gross revenue by 30 percent, for example, can result in revenues becoming less than expenses, turning a profitable project into a loss-making one, and effectively resulting in a change in profitability greater than 100 percent.

⁴¹ Much of MIGA's reinsurance is "automatic" – treaty reinsurance in which MIGA is obligated to offload a proportion of its exposure.

⁴² The Board approved an increase in MIGA's exposure limits to \$600 million per country and \$180 million per project in April 2007. These limits can be raised by 10 percent per annum at MIGA's discretion.

MIGA's portfolio preceded the crisis by several years. The financial sector per se is not among MIGA's priority areas and the alignment of financial sector projects with MIGA's priority areas is weak. Moreover, the dominance of financial sector guarantees issuance appears to be driven by a handful of repeat clients.

3.25 *The dominance of financial sector guarantees also had negative effects on MIGA's financial results.* Perhaps because of their strong regional concentration, MIGA opted for a higher level of reinsurance which, in turn, drove down the financial sector's contribution to MIGA financial results.

3.26 *Future strategies need to better define the relative weight of the different sectors* in MIGA's portfolio. Its implementation plan also needs to suggest how MIGA will manage its issuance of guarantees in a more strategic fashion so that its operational activities are more in line with its strategic objectives and with its financial goals.

II. Strategic Relevance of MIGA's Financial Sector Projects

FINANCIAL SECTOR PLAYS AN IMPORTANT ROLE IN DEVELOPMENT

3.27 Well-functioning financial markets play a key enabling role for sustainable development and a healthy and growing economy.⁴³ Banks provide payments services, housing and consumer finance, provide businesses with access to working capital and investment financing to support investment and growth. The entry of foreign banks into developing country financial systems is generally a positive development, with the potential to broaden and deepen the market, accelerate the introduction of new instruments, and bring new technologies and management approaches to banking. This has occurred in many countries through privatization of formerly state-owned banks or foreign bank investments into local bank subsidiaries. Many of MIGA's financial guarantees have supported such transactions. However, the role of foreign banks in transition or developing countries has not been uniformly positive.

3.28 *MIGA guarantees have the potential to contribute positively to the deepening and broadening of financial markets.* An example is banks seeking MIGA PRI for shareholder loans to their subsidiaries to increase their capacity to lend to local businesses. Another is foreign investors seeking PRI for their equity investment in a newly privatized state-owned bank. In the first example MIGA's guarantee contributes to "broadening" the financial sector by increasing credit penetration in the host country, while in the second, MIGA's guarantee contributes to financial "deepening" by increasing the array of financial instruments

⁴³ *The Financial Sector Strategy for the World Bank Group.*

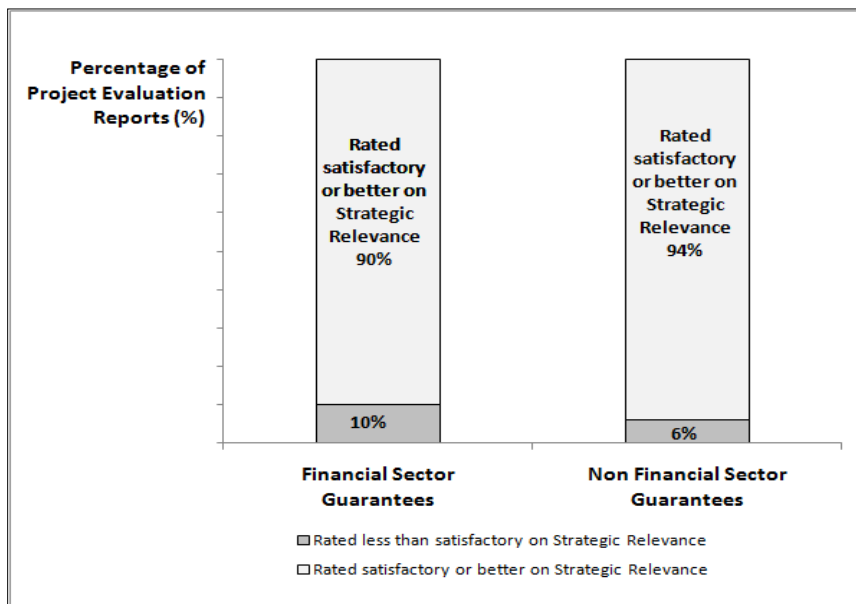
available and improving the market's ability to price and settle transactions in the host country.

3.29 *Positive development impacts can also ensue from MIGA's support for the entry of foreign banks into developing country financial systems that accelerate the introduction of new technologies and management approaches. Entry of foreign banks is also a way of "importing" home country regulatory standards, thereby raising the standards of domestic banks by competitive pressure. MIGA's support for mortgage banking through securitization helps to create a more diversified financial system with a broader range of financing options for long term assets such as housing. That said, the literature shows that the role of foreign banks in transition or developing countries has not always been uniformly positive. Through the entry of foreign banks, fragile and relatively new open financial systems may become overexposed to global shocks, as has happened in some countries/regions.*

PROJECT LEVEL FINDINGS CONFIRM STRATEGIC RELEVANCE OF FINANCIAL SECTOR PROJECTS

3.30 *IEG's project-level findings indicate that MIGA's financial sector guarantees were strategically relevant at the country level, that is, they are consistent with the Country Assistance Strategy (CAS) and Bank sector strategies. Ninety percent of the evaluated financial sector projects were rated satisfactory or better with regard to Strategic Relevance (Figure 5). This rating is consistent with those of non-financial sector projects (94 percent) and all evaluated projects (93 percent).*

Figure 5. Most Financial Sector Projects Are Strategically Relevant



Source: IEG Project Evaluation Database.
Note: PER = Project Evaluation Report.

3.31 *The large share of financial sector projects rated high on Strategic Relevance validates efforts by MIGA management* to ensure that guarantee projects are aligned with country strategies. MIGA's underwriting template now requires a description of the project's alignment with the CAS, and underwriters and the risk management team consult regularly with World Bank sector and country staff to ensure that MIGA projects are consistent with the Bank's country assistance strategies. In a few instances, MIGA staff has also participated in CAS preparation.

3.32 The alignment of MIGA financial sector projects with the host country development priorities indicates that MIGA projects are delivering on MIGA's goal of supporting host country development objectives. Further, projects rated high on Strategic Relevance often had a salient role in the sector – particularly those designed as part of sector reforms or those that alleviated sector specific structural and regulatory weaknesses. Some examples from the Europe and Central Asia Region follow.

MIGA FINANCIAL SECTOR GUARANTEES WERE STRATEGICALLY RELEVANT IN EUROPE AND CENTRAL ASIA'S TRANSITION ECONOMIES

3.33 MIGA's support to foreign-owned banks has been strategically relevant and developmentally impactful in Europe and Central Asia's banking systems that have not completed their reforms. MIGA guarantees⁴⁴ have been critical in establishing the credibility and sustainability of private foreign bank subsidiaries in an environment where weaknesses in the regulatory regime present high risk to the operations of private banks and where the dominance of state-owned and politically-connected private banks limits private banks' client pool for both loans and deposits. State-owned banks that operate with implicit government support bring serious operational challenges to private banks that are not politically connected.

3.34 *IEG found that the foreign bank subsidiaries supported by MIGA competed effectively in this environment.* This was due to their better operational efficiency, more selective lending which reduces credit risk and non-performing loans, and better banking services. These operational responses have greatly increased competition and efficiency in the host countries' banking system, and also accelerated the introduction of a wide range of banking products for both corporate and household customers. MIGA's support for private financial intermediaries in transition countries hence becomes strategically important in developing sound financial systems, promoting competition, and supporting private sector development.

⁴⁴ Four of the evaluated projects involved financial intermediaries that also received investments from other multilateral agencies, including IFC.

3.35 *IEG also found that MIGA-supported banks contributed positively in upgrading the host countries' banking sectors.* Most of the evaluated banks increased competition for deposits and financial products and services, were more efficient in their operations, and introduced new and innovative banking products that better met local needs. Overall, these projects have contributed positively in upgrading the host countries' banking sectors.

Box 5. Supporting SMEs Is Neither Necessary nor Sufficient for Satisfactory Development Outcomes

MIGA often justifies its support for financial sector projects based on their providing finance to SMEs. However, IEG found that most of the foreign bank subsidiaries supported by MIGA faced a non-level playing field in retail and SME lending. Especially in transition economies, financial systems tended to be dominated by state-owned and "politically-connected" private banks often offering preferential rates. Thus, foreign private banks such as those supported by MIGA are placed at a competitive disadvantage in pursuing retail and SME lending.

IEG also found that retail lending facilities (credit lines) guaranteed by MIGA can contribute to financial distress if on-lent to borrowers such as households and SMEs unable to hedge or absorb foreign exchange risks. Foreign bank subsidiaries in transition economies relied heavily on foreign currency shareholder loans rather than domestic deposits, to fuel their growth and many households and SMEs took advantage of the seemingly lower (by 200-600 basis points) foreign currency interest rates. The sharp deterioration of exchange rates in early 2009 as the global financial crisis unfolded left many such borrowers unable to repay. This translated into higher incidence of non-performing loans (and loan write-offs) for the evaluated banks.

IEG found that SME lending facilities guaranteed by MIGA have low utilization rates. For example, MIGA supported a credit facility designed to give SMEs access to much-needed medium term-financing. However the credit line facility could be used only by SMEs with the financial strength to take on currency devaluation risk over the 4 to 8 year term of the loans. The facility's utilization rate was low because devaluation risk discouraged many SMEs from accessing it, especially those without a stable foreign currency revenue source. Businesses adversely impacted by devaluation were also reluctant to use the credit facility.

This suggests that MIGA needs to carefully assess the host country environment and determine whether the project seeking MIGA's support is workable there, and also that MIGA's underwriting guidelines need to lay out more clearly how such ex ante assessments of expected development outcome are done.

3.36 *Support for SMEs is neither necessary nor sufficient for MIGA projects to have satisfactory development outcomes.* MIGA often justifies its support for financial sector projects based on their providing finance to SMEs. IEG found that all of the developmentally successful financial sector projects had clearly focused and defined business segments based on their competitiveness. However, most of them (67 percent) had minimal retail banking services and did not provide loans to SMEs. Corporate banking segments generated the bulk of their profits. These banks introduced innovative financial products to the host country's financial sector that local banks eventually emulated and served larger businesses through efficient deli-

very of banking services, risk management, and investment products that positively contributed to their businesses. Few of the developmentally successful financial sector projects had SMEs at their core (33 percent). Those that did involved the acquisition of local banks with an existing retail network and deposit base. These were able to grow their retail client base and branch network without the huge start-up costs involved in establishing retail banking operations from scratch.

III. Development Outcome of Evaluated Financial Sector Projects

PROJECT EVALUATION DATABASE USED IN THIS REPORT

3.37 IEG's project evaluation database comprises 41 ex post evaluations of MIGA guarantee projects. The 41 projects, except for one, were underwritten by MIGA between FY96 and FY08 and evaluated by IEG between FY 04 and FY11 (see Appendix E).⁴⁵ Included in the database are 10 financial sector projects of which 50 percent are rather recent guarantees, that is, all but one underwritten by MIGA between FY06 and FY08, and the other half underwritten between FY98 and FY02. These financial sector projects were evaluated by IEG between FY05 and FY11.⁴⁶ All Project Evaluation Reports (PERs) in IEG's database used in this report have been discussed with MIGA staff and management.⁴⁷

3.38 *Development impact is at the heart of MIGA's mandate and "brand."* Development impact relates to MIGA's role as a catalyst of high-quality foreign investment that sees value in MIGA's environmental and social safeguards and its developmental orientation. In IEG's methodology, the development outcome rating aims to capture a project's overall economic and social impacts, and reflect how well a project has contributed to fulfilling MIGA's mission of facilitating for-

⁴⁵ Projects to be evaluated are randomly sampled from a population of MIGA guarantee projects issued *three years* earlier. *Cancelled* projects are included in the sampling population.

⁴⁶The cohort of evaluated financial sector projects includes three purposively sampled projects in order to increase the pool of evaluated financial sector projects. One of these three projects was issued in FY09 and *purposively* selected for its unique characteristic: the project was issued as part of MIGA's response to the global financial crisis.

⁴⁷ PERs are peer reviewed to ensure objectivity and quality. In FY10, a sample of PERs was also independently reviewed by an external consultant to ensure compliance with Good Practice Standards, as part of the recently concluded *3rd Benchmarking Exercise* of the Evaluation Cooperation Group's Working Group on Private Sector Evaluation.

eign direct investment that promotes sustainable growth and development.

3.39 IEG evaluates the development outcomes of MIGA projects and reports on project and institutional performance regularly to the Board. In IEG's CODE-endorsed methodology, a project's development outcome is assessed on the basis of four different considerations: (a) business performance; (b) economic sustainability; (c) environmental and social effects; and (d) its private sector development impact.

Box 6. An Important Reminder about the Representativeness of Aggregate Project Ratings

It is important to remember that project performance ratings cannot be extrapolated to MIGA's portfolio as a whole, since MIGA's universe of projects is too small for any sample of guarantees to allow for statistical inference at the portfolio level. (Even if IEG were to evaluate over 95 percent of all projects, this would be insufficient for statistical inference at the standard confidence level of 95 percent, as MIGA's issuance of 20 or so guarantee projects a year is too small to yield a statistically significant sample.) By contrast, the aggregate project-level performance ratings reported by IEG-World Bank and IEG-IFC are statistically significant at the portfolio level due to the larger project population overall and the large database of validated project evaluation results, derived from project self-evaluation systems in place in both institutions.

Therefore, the project-related findings in this report do not only draw on quantitative analysis of aggregate project-level ratings, but also on qualitative analysis of ex post project evaluation findings, using content analysis to identify "common patterns," "enabling conditions," and "success factors."

IEG's project evaluation database used in this report consists of 41 evaluated projects, where all but one were underwritten by MIGA between FY96 and FY08. The database includes 10 financial sector projects (25 percent). Half of the evaluated financial sector guarantees were recently issued, underwritten by MIGA between FY06 and FY08, and the other half were underwritten between FY98 and FY02.

Ex post project evaluation is by definition a backward looking exercise and in IEG's methodology, projects can only be evaluated when they are operationally mature. Thus in FY11, the most recent projects that can be evaluated are those underwritten in FY08. Evaluation findings should therefore be interpreted within the context of the prevailing underwriting procedures and practices at the time. Nonetheless, the relevance of the project findings and lessons extend beyond the past, and even where underwriting practices have evolved since then, the lessons learned will be useful for MIGA as it strives to increase its institutional and developmental effectiveness.

3.40 Each of these indicators measures a distinct aspect of guarantee project performance and is assessed separately. The "development outcome" rating is a synthesis of them. A project's development outcome rating thus encompasses all of its effects (positive and negative) on economic and social development.⁴⁸ The terms "development

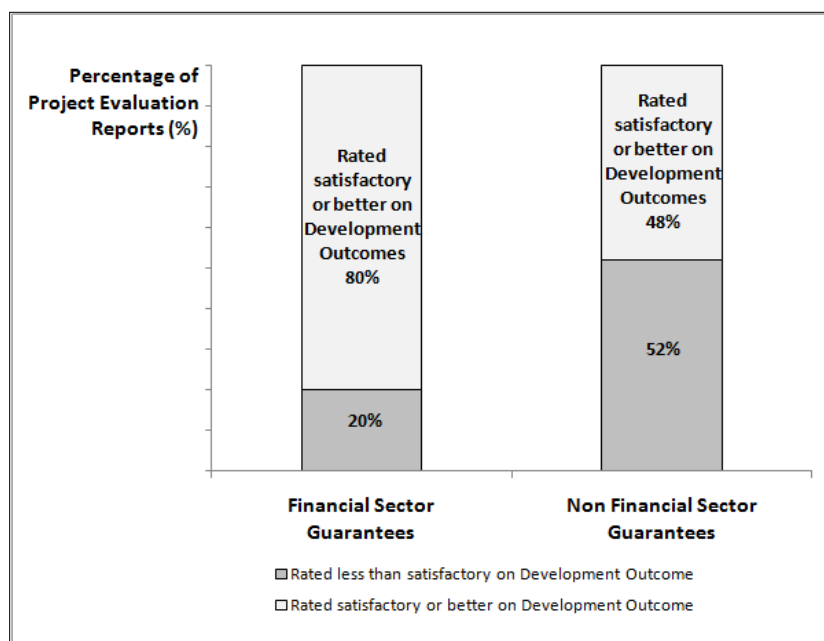
⁴⁸ See Appendix for a summary of IEG-MIGA's Ex Post Project Evaluation Methodology.

outcome" and "development outcome rating" are used interchangeably in this report.)

EVALUATED FINANCIAL SECTOR PROJECTS HAVE HIGH DEVELOPMENT OUTCOME RATINGS

3.41 *Evaluated financial sector projects had better development outcome ratings than projects in other sectors.* Eighty percent of evaluated financial sector projects had ratings of "satisfactory" or better on development outcomes, compared to 48 percent of evaluated non-financial sector projects (Figure 6) including AMS, infrastructure, and OGM.

Figure 6. Financial Sector Projects Have Higher Development Outcome Ratings



Source: IEG Project Evaluation Database.
Note: PER = Project Evaluation Report.

WHAT CAN WE LEARN FROM EVALUATED FINANCIAL SECTOR PROJECTS WITH GOOD DEVELOPMENT OUTCOMES?

3.42 *Financial sector projects with better development outcomes had established and experienced sponsors.* All evaluated financial sector projects rated satisfactory or excellent on development outcomes had sponsors with long operating experience in the host country and/or globally. For example, one financial intermediary supported by MIGA has been providing financial services in the country for almost 94 years. This financial intermediary has survived waves of economic shocks, political upheavals, changes in ownership, regulatory

uncertainty, and competition over several decades, making it adept at introducing financial products and services tailored to the market.

3.43 The globally experienced financial institutions that MIGA supported quickly became operational in the transition economies of Europe and Central Asia. They introduced new products ahead of local banks and adopted the parent bank's more stringent governance standards. Established and experienced sponsors were also able to provide diversified funding for their subsidiaries that lacked a local deposit base. Experienced and established parent banks can also help local subsidiaries weather a crisis by giving customers the comfort of a strong backstop.

3.44 *Financial sector projects with better development outcomes were consistent with Country Strategies.* Most (83 percent) evaluated financial sector projects rated satisfactory or better on development outcomes were consistent with the CASs at the time of underwriting. For example, the MIGA-supported projects in the Europe and Central Asia transition economies were fully aligned with country and World Bank Group efforts to strengthen banking systems and develop the countries' financial markets. MIGA's support was in parallel to that of IFC and other multilateral development banks that provided equity and loans to several of the evaluated projects.

3.45 *Projects with better development outcomes had clearly focused and profitable business segments.* All (100 percent) of successful financial projects targeted either the corporate or retail market, depending on their competitive position. Of these, two-thirds (67 percent) were focused on business with corporate clients and the corporate banking segment generated the bulk of these banks' profits. The other third (33 percent) targeted the retail banking market.

3.46 *Of those with a clear corporate market focus,* one MIGA-supported bank concentrated on offering large investment credits and associated full services to well-established corporate clients, including domestic financial institutions in good standing, corporate clients with foreign parent companies, and the host country's Treasury. Another grew its operations by providing banking services to local corporations neglected by foreign bank subsidiaries catering mostly to foreign companies operating in the country. A third offered comprehensive financial services such as integrated cash management solutions, currency and interest risk management, and hedging instruments not offered by local domestic banks. *Those financial intermediaries with a clear retail focus* typically acquired local banks with existing retail networks and a deposit base and were able to grow their retail client base and expand their branch network without the huge start-up costs involved in establishing retail banking operations.

3.47 Projects with better development outcomes, that is, those rated satisfactory or better, tended to bring new financial products and services to the host country's economy. Half of the evaluated project financial intermediaries introduced financial products and services that were not available from domestic banks. For example, in one country, MIGA supported one of the first banks to offer liquidity financing to the corporate sector, lowering their cost of funds and improving credit ratings. Another MIGA-supported financial intermediary was the first to offer a portfolio of hedging instruments to corporate clients, together with advisory services on liquidity monitoring and management of currency and interest rate risks. Another MIGA-supported bank was the first to offer structured trade financing, project financing, factoring, cash management, and other specialized services for large corporate clients.

3.48 *Projects with better development outcomes partnered effectively with domestic banks and transferred know-how.* Successful project intermediaries have usually partnered with local banks in providing their services. Know-how was transferred to local banks when new products and services were introduced. For example, a mortgage bank helped its regional partners to put together a uniform mortgage loan product that could be pooled and packaged for securitization as mortgage-backed securities.

IV. MIGA's Quality of Underwriting Financial Sector Projects

3.49 "Quality of Underwriting" assesses the quality of MIGA's own work in selecting, assessing, underwriting, and monitoring its guarantees. It is not a rating of the project's performance, but of MIGA's own performance in underwriting (see Appendix D on IEG's project evaluation methodology).

3.50 The findings and lessons below relate to ten MIGA financial sector guarantees of which half are recent projects, that is, projects underwritten by MIGA between FY06 and FY09.⁴⁹ Ex post evaluation is by definition a backward looking exercise, and projects underwritten in FY08 are, in principle, the most recent that can be evaluated in

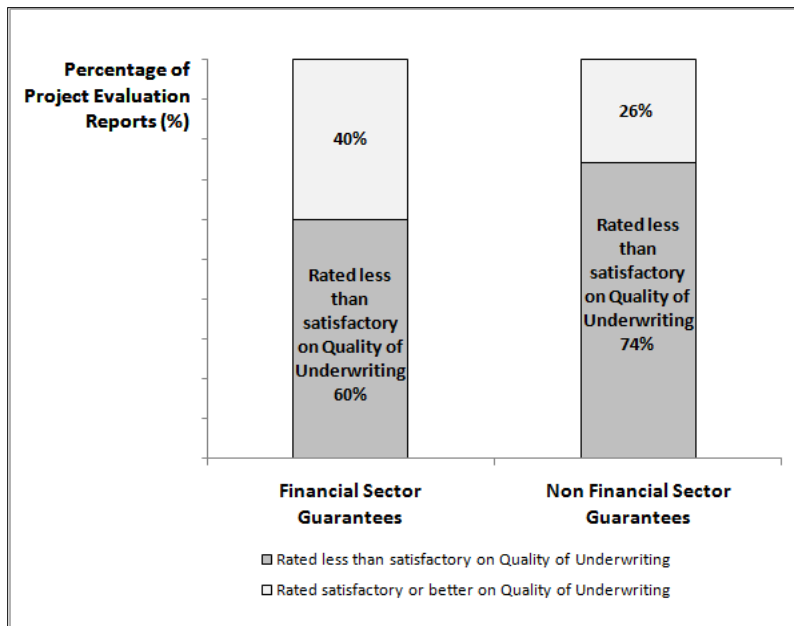
⁴⁹ Compared to previous reports on MIGA's Quality of Underwriting in the IEG independent evaluation "*MIGA Development Results and Institutional Effectiveness 2010 – Achieving Value Driven Volume*," the findings presented in this report refer to a "younger" project sample as it contains more recent projects. Secondly, findings on Quality of Underwriting in this report relate mainly to financial sector guarantees and juxtaposes their Quality of Underwriting against the one of non-financial sector guarantees.

FY11.⁵⁰ The other half was underwritten between FY98 and FY02. All of these financial sector projects were evaluated by IEG between FY05 and FY11. Hence potential shortcomings (or strengths) identified can only be associated with underwriting practices of a few years ago. However, the relevance of the findings and lessons extend beyond the past, and even if underwriting practices have evolved since that time, the lessons learned will be useful for MIGA as it strives to increase its institutional and developmental effectiveness.

MIGA'S QUALITY OF UNDERWRITING IS WEAK IN GENERAL, BUT IS BETTER FOR FINANCIAL SECTOR PROJECTS THAN OTHER SECTORS

3.51 Over half (60 percent) of evaluated financial sector projects were rated less than satisfactory on Quality of Underwriting, that is, rated partly unsatisfactory or unsatisfactory. Still, financial sector projects had substantially better Quality of Underwriting than non-financial sector projects where fully 74 percent were rated partly unsatisfactory or unsatisfactory⁵¹ (Figure 7).

Figure 7. Quality of Underwriting of Financial Sector Projects Is Better than in Other Sectors



Source: IEG Project Evaluation Database.
Note: PER = Project Evaluation Report.

⁵⁰ The cohort of evaluated financial sector projects includes three purposively sampled projects in order to increase the pool of evaluated financial sector projects. One of these three projects was issued in FY09 and purposively selected for its unique characteristics as it was issued as part of MIGA's response to the global financial crisis.

⁵¹ These projects were underwritten between FY96 and FY09.

3.52 Quality of Underwriting shortcomings identified in recent PERs of financial sector projects were linked to various aspects of the underwriting process, for example conducting environment and social due diligence. For projects involving financial intermediaries, MIGA's Performance Standards call for a review of the social and environmental management systems of the project enterprise (that is, the subsidiary bank) and not the parent financial intermediary. In a project involving a shareholder loan to a wholly owned subsidiary, MIGA's Environment and Social (E&S) due diligence was limited to a review of the E&S policies of the parent bank and may have missed the significant differences in the implementation capacity between the parent and the subsidiary. In another project, MIGA missed an opportunity to consult World Bank and IFC guidelines on credit lines and to bring in lessons from their experience with such credit line facilities and lending to SMEs. This would have been especially valuable, since this was a new product for MIGA. Subsequently the credit line facility had a low utilization rate. On top, monitoring of this new product line was neglected by MIGA – despite early signs of low uptake. MIGA hence missed an opportunity to work with its client to improve the uptake and serve more SMEs.

QUALITY OF UNDERWRITING REMAINS A PERSISTENT CHALLENGE FOR MIGA ... WITH IMPLICATIONS FOR DEVELOPMENT OUTCOMES

3.53 With 71 percent of all evaluated projects rated less than “satisfactory,” quality of underwriting is clearly a problem area for MIGA. Looking at the more recently evaluated projects underwritten between FY05 and FY08, IEG found that quality of underwriting was less than satisfactory in 64 percent of them, compared to 62 percent for projects underwritten between FY00 and FY04. This lack of improvement suggests that Quality of Underwriting continues to be a significant problem for MIGA.

3.54 *There is evidence that MIGA's Quality of Underwriting and project Development Outcomes go hand in hand.* Poor Quality of Underwriting and low Development Outcomes often go hand in hand.⁵² IEG also found that most project weaknesses identified in its ex post evaluations were already evident in the underwriting documents, and that with a better Quality of Underwriting these shortcomings would have been identified and brought to the attention of MIGA's decisions process. To deliver on MIGA's “value-driven volume” objective and to improve project development outcomes, strengthening the Quality of Underwriting is hence crucial – and fully within MIGA's control.

⁵²See: IEG-MIGA “*Achieving Value Driven Volume – MIGA's Development Results and Institutional Effectiveness – 2010.*”

MAINSTREAMING INSTITUTIONAL LEARNING

3.55 To address the quality of underwriting issues above and improve its development effectiveness, MIGA needs to ensure that lessons distilled in evaluations and self-evaluations are applied to new operations. MIGA has made progress with its self-evaluation program. Since FY10, MIGA has completed three project evaluations and has committed to evaluate 10 projects in FY11. Project self-evaluation is now a key component of the annual Results Agreements between MIGA's underwriters, risk management officers, and environmental and social specialists and MIGA management. To incentivize MIGA staff, project self-evaluations are eligible for MIGA EVP awards giving the self-evaluation teams the possibility of receiving cash awards for quality work.

CREATING AN INSTITUTIONAL FEEDBACK LOOP BETWEEN EVALUATION AND NEW OPERATIONS

3.56 *MIGA's ability to learn from its own project successes and mistakes is currently very limited.* MIGA lacks an institutional learning culture, and it would be rare for underwriters to look for lessons from their experience in underwriting or structuring previous guarantee projects. MIGA does not presently have a feedback mechanism in place to extract and use knowledge gained from years of underwriting experience and from lessons emerging from evaluated projects in underwriting of future projects.

3.57 Going forward, it will be important for MIGA to establish mechanisms that mainstream findings from self-evaluations and evaluations into institutional learning for MIGA as a whole, and that integrate evaluative learning into MIGA's underwriting and decision-making processes.

V. Summary

3.58 *Financial sector guarantees are strategically important for MIGA* even though they are not among MIGA's four priority areas: Financial sector guarantees are now MIGA's most important business segment in terms of volume of newly issued guarantees and in terms of their share of MIGA's outstanding portfolio. This suggests that the sector is of high overall strategic importance to MIGA, and to the Agency's operational and financial/business performance. The current global financial crisis has further heightened attention to MIGA's financial sector guarantees and their strategically important role in the crisis response.

3.59 *The alignment of MIGA's financial sector guarantees' with MIGA's strategic priorities is weak.* Such guarantees seem to lend

themselves more to support IBRD countries and with a striking absence in Africa. In general they also lend themselves less to South-South investments than non-financial guarantees. The flip side of the growing preponderance of the financial sector guarantees is MIGA's declining issuance of guarantees in its formal priority areas. Entering now the new strategy period FY12-14, a more strategic approach to guarantee issuance would enable MIGA to better align its operations with its strategic objectives while maintaining its financial sustainability.

3.60 *Financial sector guarantees have some important characteristics.* MIGA's financial sector guarantee issuance has been much more regionally concentrated than issuance in the other sectors and issuance has been concentrated in a few host countries. Further, financial sector guarantees do not contribute positively to MIGA's financial results. Despite their high business volume, high levels of reinsurance appear to have reduced the profitability of MIGA's financial sector projects.

3.61 *Evaluated financial sector projects have high Development Outcome ratings* and have therefore contributed to MIGA's achievement of its objective of "value driven volume."

3.62 *MIGA's financial sector guarantees had a strategically important role in transition economies.* Project-level findings confirmed that MIGA's financial sector guarantees were strategically relevant at the country level.

3.63 *By contrast, MIGA's quality of underwriting is a less positive story.* While the quality of underwriting of financial sector projects was better than all other sectors, it remains that 60 percent of evaluated financial sector projects were rated low on Quality of Underwriting. As there is evidence of links between MIGA's Quality of Underwriting and project Development Outcome strengthening the Quality of Underwriting is crucial to deliver on MIGA's "value driven volume" objective – and is fully within MIGA's control.

3.64 *To address these quality of underwriting issues and improve its development effectiveness,* MIGA needs to ensure that lessons distilled in project evaluations and self-evaluations are applied to new operations. Even though MIGA has made progress with its self-evaluation program, it remains a work in progress. The quality of MIGA's self-evaluations varies, consistent with being on a learning curve. Moreover, MIGA needs to develop a feedback loop for lessons identified in PERs to be considered by underwriters in their day-to-day work and senior management when reviewing projects or taking more strategic project decisions. Going forward, it will be important for MIGA to disseminate findings from evaluations for institutional

learning, and to establish mechanisms that systematically integrate evaluative learning into MIGA's underwriting and decision-making processes.

4. Conclusions and Issues Going Forward

4.1 MIGA has successfully removed the most important external constraint to its effectiveness with the change in its Convention and the amendment of its Operational Regulations. The *Strategic Directions FY12–14* and its implementation will be instrumental in getting the most out of MIGA’s broadened mandate and potential developmental reach. The opportunity to support private sector investment in the post-crisis recovery only heightens this challenge.

4.2 In parallel with its now broader mandate, MIGA also needs to exploit more fully the flexibility and range of eligible investments that have been allowed all along by its charter. IEG’s analysis shows that MIGA has substantial, unused leeway available within its original scope of operations – and has even more so now.

4.3 *This evaluation reviews and assesses the achievement of MIGA’s strategic objectives in the previous strategy period.* The *Operational Directions FY09–11* reconfirmed MIGA’s priority areas – projects in IDA countries, especially Africa, conflict-affected environments, complex infrastructure projects, and South-South investments – and identified targets that MIGA would meet in key areas. MIGA also took steps to clarify its mission and strategy, to align its organizational structure and enhance tracking of its strategic progress.

4.4 The ultimate test of a strategy lies in its results. MIGA was on track in meeting some but not all of its key performance targets for the strategy period, FY09–11:

- *MIGA’s guarantee volume* (new guarantees issued) initially fell short of the strategy’s target of \$1.8–\$2.2 billion a year, subsequently revised to \$1.4–\$1.8 billion. With guarantee issuance of \$1.4 billion (FY09), \$1.5 billion (FY10) and \$2.1 billion (FY11), MIGA’s guarantee issuance met its target in the last year of the strategy period, but was at the lower end of its revised target range during the beginning of the strategy period.

- *MIGA's outstanding portfolio of guarantees* – a measure of its total coverage outstanding even though not a formal key performance target – reached an all-time high of \$7.7 billion in gross exposure as of 30 June 2010, as cancellations dropped sharply during the crisis period.
- *The number of new guarantee projects* met the strategic targets of 20–30 new projects a year in two years out of three: MIGA supported 20 new projects in FY09, 16 projects in FY10 and 38 in FY11.
- MIGA met its target of being “*overweight*” in IDA countries, with 23 percent of its new guarantee issuance going to IDA countries, compared to the 5 percent of all FDI flows flowing to IDA countries. Similarly MIGA’s *outstanding portfolio was “overweight” in IDA countries*, with 26 percent of gross exposure in IDA countries in the strategy period, far more than IDA countries’ share in the stock of FDI flows to developing countries.
- At the same time, *the share of guarantees in areas outside its strategic priorities remained above 50 percent*. Guarantees aligned to priority areas rose from 16 percent in FY09 to 30 percent in FY10 and 50 percent for the first half of FY11. This follows the sharp decline in the previous strategy period, largely as a result of MIGA’s financial sector guarantees in the ECA Region. While financial sector guarantees are part of MIGA’s crisis response and can be considered strategic in the crisis period, the growing dominance of financial guarantees in non-IDA countries predated the crisis by several years and was apparent starting in FY05.
- *MIGA’s administrative expenses in relation to premium income* remained below the targeted threshold of 85 percent. However the ratio has increased from 74.6 percent in FY08 to 68.3 percent in FY09 and 78.7 in FY10.
- *MIGA’s return on operating capital* was well below its target range of 7–10 percent (before provisions) during the strategy period to date. The return on operating capital was 1.4 percent in FY10.

4.5 **Guarantee volume and the number of projects matter, but development effectiveness is the fundamental measure of success**, consistent with MIGA’s emphasis on “value-driven volume.” IEG’s analysis of development effectiveness revealed that project performance is broadly unchanged during FY00 and FY08 – the last year sampled – with 64 percent of IEG-evaluated projects rated “satisfactory” or better on development outcome. The performance of MIGA guarantees issued before FY00 was substantially weaker, with fewer than 50 percent of evaluated projects rated “satisfactory” or better. As projects can only be evaluated when they are operationally mature

(for example, three years after their issuance), the performance of projects issued during the current strategy period could not be evaluated as they are too “young.” (These project performance ratings cannot be extrapolated to MIGA’s portfolio as a whole, since MIGA’s universe of projects is too small for any sample of guarantees to allow for statistical inference at the portfolio level.)

4.6 *MIGA’s capital is a significant resource – and an indicator of MIGA’s risk bearing capacity.* MIGA’s capital utilization stood at 31.3 percent as of June 30, 2010 – a low value not only by IEG’s assessment but by also MIGA’s own reports (economic capital of \$323 million over operating capital of \$1.036 billion).

4.7 *The upcoming strategy should take into account the lessons of past strategies and their implementation.* The current strategy presented, for the first time, a single, integrated framework linking business performance, development results, and risk-exposure aspects of MIGA’s future directions. This report outlines critical questions for MIGA’s upcoming Strategic Directions to be conceptually complete, and identifies key lessons on monitoring, financial sustainability and implementation of MIGA’s strategy.

MONITORING STRATEGY IMPLEMENTATION

4.8 MIGA’s initiative to develop KPIs to track institutional performance and strategy implementation is an important step in the right direction. KPIs were introduced in FY09 with a view to enhancing MIGA’s ability to track strategy implementation. However, the proposed metrics need further enhancement to adequately track progress in achieving strategic and operational objectives and provide management with sufficient information for strategic decision-making. Going forward:

- The five KPIs introduced in FY09 need to be mainstreamed and more systematically monitored on a rolling basis.
- New KPIs need to include at least *one* KPI to track the alignment of new guarantees to strategic priorities and indicators that monitor client satisfaction – tracking the number of repeat clients and findings of client satisfaction surveys would be particularly relevant.
- There is scope for also improving the current KPIs that track internal productivity, for example, staff productivity (deals per underwriter), costs per transaction in relation to norms, and so forth.
- Most importantly, MIGA needs to track systematically the development outcomes of its projects by reporting the “disconnect” between IEG’s independently validated project ratings and MIGA’s own self-assessed project ratings.

- Finally, MIGA needs to refine its currently proposed approach for tracking development effectiveness by means of “development reach indicators,” as they are only partial measures of MIGA’s development footprint and – without the independently validated project ratings – also are potentially misleading.

FINANCIAL SUSTAINABILITY OF MIGA’S STRATEGY

4.9 *MIGA’s guarantee portfolio is profitable overall.* MIGA currently focuses only on financial results at the overall portfolio level, and does not calculate individual projects’ all-in costs or their contribution to MIGA’s income. As a result, MIGA cannot know how different strategic priorities will affect its overall income from guarantees. As an insurer, MIGA operates on margins that are much thinner than those of a lender/investor such as IFC: spreads in the PRI industry are about one-fifth of a lender’s. Hence knowing how much income MIGA’s projects generate is essential.

4.10 *Project contribution to MIGA’s financial results varies greatly.* IEG’s analysis shows that project contributions to financial results are largely determined by a guarantee’s size, duration, “administrative intensity,” and reinsurance. A project’s financial contribution will be reduced if MIGA cedes a portion of its premium income to the reinsurer. IEG estimates that projects having less than \$45 million in guarantee coverage contribute negatively to MIGA’s financial results: large projects, such as infrastructure projects, have tended to contribute positively to MIGA’s bottom line, whereas smaller projects, such as in AMS, do not. As a result, most projects in the priority areas of MIGA’s FY09–11 strategy as well as guarantees issued under SIP, contribute negatively to MIGA’s financial results because of their size. Financial sector guarantees, despite being generally of large size, are also estimated to have contributed negatively to MIGA’s aggregate financial results in the period since FY01, because of high levels of reinsurance.

4.11 Issuance of guarantees with negative financial returns is entirely warranted to the extent that they support projects with positive development impacts. These findings do not imply that MIGA should focus on more profitable business lines. Rather, measuring financial results at the project level can help MIGA determine the implications of its strategic directions for financial sustainability – MIGA needs to find the right project mix for impact and financial sustainability. However, cross-subsidization within the portfolio does imply a significant burden of proof to demonstrate strong development impact based on rigorous ex ante assessment during underwriting. Underwriting projects that contribute negatively to MIGA’s profitability and have poor development results would be a “lose-lose” combination.

4.12 MIGA can improve its financial results and its strategic relevance by being more selective with respect to which projects it underwrites. IEG estimated that MIGA could have improved its financial results without compromising on its strategic priorities, by being more selective about the projects underwritten. And going forward, informed by project-level financial results, MIGA could steer its underwriting away from non-strategic projects that generate negative financial results, toward strategic priority area projects – whether they generate positive financial results or not.

4.13 *Project-level profitability metrics also are an important input to strategy development.* At present, MIGA does not incorporate project-level financial result considerations into its strategy. With projects in three out of MIGA's four priority areas estimated by IEG to have underwriting costs exceeding the premium income received – either due to their size, their duration, early cancellation, or reinsurance – there is substantial basis to conclude that project-level profitability matters for strategy development.

FACTORS AFFECTING STRATEGY IMPLEMENTATION

4.14 During the current strategy period, MIGA has made progress in addressing issues relating to its institutional and developmental effectiveness, to consolidate its long-term viability and strengthen its operational and development results. MIGA has changed its business model to align its operations with the Bank's country assistance strategies and to collaborate at the project level – a significant improvement compared with past practice. More effort is being made to assess projects' expected development impacts as a part of underwriting due diligence, although the practice is not consistent and there are issues with the quality of the development impact analysis. MIGA has improved the risk and finance analytics underpinning its decision making on guarantee pricing, provisioning, reinsurance, and capital deployment. MIGA is piloting self-evaluation of its guarantee projects, and has completed its three first self-evaluations as of December 2010 with IEG support. Several innovative projects have been underwritten, although systematic development of innovative product lines is still lacking. Business development efforts have been strengthened, including the Joint Business Development Agreement signed with IFC and MIGA's recently established Asia Hub in Hong Kong SAR, China. But it is too early to assess actual impacts on MIGA's business.

4.15 *Product innovation, in particular adaptation of existing products, remains a substantial challenge for MIGA.* As highlighted in IEGs Guarantees Report, MIGA has not made use of its ability to offer a wider range of guarantee products and terms allowed within the scope of its then-prevailing Convention and Operational Regulations. Narrow interpretations and internal "soft policies" and practices

led MIGA to offer a rigid and limited product mix in an industry whose products are flexible and customized. The scope for innovation is even greater now and it is essential for MIGA to introduce more innovative products by taking advantage of the space allowed by its amended Convention and Operational Regulations.

4.16 *MIGA's pricing and economic capital models need further strengthening.* Introducing product innovation and greater flexibility in the terms of its coverages will require MIGA to strengthen its models to better support managerial decision-making and ensure that new products and more flexible terms are appropriately priced for risk. But not only the pricing, MIGA's entire underwriting process should become more responsive to clients' requests for modification in existing coverage terms. MIGA needs hence to review its pricing model and make the necessary refinements needed to support these changes, including revision of its pricing model.

FINANCIAL SECTOR GUARANTEES AND MIGA'S STRATEGY

4.17 This evaluation provides an in-depth assessment of MIGA's financial sector guarantees as an illustration of strategy implementation. The financial sector has been MIGA's most important business segment in terms of volume of newly issued guarantees since FY08 and throughout the implementation period of the FY09–11 strategy.

4.18 *Financial sector guarantees are now the most important business segment* in terms of volume of newly issued guarantees. FY09 was a peak year, when 89 percent of MIGA's guarantees were in the financial sector. This share was 64 percent in FY10, demonstrating the continued importance of the financial sector in the overall business volume. Financial sector guarantees also make up the largest share of the outstanding portfolio, accounting for about 43 percent of the outstanding portfolio (net exposure) as of June 2010. Infrastructure was the next-highest, at 34 percent.

4.19 *MIGA's support to the financial sector in developing countries has significant potential for development impact.* It can contribute positively to the deepening and broadening of financial markets and thereby to growth and investment, as well as to macroeconomic stabilization and financial access for SMEs and poorer segments. For example, when banks seek PRI coverage from MIGA for shareholder loans to their subsidiaries to increase their capacity to lend to local businesses, this contributes to "broadening" the financial sector in the host country. When foreign investors seek PRI coverage for their equity investment in a newly privatized state-owned bank, this increases competition, widens the array of financial instruments in the local market, and improves the market's ability to price and settle transactions, contributing to financial "deepening" in the host country.

4.20 MIGA's support for the activity of foreign banks in host country financial systems is associated with important development impacts. Entry of foreign banks has accelerated the introduction of new technologies and management approaches, and has also been a way of "importing" home country regulatory standards and raising the standards of domestic banks by competitive pressure. MIGA's support for mortgage banking through securitization helped to create more diversified financial systems, able to finance long term assets such as housing. At the same time, the role of foreign banks in developing countries has not always been an unalloyed gain, as for example, fragile and relatively new open financial systems may become over-exposed to global shocks, as happened in some regions.

4.21 *The alignment of financial sector guarantees' to MIGA's strategic priorities is rather weak.* Financial sector guarantees typically support projects in IBRD countries and are strikingly absent in Africa. Financial sector guarantees were less associated with South-South investments than guarantees in other sectors. As a result of the growing importance of financial sector guarantees and their weak alignment with strategic priorities, projects in MIGA's priority areas declined to 16 percent of guarantee volume in FY09 and 30 percent in FY10, from a high of 91 percent in FY06. For the first half of FY11, the share of projects in priority areas was 22 percent.

4.22 *MIGA's financial sector activities are aligned to the World Bank Group's goal of responding to the global financial crisis.* MIGA adopted the Financial Sector Initiative in March 2009, a MIGA-specific crisis response effort that is part of the wider, internationally coordinated Joint IFI Action Plan supported by the European Bank for Reconstruction and Development, the European Investment Bank, and the World Bank Group. MIGA's total cumulative support (gross exposure) under the Financial Sector Initiative to date is \$1.5 billion. While financial sector guarantees are part of the World Bank Group's crisis response and can be considered strategic during the crisis period, their growing importance in the Europe and Central Asia Region was apparent starting in FY05, predating the crisis by several years.

4.23 *Financial sector guarantees have some interesting characteristics.* First, they are *substantially larger* on average than the average non-financial sector guarantee (\$96 million versus \$43 million). Second, they have a *shorter tenor at inception* than guarantees in other sectors (7 versus 11 years). Cancellations bring this down to a *de facto* tenor of 5 years, compared to 7 years for the average guarantee in the portfolio. Thirdly, financial sector guarantees are also *more regionally concentrated* than guarantees in the other sectors. Fully 95 percent of financial sector guarantees were issued in one single region, ECA, compared to 48 percent in a single region for the next highest sector,

OGM. *Fourth*, financial sector guarantees *are concentrated in a few host countries*, with fully 80 percent issued in only five host countries over the past five years. They have also been “client concentrated,” with 93 percent going to five clients in FY06–10. *Finally*, IEG estimates that financial sector guarantees *do not contribute positively to MIGA’s financial results*. Despite the high business volume, the profitability of MIGA’s financial sector projects appears to have been negative, due to high levels of reinsurance.

4.24 MIGA’s new *Strategic Directions FY12–14* needs to articulate how to manage the issuance of financial sector guarantees in a more strategic fashion. The dominance of financial sector guarantees in the portfolio, their weak alignment with priority areas, and their negative contribution to financial results suggest the need for the FY12–14 Strategy to ensure that its operational activities are in line both with its strategic objectives and with its financial goals.

PERFORMANCE AND FINDINGS FROM EVALUATED FINANCIAL SECTOR PROJECTS

4.25 The findings of this section are based on IEG’s project evaluation database comprised of 41 ex post evaluations of MIGA guarantee projects. Included in the database are 10 financial sector projects of which 50 percent are rather recent guarantees, that is, all but one underwritten by MIGA between FY06 and FY08, and the other half underwritten between FY98 and FY02. Project-level findings thus reflect MIGA’s experience with financial sector guarantee projects issued since FY98. Even though most of the evaluated projects were underwritten before the start of MIGA’s last strategy period, many are still active and under implementation at the current time and the report gives special emphasis to those issued in FY06–08. Several striking results emerge from an analysis of these financial sector projects.

4.26 *It is important to remember that project performance ratings cannot be extrapolated to MIGA’s portfolio* as a whole, since MIGA’s universe of projects is too small for any sample of guarantees to allow for statistical inference at the portfolio level. Therefore, the project-related findings in this report do not only draw on quantitative analysis of aggregate project-level ratings, but also on qualitative analysis of ex post project evaluation findings, using content analysis to identify “common patterns,” “enabling conditions,” and “success factors.”

4.27 *Evaluated financial sector projects have high development outcome ratings*. Fully 80 percent of evaluated financial sector projects were rated “satisfactory” or better on development outcomes – far higher than non-financial sector projects (48 percent). Financial sector projects performed better in this regard than projects in any other sector, outperforming for example AMS (47 percent), and Infrastructure, including OGM (50 percent).

4.28 *MIGA's financial sector guarantees were strategically relevant at the country level.* Project-level findings indicate that most guarantees in the financial sector are consistent with the CAS and Bank sector strategies. Fully 90 percent of the evaluated financial sector projects were rated satisfactory or better with regard to Strategic Relevance. Financial sector guarantees in transition economies stand out in terms of supporting the modernization of the host countries' financial markets.

4.29 In ECA's transition economies in particular, MIGA's support to foreign-owned banks has been strategically relevant and developmentally impactful in those banking systems that have not completed their reforms. IEG also found that the foreign bank subsidiaries supported by MIGA competed effectively in this environment, and contributed positively in upgrading the host countries banking sectors. Many introduced financial products and services that were not available from domestic banks, and transferred their know-how in delivering the new products and services by partnering with local banks.

4.30 *Financial sector projects rated "satisfactory" or better on development outcomes had several interesting features in common.* First, all successful evaluated financial sector projects had sponsors with long operating experience as global financial institutions or in the respective host country or both. Several successful projects were supported by IFC, either as a shareholder/investor or a lender. Second, the financial intermediaries tended to be strategically selective, focusing their lending activities on a narrow but profitable niche.

4.31 *Quality of Underwriting is a less positive story.* The Quality of Underwriting indicator measures MIGA's work quality in underwriting the project – not the performance of the project itself. The Quality of Underwriting was rated less than "satisfactory" in 60 percent of evaluated financial sector projects. Still, financial sector projects perform better on quality of underwriting than other sectors. More generally, MIGA faces a challenge in improving the quality of its underwriting which IEG rated as less than satisfactory in 71 percent of all of MIGA's evaluated projects taken together, and in 74 percent of evaluated non-financial sector projects.

4.32 To address these Quality of Underwriting issues and improve its development effectiveness, MIGA needs to ensure that lessons distilled in project evaluations and self-evaluations are applied to new operations. Even though MIGA has made progress with its self-evaluation program, it remains a work in progress. The quality of MIGA's self-evaluations varies, consistent with being on a learning curve. Moreover, MIGA needs to develop a feedback loop for lessons identified in PERs to be considered by underwriters in their day-to-

day work and senior management when reviewing projects or taking more strategic project decisions. Going forward, it will be important for MIGA to disseminate findings from evaluations for institutional learning, and to establish mechanisms that systematically integrate evaluative learning into MIGA's underwriting and decision-making processes.

CONCLUSIONS AND ISSUES GOING FORWARD

4.33 The aim of this report, *MIGA's Financial Sector Guarantees in a Strategic Context*, has been to inform the design and the implementation of MIGA's new *Strategic Directions FY12-14* by drawing lessons from recent experience with one of MIGA's main pillars, financial sector guarantees – the fastest growing business area for MIGA.

4.34 *This evaluation underscores the relevance of several recommendations issued previously* in the IEG report *MIGA Development Results and Institutional Effectiveness – 2010: Achieving Value Driven Volume*. This report confirms the need for MIGA to articulate a fundamental value proposition and make this the basis for its next strategy, and presents broader evidence on the need to measure project-level financial results, also recommended by IEG in 2010. Furthermore, the report confirmed that product innovation, in particular adaptation of existing products, remains a substantial challenge for MIGA. Going forward, it will be essential for MIGA to take fuller advantage of the space allowed by its amended Convention and Operational Regulations. Reviewing MIGA's eligibility policies and practices (including "soft policies") and its Pricing model and Economic capital modes appears essential in this context.

4.35 Based on new evaluative evidence and analysis presented in this report, IEG found that MIGA's approach to tracking strategy implementation, development effectiveness, and institutional performance can be further enhanced. To this end, it will be important for MIGA to refine its current strategy monitoring to systematically track the development outcome performance of its projects and report any "disconnect" between IEG's independently validated project ratings and MIGA's own self-assessed project ratings.

4.36 *With regard to financial sector guarantees this report found that they have an important role to play in development* – not only in crisis response. MIGA's financial sector guarantees were strategically relevant at the country level. In particular in ECA's transition economies MIGA's support to foreign-owned banks has been strategically relevant and developmentally impactful in those banking systems that had not completed their reforms. Evaluated financial sector projects had also better Development Outcomes than projects in any other sectors. Finally, to improve on the Quality of Underwriting of

financial sector projects—and also of all MIGA sectors—
institutionalizing a culture of learning by distilling lessons from
project evaluations and self evaluations and applying them to new
operations will be essential.

Appendixes

APPENDIX A: APPROACH AND METHODOLOGY FOR THE EVALUATION

APPENDIX B: DEFINITIONS OF MIGA GUARANTEE AND RELATED TERMS

APPENDIX C: MIGA RISK COVERAGES OFFERED

APPENDIX D: IEG'S EX POST PROJECT EVALUATION METHODOLOGY FOR MIGA PROJECTS

APPENDIX E: IEG PROJECT EVALUATION DATABASE FOR THIS REPORT

APPENDIX F: WHAT IS ECONOMIC CAPITAL?

APPENDIX G: IEG METHODOLOGY FOR ESTIMATING PROJECT-LEVEL CONTRIBUTIONS TO MIGA'S FINANCIAL RESULTS

MANAGEMENT RESPONSE

Appendix A: Approach and Methodology for the Evaluation

The evaluation covers the Multilateral Investment Guarantee Agency (MIGA) guarantee operations from 1996 to 2009. The evaluation used the methods outlined here to gather evidence and compile the evaluation.

The focus of this report is MIGA's Strategic Directions FY12-14. The report presents a forward-looking analysis aimed to inform the development and implementation of MIGA's new strategic direction framework for FY12-14. It analyzes the implementation of MIGA's current strategy, *Operational Directions FY09-11*, and assesses MIGA's performance over the strategy period with respect to its KPIs and other indicators. It also includes an updated assessment of MIGA's institutional and operational effectiveness in those areas that are most relevant to strategy implementation. In addition, from the perspective of strategy design and implementation, an in-depth assessment of MIGA's financial sector guarantees is presented.

External data included market reports and Berne Union data. The external literature included major publications on strategy and strategic decision making, political risk mitigation and credit enhancement; journal articles; and research conducted by private sector practitioners, academics, and other multilateral and bilateral development agencies.

The evaluation is based on a range of evaluative evidence, and uses several methodological approaches ("mixed methods").

Project-level evaluative evidence:

A key building block for the assessment is the Independent Evaluation Group's (IEG) project evaluation database of 41 ex post evaluations of MIGA guarantee projects. All PERs in IEG's database and used in this report have been discussed with MIGA staff and commented on by MIGA management, as per IEG's protocols. These evaluations follow IEG's Committee on Development Effectiveness-endorsed methodology for ex post project evaluation.

The [41] projects were underwritten by MIGA between FY96 and FY09, and evaluated by IEG between FY04 and FY11. The evaluation findings and lessons therefore relate to MIGA's prevailing underwriting procedures and practices at the then time of underwriting (although the relevance of these findings and lessons may extend beyond that period). A complete list of the 41 projects evaluated for this report, including when they were issued and when the evaluations were completed, is given in Appendix E.

The findings on financial sector guarantees in chapter 2 are based on IEG's project evaluation database of 10 ex post evaluations of MIGA guarantee projects in the financial sector. Half of these projects, except for one, were underwritten by MIGA between FY06 and FY08 and the other half between FY98 and FY02, and evaluated by IEG between FY05 and FY11. Ex post evaluation is by definition a backward-looking exercise, and projects under-

written in FY08 are the most recent that can be evaluated in FY11.⁵³ Hence potential shortcomings (or strengths) identified can only be associated with the underwriting practices of a few years ago. However, the relevance of the findings and lessons extend beyond the past, and even if underwriting practices have evolved since that time, the lessons learned will be useful for MIGA as it strives to increase its institutional and developmental effectiveness.

The financial sector specific findings are placed in context with the findings from all 41 evaluated MIGA projects. These 10 financial sector projects are included in the list of all 41 projects evaluated for this report in Appendix E (shaded in grey).

IEG's analysis draws on qualitative assessments of project evaluation findings, using content analysis to identify "common patterns," "enabling conditions," and "success factors."

The evaluation also presents findings from quantitative analysis of project-level ratings. It is important to stress that the project-level ratings reported in this evaluation *cannot be extrapolated to MIGA's overall portfolio of guarantees*: the sample of project evaluations in MIGA is as yet too small to be the basis for statistical inferences at the portfolio level. (The situation is very different for IEG's findings on World Bank and IFC project quality which are statistically representative of their overall portfolios, and where IEG is able to rely on these institutions' own self-evaluation systems for its substantial project evaluation database.)

In addition, there are several well-established evaluation methodologies currently in use for evaluating institutional, organizational, and process themes, which were drawn on for this report. Methodologies endorsed by organizations like the Government Accountability Office (U.S.), American Evaluation Association (AEA), and the International Development Evaluation Association (IDEAS) include:

- Prospective evaluations answer questions about the future and usually involve analyses of alternative proposals or projections of various kinds. These are especially useful for policy makers to provide expert insights on a new program at the point when it is most needed and when it can help convince others of the basic logic and likely success of the program. From a public policy perspective, providing understanding ahead of time about how a program is likely to work renders an important service by validating the basic soundness of what is to be undertaken and thereby increasing its chances for success.
- Process evaluations investigate the process of delivering a program, project, or task, including alternative delivery procedures.

⁵³ The cohort of evaluated financial sector projects includes three purposively sampled projects in order to increase the pool of evaluated financial sector projects. One of these three projects was issued in FY09 and purposively selected for its unique characteristics as it was issued as part of MIGA's response to the global financial crisis.

- Formative evaluation is a type of evaluation that has the purpose of improving programs, for example assessing ongoing projects during their implementation to identify needed improvements. It is a form of prospective evaluation.

Evaluative evidence used in the report:

IEG triangulates information available from the above sources with other primary and secondary data sources and also draws on findings from previous evaluations as applicable. For this report these include:

- Semistructured interviews with key stakeholders were undertaken, including MIGA management; MIGA's sector team leaders; as well as IFC and Bank staff, MIGA's guarantee-holders, and selected development partners.
- Evidence for this evaluation includes a trend and pattern analysis of MIGA's guarantee portfolio/portfolio review.
- Assessment methods also included desk reviews of World Bank Group and MIGA documents, including MIGA strategies, policy documents, guidelines, Board reports and documents prepared for the Budget and Audit Committees of the Board, and operational reports on MIGA's intranet.
- Relevant literature and secondary data relating to foreign direct investment trends and Berne Union data on political risk insurance trends were reviewed.
- A commissioned background paper examined project-level financial contributions to MIGA's profitability. Project-level financial contributions were estimated based on an analysis of relevant financial data provided by MIGA's Finance and Risk Management Group (including revenue data, cost indicators, and balance sheet information) and a sensitivity analysis of key parameters. Details of the methodology for estimating project-level contribution to MIGA's profitability are described in Appendix G.

Appendix B: Definitions of MIGA Guarantee and Related Terms

The following are standard definitions for terms frequently used in relation to insurance and guarantees.

Acceleration: Payments due under the underlying obligation can be made to fall due immediately in specified circumstances.

Assignment: Assignment of rights under a contract is the complete transfer of the rights to receive the benefits accruing to one of the parties to that contract.

Cancellation: The early termination of a guarantee contract.

Contract of guarantee: Is the legal agreement by which MIGA provides a guarantee of compensation for a specified loss in return for payment of a premium.

Credit insurance: A form of guarantee against loss from default by debtors.

Credit-Linked Guarantee: Credit guarantee conditional on a reference event not occurring.

Direct Debt Substitute: Credit enhancement guarantee to cover some or all principal and interest payments, and may be applied to, among other instruments, loans, bond issues, commercial paper facilities, note issuance facilities, revolving credits, and portfolio of credits. 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: Double default occurs when the obligor and the guarantor fail to meet their obligations.

Economic Capital: The amount of capital needed to sustain portfolio losses at a particular confidence level over a particular time horizon. MIGA defines Economic Capital as the minimum amount of capital needed to sustain losses on its guarantee portfolio at the 99.99th percentile confidence level over a one-year time horizon.

Facultative Reinsurance. An agreement between an insurer and a reinsurer in which the reinsurer agrees to take a part (or all) of the risk under a specific contract. The key element of Facultative Reinsurance is that the reinsurer evaluates the specific risk it is assuming and agrees to assume that risk.

Financial Guarantee: A form of coverage in which the insurer guarantees the payment of insurance interest and/or principal of the insured in connection with debt instruments issued by the insured.

First-loss tranche: 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. Underlying instrument guaranteed is a first-loss tranche.

Fortuitous event: 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.

Full Credit Guarantee: Unconditional guarantee of 100 percent of the principal in present value (PV) 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.

Gross exposure: Maximum amount for which MIGA is liable in the event of a claim, specified in the contract of guarantee.

Guarantee: The agreement by a guarantor to assume the responsibility for the performance of an action or obligation of another person or entity by agreeing to compensate the beneficiary in the event of such nonperformance.

Guarantee project: Refers to a project in which an investment covered by a MIGA contract of guarantee has been made.

Guarantee-holder: Refers to the holder of a guarantee issued by MIGA.

Guarantee for Commercial Operations: Credit enhancement guarantee in a non-lending situation where the objective is to back up a client's performance of its obligation in a commercial transaction involving the provision of goods and services, such as guarantees of bid or performance bonds (called stand-by letters of credit in the United States). A guarantee that facilitates commercial transactions between the associated parties.

Guarantee volume: Refers to the dollar amount of exposure issued through MIGA contracts of guarantees.

Host country: Refers to a member country, its government, or any public authority of a member in whose territories an investment guaranteed by MIGA is located.

Insurance: A practice or arrangement by which a company provides a guarantee of compensation for specified loss in return for payment of a premium.

Maximum Aggregate Liability: The maximum aggregate amount of compensation payable by MIGA under the contract over the term of the guarantee period, irrespective of the number of losses. This is the sum of the current amount and the standby amount.

Net exposure: Amount of gross exposure adjusted for the amount reinsured with other political risk agencies.

Net premium income: Defined as gross premium less any reinsurance ceding commission.

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Non-honoring of sovereign guarantees: Failure of sovereign, sub-sovereign entities and some state-owned enterprises to satisfy direct debt obligations or guarantees.

Novation: Term used in contract law 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, a novation must be agreed upon by all the parties to the original agreement.

Partial Credit Guarantee: Unconditional guarantee of a portion of the principal and/or interest in present value (PV) terms for all categories of risks.

Partial Risk Guarantee: Conditional guarantee of 100 percent of principal in present value (PV) 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 (PV) 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.

Reinsurance: Insurance or indemnification by a second insurer of all (or part) of the risk assumed (insured) by another (the first or primary) insurer.

Reinstatable Guarantee: 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 number of days, or after the client has repaid the guarantor.

Risk-Sharing Facility: A risk-sharing facility, like a securitization, allows a client to sell a portion of the risk associated with a pool of assets. However, 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 been already originated.

Rolling Guarantees: Guarantee of debt service payment(s) that moves or "rolls" to cover new debt service payment(s) upon 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.

SIP: Small Investment Program. MIGA's board-approved program for assisting small and medium sized projects under \$10 million.

Standby Coverage: The amount placed on standby under the standby option or the act of providing a standby option.

Standby Option: The commitment for additional coverage in connection with future disbursements of the Guarantee Loan, specified in Part IV of the Contract. Amounts placed on standby are not included in MIGA's current exposure.

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. It provides for the assignment of an existing claim from the guaranteed investor to the insurer. Then, the insurer (MIGA), as the subrogee, acquires the same rights as the investors had.

Subrogation in local currency: After the guarantee has been called and the guarantor has disbursed the loan, the Guarantor will recover the claim from the client in local currency.

Tenor: Period of time from the contract effective date (or the date on which the contract becomes effective) to the date it is scheduled to terminate.

Transfer restriction and currency inconvertibility: An action taken by the government to prevent conversion of local currency to some form of foreign exchange.

Treaty Reinsurance: An agreement between an insurer and a reinsurer in which the reinsurer agrees to take a specified portion of the risks of the insured. The most usual form is for a reinsurer to accept a given percentage of all contracts in a given period. In other arrangements it can relate to specific regions or to amounts in excess of certain limits. The key element of a reinsurance treaty is that the reinsurer commits to take all of a specified type of risk.

Underwriting: The process of selecting risks and classifying these risks according to their degrees of insurability so that the appropriate rates may be assigned. It also includes rejecting risks that do not qualify.

Value at Risk: It measures the largest market-to-market losses a portfolio of financial assets would sustain, at a particular confidence level and over a particular time horizon.

Appendix C: MIGA Risk Coverages Offered

Breach of contract coverage protects against losses arising from the government's breach or repudiation of a contract with the investor. Breach of contract coverage may be extended to the contractual obligations of state-owned enterprises in certain circumstances. In the event of an alleged breach or repudiation, the investor should invoke a dispute resolution mechanism set out in the underlying contract and obtain a final arbitral award or judicial decision for damages. If, after a specified period of time, the investor has not received payment under the award, MIGA will pay compensation. MIGA may make a provisional payment pending the outcome of the dispute. MIGA may also elect to pay compensation without an award if the investor does not have recourse to a dispute resolution forum or there is unreasonable government interference with the investor's pursuit of legal rights against the host government.

Expropriation coverage offers protection against loss of the insured investment as a result of acts by the host government that may reduce or eliminate ownership of, control over, or rights to the insured investment. This policy also covers partial losses, as well as "creeping expropriation," a series of acts that over time have an expropriatory effect. Bona fide, nondiscriminatory measures taken by the host government in the exercise of its legitimate regulatory authority are not considered expropriatory.

Transfer restriction coverage protects against losses arising from an investor's inability to convert local currency (capital, interest, principal, profits, royalties, or other monetary benefits) into foreign exchange for transfer outside the host country. The coverage also insures against excessive delays in acquiring foreign exchange caused by the host government's actions or failure to act. Currency devaluation is not covered.

War and civil disturbance coverage protects against loss due to the destruction, disappearance, or physical damage to tangible assets caused by politically motivated acts of war or civil disturbance, including revolution, insurrection, and coups d'état. Terrorism and sabotage are also covered. This coverage also extends to events that result in the total inability of the project enterprise to conduct operations essential to its overall financial viability.

Temporary business interruption can also be included upon a request from the investor and would cover three sources of interruption: damage of assets, forced abandonment, and loss of use. This coverage encompasses not only violence in the host country directed against a host country government, but also against foreign governments or foreign investments, including the investor's government or nationality. This coverage became available following the amendment of MIGA's Operational Regulations and Policies in April, 2009.

Nonhonoring of sovereign financial obligations coverage protects against losses resulting from a government's failure to make a payment when due under an unconditional financial payment obligation or guarantee given in favor of a project that otherwise meets all of MIGA's normal requirements. It does not require the investor to obtain an arbitral award. This coverage is applicable in situations when a sovereign's financial payment obligation is unconditional and not subject to defenses.

Source: www.miga.org.

Appendix D: IEG's Ex Post Project Evaluation Methodology for MIGA Projects

IEG-MIGA uses a standard benchmark-based methodology for its evaluation of MIGA guarantee projects. It rates projects on three dimensions: Development Outcome, MIGA's Effectiveness, and the Project Contribution to MIGA's financial results. The methodology is consistent with Good Practice Standards established by the Evaluation Cooperation Group (ECG) Working Group for Private Sector Evaluation, established by the Development Committee in the 1980s to harmonize evaluation standards for private sector operations across multilateral development institutions.

Development Outcome aims to capture the project's overall impact on a country's economic and social development, and is thus important as an implicit proxy for how well the project has contributed to MIGA's purpose and mission. *Development Outcome* is evaluated for each project across four dimensions: (i) project business performance; (ii) economic sustainability; (iii) environmental and social effects; and (iv) private sector development impact. Each of these measures rates a distinct aspect of the guarantee project's performance.

- a. **Business Performance** measures the guarantee project's actual and projected financial impact on the project financiers – its lenders and equity investors.
- b. **Economic Sustainability** measures whether the project has contributed to the country's development.
- c. **Environmental and Social Effects** measures a project's performance in meeting MIGA's environmental and social requirements, as well as its actual environmental and social impact.
- d. **Private Sector Development** aims to capture the effects of the guarantee project on the development of productive private enterprise beyond the project, and relates to MIGA's mandate to enhance the flow of private foreign investment to developing countries.

MIGA's Effectiveness aims to capture MIGA's work quality in assessing, underwriting, and monitoring of its guarantee projects, and the value added MIGA brings to the client or project. IEG assesses MIGA's effectiveness across three dimensions of MIGA's operational performance: (i) Strategic Relevance; (ii) MIGA's Role and Contribution; and (iii) Quality of MIGA's Assessment, Underwriting, and Monitoring.

- a. **Strategic Relevance** refers to the degree of consistency of the guaranteed project with the development priorities of the host country and the Bank's country strategy.
- b. **MIGA's Role and Contribution** relates to the benefits or value added that MIGA brings as a development institution. The contribution may be catalytic (in facilitating foreign direct investment in economically sound and sustainable businesses) in encouraging the development of the political risk industry or in conveying additionality.
- c. **Quality of MIGA's Assessment, Underwriting, and Monitoring** assesses (i) the extent to which the project's expected Development Outcomes were adequately

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assessed, key material risks were identified and mitigated, and whether MIGA's underwriting policies and guidelines were adhered to; and (ii) whether MIGA took adequate remedial action if country or project conditions changed subsequent to issuing the guarantee.

Contribution to MIGA's financial results relates to a guarantee's impact on MIGA.

Project Ratings. IEG rates Development Outcome and MIGA's effectiveness and each of their dimensions using a four-point rating scale: "excellent, satisfactory, partly unsatisfactory, and unsatisfactory."

Harmonization. The methodology and framework are consistent with the Good Practice Standards established by the Evaluation Cooperation Group Working Group for Private Sector Evaluation, which aims to harmonize evaluation standards for private sector operations of multilateral development institutions.

Appendix E: IEG Project Evaluation Database for This Report

EVALUATED PROJECTS, BY FY ISSUED AND FY EVALUATED		
(As of November 30, 2010)		
FY ISSUED	Count	FY EVALUATED
FY96	1	
PT Paiton Energy Company		FY05
FY97	3	
Light Servicos de Eletricidade		FY05
Philips do Brasil, Ltda.		FY05
Wuxi Huada Gas Turbine Electric Power Company		FY06
FY98	11	
ABN AMRO Bank NV Istanbul Branch		FY05
Asia Power (Private) Limited		FY05
Compania Hidroelectrica Dona Julia, S.R.L.		FY06
Grain Bulk Handlers Limited (GBHL)		FY06
Inertes de Cabo Verde, Lda.		FY10
Manas Management Company		FY04
Mozambique Aluminum Smelter (MOZAL)		FY06
Romania Efes Brewery		FY04
Suzhou Coastal Cogeneration Power Plant.		FY06
Tilda Holdings Africa Limited		FY04
ZAO Knyaz Rurik Efes Breweries		FY04
FY99	6	
Banco WestLB do Brasil		FY06
Nanjing Coastal Xingang Power Plant		FY06
Salvorhoteis Mozambique - Investimentos Turisticos, S.A.		FY06
Shanghai White Cap Ltd.		FY06
Vidriera Centroamericana S.A. (VICESA)		FY06
Westdeutsche Landesbank Girozentrale Istanbul Branch		FY06
FY00	2	
Ormat Momotombo Power Company		FY10
OrPower 4 Inc. (Olkaria III)		FY10
FY01	1	
JSBC Raiffeisen Bank Ukraine		FY10
FY02	4	
HVB Bank Romania		FY10
Hydelec BPA		FY10
Lima Airport Partners S.R.L.		FY06
Manila North Tollways Corporation		FY10
FY03	1	
Cotecna Destination Inspection Ltd		FY10
FY05	3	
MINL Ltd		FY10
Anvil Mining Company		FY11
SOCOMA		FY11
FY06	4	
Barclays Bank of Ghana Limited		FY10
Meridian Development Limited		FY10
SGS Scanning Nigeria Limited		FY10
Shenzhen Water Company Ltd		FY10
FY07	4	
BRAC Afghanistan Bank		FY11
Commercial DeltaCredit Bank		FY11
PT MTU Detroit Diesel Indonesia		FY11
ZAO Raiffeisenbank		FY11
FY09	1	
ZAO Unicredit Bank		FY11
TOTAL	41	
Shaded projects are the 10 financial sector projects evaluated for Chapter 3 of this report		

Appendix F: What Is Economic Capital?

“Economic capital” is a measure of the ‘value at risk’ in a loan or guarantee and provides a uniform way to measure risk across projects, products and sectors, geographical areas, and risk types. Economic capital reflects an entity’s *internally*-determined capital needs, and thus differs conceptually and operationally from the *externally* imposed regulatory capital requirements.

Conceptually, economic capital is the amount of capital a business thinks it would need to cover worst-case losses in all but the most extreme economic scenarios. Accordingly, it represents the largest cumulative loss a business can withstand with a high degree of certainty (typically at a confidence level of 99.5 percent over a horizon of one to three years.)

In MIGA’s case, economic capital is the estimated value at risk embodied by its outstanding portfolio of guarantees. MIGA’s model estimates the economic capital consumed by each project and by the portfolio as a whole, based on country, sector project and other risk factors. The amount of economic capital, or value at risk consumed by a given project or portfolio can vary over time, for example when country risk changes.

MIGA applies a more conservative confidence level of 99.9 percent to the economic capital model, which means that for given level of economic capital (value at risk), there is 99.9 percent certainty that MIGA can cover modeled worst-case losses. This 99.9 percent confidence level would typically correspond to an AAA-rated institution.

MIGA estimated is that there was \$323 million of value at risk in its portfolio of outstanding guarantees as of end FY10. This means that its guarantee portfolio consumed about 30 percent of its available operating capital (\$1.036 billion), highlighting MIGA’s very conservative management of its capital base.

How high (or low) should this ratio be? Theoretically, if value at risk (economic capital) could be accurately calibrated based on perfect knowledge of loss and probability distributions, a ratio of 100 percent of operating capital would still leave the insurer able to withstand worst-case losses. In the real world of imperfect knowledge of loss and probability distributions, the prudent level of operating capital consumed would allow for some cushion below this level.

Source: Quraishi, Faisal, Mikael Sundberg, and Sidhartha Choudhury, “Linking political risk insurance pricing with economic capital modeling, a multilateral perspective,” in Kevin W. Lu, Gero Verheyen, Srilal Mohan Perera, eds, *Investing with Confidence: Understanding Political Risk Management in the 21st Century*; World Bank, 2009.

Appendix G: IEG Methodology for Estimating Project-Level Contributions to MIGA's Financial Results

This section describes the methodology used in this report to estimate the profit MIGA generates for each project it underwrites.⁵⁴ Project-level profitability estimates differ from year-end financial statement profitability measures in a few fundamental ways. Financial year-end data looks at the revenue and expenses generated each year, providing a snapshot of the net income that was generated in that particular one-year time period. Project-level profitability estimates, on the other hand, look at the revenue and expenses generated over the life of a project, providing a view of the profit (or loss) that resulted from MIGA's decision to underwrite each project. The former has more definite numbers, given that its calculations are all based upon results which occurred in the previous year. The project-level estimates, on the other hand, use both historical data on past revenues and expenses, as well estimates of future revenues and expenses. This is because project-level estimates estimate the profitability of projects that were issued and terminated in the past, as well as those issued in the past but still ongoing.

In this revised model a measure of profitability without reinsurance was added to the analysis. This calculation was essentially the same as that carried out previously, except for the fact in place of net revenues (net of reinsurance), gross revenues (gross of reinsurance) were used. Gross revenues were calculated by adding back the reinsurance ceded and then subtracting the ceding commissions, to get back to the figures originally given in the premium database referred to as "Premium due."

The profitability for some projects changed more than 100 percent due to reinsurance because of the leverage effect that reinsurance can have upon profitability. Although reinsurance can only theoretically extend up to 100 percent of gross revenue, when expenses are very high and so just a little bit lower than the value of revenues, then a reduction of gross revenue by 30 percent, for example, can result in revenues becoming less than expenses, turning a profitable project into a loss-making one, and effectively resulting in a change in profitability greater than 100 percent.

METHODOLOGY

The IEG project-level profitability methodology has undergone a number of revisions and refinements since 2005, benefitting from the input of management and access to time reporting system (TRS) data.

The revenue and cost-based cash flows of a project are calculated, and then discounted back to the project's inception with a discount rate of 4 percent. The *revenue measure* is based on histor-

⁵⁴ Underwriting profit takes into account premiums and expenses incurred, but not investment returns.

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ical premium data (net of reinsurance and ceding commissions) over the life of projects combined with projected future cash flows for projects that are still active. The expected length of projects that are still active is estimated using sector-specific cancellation-adjusted durations. The *cost measure* estimates project costs on the basis of upfront (initial) underwriting and ongoing administration costs.

As the manner in which administrative costs are allocated to projects determines to a large extent their expected profitability, an approach was taken that is both transparent and consistent with MIGA's pricing model. Specifically, 80 percent of total administrative costs were categorized as ongoing, and allocated to projects evenly within any given year, and 20 percent as upfront, allocated on the basis of the number of new projects issued that year. For each year a project's coverage was active, a corresponding ongoing cost was charged, and an upfront cost was charged only the first year of the project, as described in the following equations.

$$\text{Initial Cost} = 1.05(\text{Annual Risk} - \text{adj Net Revenue})$$

$$\text{Ongoing Cost} = \frac{.8(29,500,000)}{170} = \$138,824$$

"Annual Risk-adj Net Revenue" is the net revenue (premium due less reinsurance ceded plus ceding commission), adjusted by subtracting the risk load component, averaged over the period of time for which the project had active coverage. The initial cost calculation reflects the fact that projects vary in complexity and those that have high levels of active coverage and so premium due will tend to incur greater administrative cost. The minimum initial cost per project is set at \$130,000, and the maximum according to the formula above rises to \$1.35 million for the largest net revenue project. Analysis of the time reporting system data suggests that the maximum initial cost is in line with the maximum actual cost charged to the most complex projects.

The formulaic expressions of the cash flow calculations are as follows, where PD is premium due; RC is reinsurance ceded, RCPP is risk component as a percentage of premium, CC is ceding commission, IC is initial cost, OC is ongoing cost, i is project, t is year:

$$\text{Revenue Cash Flows: } \text{Revenue} = \sum_{t=1}^n \frac{(PD_t - RC_t)(1 - RCPP_t) + (CC_t)}{(1 + i)^t}$$

$$\text{Cost Cash Flows: } \text{Cost} = \frac{IC_1}{(1 + i)} + \sum_{t=1}^n \frac{OC_t}{(1 + i)^t}$$

The risk-related costs are drawn from a table of risk loads generated from the pricing model, and represent estimated risk loads applied by the pricing model based on project/country risk ratings (from A+ to C-), and various possible combinations of types of coverages.

Given the difficulty of identifying a single correct manner of allocating administrative costs to projects, the ability to arrive at a single conclusive measure of project profitability is also complicated. There are different ways to address these methodological issues. One is to hold the cost allocation side of the profit measure constant, essentially by creating a profitability

measure based solely upon revenues. This report shows how total project revenues per project for all 246 projects measured over the FY01–FY10 period compare.

Management Response

MIGA would like to thank IEG for the report on “MIGA’s Financial Sector Guarantees in a Strategic Context,” which aims to inform the design and implementation of MIGA’s FY12–14 Strategy by drawing lessons from MIGA’s recent experience with financial sector guarantees.

Management appreciates the views expressed with reference to MIGA’s FY12–14 Strategy, but would also note that providing detailed prescriptive guidelines could have a constraining effect in terms of what management feels it can propose to the Board. Management believes IEG’s real value added in this regard is in evaluating management’s execution of a Board-approved strategy rather than in seeking to preempt it, and that going forward this would be the most useful area for IEG’s focus.

The IEG report discusses MIGA’s results over the past few years against areas of operational priority. It correctly notes the importance of removing constraints to the Agency’s effectiveness with the changes in its Convention and the amendment of its Operational Regulations. It also notes that MIGA will now need to capitalize on these changes – a view with which MIGA is in complete agreement.

When assessing MIGA’s recent results, management believes there is insufficient recognition of the significant impact that the global financial crisis had on MIGA’s core business, and in particular the effect this had on MIGA’s level of activity in areas such as infrastructure. In general, the market context is underrepresented in this report. This is evidenced not only in the report’s assessment of MIGA’s performance, but also in the recommendations that are put forward regarding the types of business MIGA should be guaranteeing. Those recommendations and the observations that underpin them fail to account for the fact that MIGA’s business is demand driven.

With regard to Strategy Implementation, the IEG report notes that MIGA introduced five Key Performance Indicators (KPIs) in FY09 and that this was an important step. The report also notes that MIGA needs to mainstream these and monitor them on a more systematic basis. Management would like to note that these 5 KPIs are tracked on a quarterly basis and discussed in the EVPs’ Quarterly Report to the Budget Committee. Management plans to continue reporting on KPIs and will fine tune these metrics going forward and may introduce additional performance tracking measures if warranted. Management would also note that alignment of guarantees with operational priorities is in fact already tracked and reported on publicly in MIGA’s annual report, as well as in each individual project description that MIGA publishes at the time that a guarantee is issued.

The report’s assessment of MIGA’s financial sector guarantees posits that such guarantees have rather weak alignment with Priority Areas and that they provide a negative contribution to MIGA’s financial results. As a development institution, MIGA’s primary purpose is to promote projects that generate strong development impact, and financial sector projects are widely viewed as being highly productive in this respect. The positive effects associated with injecting liquidity into sound financial institutions in developing countries are well documented, and would seem to be fully aligned with MIGA’s mandate. It should also be noted that while MIGA does have Priority Areas of focus, which are intended to guide operational activities and choices, these are by no means exclusory.

With respect to the contribution to MIGA's financial results, the IEG report acknowledges that negative results they obtained are due to past high levels of reinsurance in the financial sector, and that the IEG findings on this matter should be taken with caution. Management would certainly like to underscore this caveat, believing as it does that financial sector projects tend to be high-premium, low-complexity projects and that this is underestimated in the profitability analysis. Management would also like to repeat an important point made previously, which is that the nature of managing an insurance portfolio is such that profitability has to be considered at an aggregate level precisely because reinsurance/retention decisions are made at a portfolio level—looking at individual projects outside the overall context can therefore be misleading. The impact of reinsurance as a portfolio management tool needs to be considered separately and should not be conflated with the profitability analysis of individual projects in a single sector. The relatively high levels of reinsurance for financial sector guarantees since 2004 reflect MIGA's response to Board concerns regarding concentration risk in MIGA's portfolio (sectoral and investor). Financial sector guarantees conceivably may in some instances be less profitable than other guarantees, but it is unclear how they make negative contribution on a gross basis. If such guarantees are heavily reinsured, the remaining net premium may in some isolated cases be insufficient to recover the cost, and this potentially could lead to negative net results, but is not a function of these guarantees being in the financial sector.

Finally, the IEG report notes that, "the flip side of the growing preponderance of financial sector guarantees is MIGA's declining issuance of guarantees in priority areas." It is important to understand that the issuance of financial sector guarantees and guarantees in other areas is not a zero-sum game. MIGA is not and has not been capital constrained. The pattern of guarantee issuance reflects global foreign direct investment and private debt flows, and most recently the financial crisis as well as MIGA's participation in the Joint IFI Action Plan, the focus of which was primarily financial institutions, particularly in the Europe and Central Asia region.

With these comments, management once again would like to thank IEG for its work on this report.

IEG–MIGA Reports

IEG–MIGA Annual Reports

- **Achieving Value-Driven Volume: MIGA's Development Results and Institutional Effectiveness—2010**
- **Enhancing MIGA's Risk Mitigation in IDA and Conflict-Affected Countries: Independent Evaluation of MIGA's Development Effectiveness—2009**
- **Independent Evaluation Group—MIGA 2008 Annual Report: Evaluating MIGA's FY05–08 Strategic Directions**
- **Independent Evaluation Group—MIGA 2007 Annual Report**
- **Independent Evaluation Group—MIGA 2006 Annual Report**
- **Operations Evaluation Unit—2005 Annual Report**
- **2004 Review of Development Effectiveness in MIGA**
- **2003 Report on Operations Evaluation in MIGA**

IEG–MIGA Joint Evaluations

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