



Guarantees for development

A review of multilateral development bank operations

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Key messages

- Guarantees have several characteristics that bring advantages over the more traditional lending operations of multilateral development banks (MDBs), such as targeting certain specific classes of risk and helping ‘crowd in’ other funding sources.
- Guarantees for development have grown in relevance, as many emerging economies are more focused on accessing private sources of finance than traditional development loans, and instruments like guarantees can leverage external resources beyond the lending capacity of MDBs.
- MDBs face a number of major impediments to using guarantees more extensively, linked to their capital structure, financial and operational policies and staff skill sets. A number of options exist to promote greater guarantee usage by MDBs, but all come with trade-offs.
- Measuring guarantees as developmental aid will require a different approach because guarantees are not a flow, unless they are called. Instead, measurement should take into account the opportunity cost for the bilateral agency and development finance institution to issue guarantees.

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Abbreviations

ADB	Asian Development Bank
AfDB	African Development Bank
BCIE	Banco Centroamericano de Integración Económica
BOAD	Banque Ouest-Africaine de Développement
CAF	Corporación Andina de Fomento
CDB	Caribbean Development Bank
DAC	Development Assistance Committee
DFI	Development Finance Institution
DPL	Development Policy Loan
DPF	Development Policy Financing
EADB	East African Development Bank
EA&P	East Asia and Pacific
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
FDI	Foreign Direct Investment
FSO	Fund for Special Operations
FY	Fiscal Year
GTFP	Global Trade Finance Program
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IEG	Independent Evaluation Group
IFC	International Finance Corporation
IFI	International Financial Institutions
IPF	Investment Project Financing

LA&C	Latin America and Caribbean
LELS	Loan Equivalent Lending Spread
LIBOR	London Interbank Offered Rate
MDB	Multilateral Development Bank
MDGs	Millennium Development Goals
MENA	Middle East and North Africa
MIGA	Multilateral Investment Guarantee Agency
NHFO	Non-Honouring of Financial Obligation
OCR	Ordinary Capital Resources
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
OECD-TAD	Organisation for Economic Co-operation and Development – Trade and Agriculture Department
OPIC	Overseas Private Investment Corporation
PBG	Policy-based Guarantee
PCG	Partial Credit Guarantee
PIDG	Private Investment Development Group
PRG	Partial Risk Guarantee/ Political Risk Guarantee
PRI	Political Risk Insurance
PTA	Preferential Trade Area (Bank)
SA	South Asia
SDGs	Sustainable Development Goals
SME	Small and Medium Enterprises
SSA	Sub-Saharan Africa
TFFP	Trade Finance Facilitation Programme
TFP	Trade Finance Program
TOSD	Total Official Support for Development
UA	Unit of Account

Executive summary

This report represents an effort to step back and consider some of the main issues related to guarantees for development on the part of multilateral development banks (MDBs).

The financing model underpinning the original Millennium Development Goals (MDGs) focused largely on domestic resource mobilisation and official development assistance (ODA). The implicit underlying assumption was that when countries were unable to mobilise sufficient domestic resources to finance progress towards the MDGs, the gap should be filled either with ODA or through debt cancellation (Greenhill and Prizzon, 2012).

The current development finance landscape is very different. Traditional ODA is under pressure. Actors in development finance are mushrooming, ranging from non-Development Assistance Committee (DAC) donors and philanthropists to providers of climate finance. Furthermore, the development of new and complex innovative finance instruments has created new opportunities to mobilise additional funds and to use these in more effective ways, especially as highlighted in the debate on financing the post-2015 Sustainable Development Goals (SDGs) agenda.

Among these instruments, guarantees for development have the potential to play an important role. Guarantees are a form of insurance to help a borrower – whether a national or sub-national government, a state-owned enterprise, or a private sector actor – obtain financing at better terms than would be possible without the guarantee.

Growing interest by donors in this instrument is not a surprise considering the increasing targeting of aid to private sector development by some DAC members, tight or declining aid budgets, and a mandate to provide value-for-money results to taxpayers. Guarantee activity by MDBs is still relatively small compared to other forms of development financing: the MDBs considered in this paper approved a combined total of US\$37 billion in project (non-trade) guarantees between 2001 and 2013 – 4.5% of total lending approved by the same institutions over that period. The focus of this paper is on multilateral development banks as their development financing in the form of guarantees is on average larger than resources mobilised by bilateral donors (see Mirabile et al. 2013); the World Bank Group has a dedicated agency, MIGA (Multilateral Investment Guarantee Agency).

It is also timely to reflect on how to measure guarantees for development and whether counting guarantees against ODA targets may incentivise their use by DAC members. In the context of the debate to identify a more accurate, comprehensive and inclusive system for measuring and monitoring official external development finance post-2015, the DAC High-Level Meeting mandated the DAC Secretariat in December 2012 to elaborate a proposal for a new broader aggregate – i.e. total official support for development (TOSD), supplementary to ODA – to capture various development finance mechanisms not yet reported in a systematic and consistent way across members (OECD, 2014), as well as to explore ways of representing both ‘donor effort’ and ‘recipient benefit’ of development finance. Guarantees for development are not flows per se – and hence cannot be counted as

ODA unless they are called and utilised. This paper aims to review and compares options for guarantees to be valorised as official development assistance.

This paper considers a number of issues if multilateral development banks aim to increase the use of guarantees in development, including the rationale for their use, different types of guarantee instruments, obstacles to increasing their use at MDBs and possible solutions, trends over time at different MDBs, and possible ways to account adequately for guarantees in aid measurement. This report, however, does not investigate development effectiveness and the impact of guarantees for development.

Key messages from the research include the following:

- Guarantees have several characteristics that bring advantages over the more traditional lending operations of multilateral development banks: they can target certain specific classes of risk, they bring investors in contact with developing country borrowers, and they can help ‘crowd in’ other funding sources. In addition, the maturity of guarantees is usually considerably shorter than standard long-term MDB loans, meaning MDBs can recycle their equity capital more quickly into new development projects. However, guarantees may incur moral hazard, higher transaction costs for the borrower and ‘crowding out’ of private providers of guarantees.
- Guarantees have become more relevant in MDB operations, but their usage still remains relatively low – only 4.5% of total financing by MDBs in 2013. The instrument experienced an initial burst of usage in the late 1990s/early 2000s as guarantees were introduced by MDBs, followed by a downturn from 2002 to 2007, followed by a sharp upswing as of 2008. This evidently is linked to the overall economic cycle. Data for 2012 and 2013 indicate that guarantee usage has trended upward even as the global crisis receded, as clients, MDB staff and private financiers become more familiar with the instruments. As guarantees tend to work best in more-developed capital markets, it is unsurprising that the majority of MDB guarantees have been in middle-income emerging economies.
- MDBs face a number of major impediments to using guarantees more extensively, linked to their capital structure, financial and operational policies, and staff skill sets. MDBs provision for project guarantees at exactly the same rate as loans, so the use of guarantees does not mean the financial resources of an MDB can be stretched further. Moreover, the cost of MDB guarantees often washes out any improved financial terms to the borrower from guarantee, due to incentives facing investors, realities of capital markets, and limited ‘uplift’ given to guarantees by the bond rating agencies.
- A series of policy reforms may help expand the use of guarantees at MDBs. They include changing policy to allow full ‘wrap-around’ guarantees (as private insurers offered prior to the global financial crisis); using set-aside equity capital funds at MDBs and providing incentives to staff to encourage their use; reducing the equity capital allocation required for certain classes of guarantees (particularly partial/political risk guarantees); and unilaterally reducing pricing for guarantees. All of these options, however, come with developmental and financial trade-offs.
- Expanding the use of guarantees will have implications for the way in which MDBs manage their liquidity and risk. Because guarantees are unfunded, this would imply a lower level of necessary liquidity, but at the same time sufficient liquidity would be needed on hand in the event that several

(correlated) guarantees are called simultaneously or in close succession. As well, MDBs – with the exception of Multilateral Investment Guarantee Agency (MIGA) – are designed for lending. New skill sets, organisation and back office processes would be needed if guarantees were to grow significantly.

- Measuring guarantees for development will require a different statistical approach because guarantees are not a flow, unless they are called. The main element for measuring guarantees for development should take into account the opportunity cost of issuing them for a bilateral agency and development financial institution, especially at a time when aid budgets are shrinking in some DAC member countries. Among the different options, the two most suitable for measuring guarantees for development are (1) to count credits and debits to provisioning accounts, net of fees received (the most correct measure of the opportunity cost for the donor with minor disadvantages) and (2) to measure government support to guarantee-extending institutions (an easy measurement when it comes to most bilateral agencies).

Further analytical work would be required to better understand the mechanisms and procedures to issue guarantees, as well as the implications and opportunities of scaling up these financing instruments by bilateral donors, which was not covered in this review.

1 Introduction

The financing model underpinning the original Millennium Development Goals (MDGs) largely focused on domestic resource mobilisation and official development assistance (ODA). The implicit underlying assumption was that when countries were unable to mobilise sufficient domestic resources to finance progress towards the MDGs, the gap should be filled either with ODA or through debt cancellation (Greenhill and Prizzon, 2012).

The current development finance landscape is very different. Traditional ODA is under pressure. Actors in development finance are mushrooming, ranging from non-Development Assistance Committee (DAC) donors and philanthropists to providers of climate finance. Furthermore, the development of new and complex innovative finance instruments has created new opportunities to mobilise additional funds and to use these in more effective ways, especially as highlighted in the debate on financing the post-2015 Sustainable Development Goals (SDGs) agenda.

Among these instruments, guarantees for development have the potential to play an important role. Guarantees are a form of insurance to help a borrower – whether a national or sub-national government, a state-owned enterprise, or a private sector actor – obtain financing at better terms than would otherwise be possible. It also allows borrowers to build credit standing with financiers. Risk mitigation mechanisms like guarantees have the potential to ‘crowd in’ private sector resources for development projects (DAC WP-Stat, 2013), leveraging a relatively modest commitment on the part of an MDB into private funding of many times the size.

Growing interest by donors in this instrument is not a surprise considering the increasing targeting of aid to private sector development by some DAC members, tight or declining aid budgets, and a mandate to provide value-for-money results to taxpayers. Guarantee activity by MDBs is still relatively small compared to other forms of development financing: the MDBs considered in this paper approved a combined total of US\$37 billion in project (non-trade) guarantees between 2001 and 2013 – 4.5% of total lending approved by the same institutions over that period. The focus of this paper is on multilateral development banks as their development financing in the form of guarantees is on average larger than resources mobilised by bilateral donors (see Mirabile et al. 2013); the World Bank Group has a dedicated agency, MIGA (Multilateral Investment Guarantee Agency).

It is also timely to reflect on how to measure guarantees for development and whether counting guarantees against ODA targets may incentivize their use by DAC members. In the context of the debate to identify a more accurate, comprehensive and inclusive system for measuring and monitoring official external development finance post-2015, the DAC High-Level Meeting mandated the DAC Secretariat in December 2012 to elaborate a proposal for a new broader aggregate – i.e. total official support for development (TOSD), supplementary to ODA – to capture various development finance mechanisms not yet reported in a systematic and consistent way across members (OECD, 2014), as well as to explore ways of

representing both ‘donor effort’ and ‘recipient benefit’ of development finance. Guarantees for development are not flows per se – and hence cannot be counted as ODA unless they are called and utilised. This paper aims to review and compares options for guarantees to be valorised as official development assistance.

This report represents an effort to step back and consider some of the main issues related to guarantees for development on the part of multilateral development banks (MDBs), especially if they aim to increase the use of guarantees in development. It (1) unpacks the rationale for their use, (2) provides detailed statistics on volumes, geographical allocation and institutional arrangements of these instruments used by different MDBs and trends over time, and (3) considers obstacles and possible solutions to scaling up guarantee use. While providing descriptive statistics on amounts mobilised by selected MDBs and review obstacles for scaling up guarantees, this report does not investigate development effectiveness and the impact of guarantees for development.

There are only a few reports investigating the case of guarantees for development (PWC, 2003; Winpenny, 2005; Matsukawa and Habeck, 2007) and this review is meant to cover most recent developments in terms of volumes, allocation and modalities of these instruments. Furthermore, in light of greater interest by donors in leveraging on these instruments, the report reviews the major impediments to using guarantees more extensively (linked to MDBs’ organisation capital structure, back office infrastructure, operational policies, and staff skill sets) and suggests a series of policy reforms that may help expand the use of guarantees for development.

The methodology consisted of a desk-based analysis reviewing existing literature on the topic (including policy documents from MDBs), financial statements of MDBs and expert interviews (DAC Secretariat and officials in the development agencies and development finance institutions (DFIs) reviewed in this report. The focus of the report is on project guarantees; guarantees for trade finance are discussed briefly in the main text and more extensively in Annex 1.

The report is divided into two parts:

- Part I consists of three sections: Section 2 defines guarantees for development and considers how they differ from insurance schemes and derivatives. It constructs a taxonomy of guarantees provided by MDBs, detailing each of these guarantee options and the mechanisms that would trigger the guarantee. Section 3 reviews the financial and developmental implications of scaling up guarantees and suggests ways to overcome obstacles. Annex 2 analyses data on the use of guarantees among a set of MDBs, including types of guarantees commonly used, the evolution of guarantee activity over time, sources of financing, main recipient countries/regions sectors and type of borrower.
- Part II (Section 4) outlines and reviews (1) the current conditions for ODA eligibility of guarantees, and implications for counting guarantees as ODA, and (2) options for capturing the provider’s effort in offering guarantees currently under discussion.

Section 5 summarises key messages emerging from the analysis presented in this report.

2 Overview and justification for using guarantees in development cooperation

2.1 Definitions

At their core, financial guarantees are an instrument for the transfer of risk. At the most simplistic level, a guarantee functions as follows: Party A (debtor) borrows a given amount of money from Party B (lender), and agrees to repay the loan over a certain period of time, with interest. Party C (guarantor) contractually commits that in the event that Party A does not repay the loan on time and in full, it will fulfil the terms of the original loan contract such that Party B is made whole. In most cases, when a guarantee is called, Party C will attempt at a later date to recoup the money it paid out from Party A. This case relates to a debt obligation, but guarantees can equally apply to an equity investment.

Guarantees are a specialised form of insurance related to financial transactions,¹ in which the risk of noncompliance by one of the two sides in a transaction is taken on by a third party external to the original transaction. Guarantees can also be seen as a specialised type of derivative because guarantees are an instrument ‘derived’ from an underlying transaction. However, guarantees have a number of important characteristics that distinguish them from both insurance and derivatives.

Unlike insurance, guarantees generally:

- relate to non-performance in relation to a specific transaction, as opposed to provisioning for a loss caused by unexpected events
- involve three parties (the two transactors and the guarantor), as opposed to two (the insurer and the insured)
- are tailored to the individual characteristics of each transaction, as opposed to using a more standardised arrangement
- have relatively straightforward procedures for calling while insurance requires claims to be filed and evaluated.

Unlike derivatives, guarantees generally:

- require non-compliance or a loss to be triggered
- involve a close relationship between the guarantor and the other parties in the transaction
- are not tradable instruments.

¹ Non-financial transactions can also be guaranteed, although this is much less common and not currently done by MDBs.

A guarantee potentially offers blanket coverage against all risks. In practice, risk is segmented, and guarantee instruments (particularly those offered for developmental purposes) will only cover a certain type or certain portion of the risk of a transaction.

This report focuses on guarantees for development, which address two key types of risk:

- *Political risk.* This broadly refers to any action (or inaction) by a government that impacts the ability of a party to uphold its end of an agreed financial transaction. Most commonly these actions refer to nationalisations or expropriations, war or civil unrest, restrictions on access to foreign exchange, or regulatory changes.
- *Credit risk.* This is simply the non-payment or late payment of a financial obligation, no matter the cause (either political or commercial).

2.2 Rationale for guarantees for development

Guarantees have a clear financial rationale: they enable a transaction to move forward by transferring of the risk from a party unable or unwilling to bear it to another that will. Guarantees have several characteristics that bring advantages over more traditional development lending operations.

- Guarantees can target certain specific classes of risk – especially related to government actions – that many lenders and investors find difficult to assess and hedge against, due to incomplete information and inherent political uncertainty. Guarantees are particularly important in relation to large-scale infrastructure projects with potentially very high developmental impacts. Hence, rather than taking on all risks (as with a loan), a guarantee can undertake the minimum necessary intervention into normal market actions needed to close a transaction. They are extremely flexible and can be tightly tailored to the particular requirements of a given project, lender and/or borrower.
- Guarantees bring investors in contact with developing country borrowers (both public and private). This can ‘break the ice’ to begin private sector relationships and build a track record and trust among both borrowers and financiers, potentially beginning a virtuous cycle and reducing the need for multilateral intervention in the future.
- Guarantees can help ‘crowd in’ other funding sources for the specific project in question, broadly due to the relationship-building effect noted above, thus diversifying funding options and creating more stability in financial flows to developing countries.
- The maturity of guarantees is usually considerably shorter than standard long-term MDB loans (which often are paid out over 15-20 years), and thus allow an MDB’s equity capital to be recycled more quickly than with loans.

For several other reasons, MDBs are particularly well-suited to providing guarantees for developmental purposes:

- MDBs have a strong understanding of political risks specific to developing countries due to their close relationships with governments over an extended period of time. Multiple surveys have demonstrated that politically related risks are a major obstacle for investors in

developing countries.² MDBs – which are well positioned to assume political risks – can have an important catalytic effect in spurring greater investment for development goals.

- MDBs have very high standing in credit markets (AAA status³), hence their guarantees are the most likely to have a significant impact on the financial terms offered to a borrower (lower interest rates and/or extended maturities). Due to their mandate and structure, MDBs are able to offer longer-term guarantees than private actors, which is especially important for complex projects that may not generate returns for several years.
- The ‘halo effect’ provided by MDB involvement in a project through a guarantee is likely to make other (private and public) investors more comfortable committing resources – due to MDBs’ strong technical reputation, preferred creditor status and (particularly for public sector guarantees) close relations with governments – and thus increases the potential scope of available resources well beyond what the MDB by itself is guaranteeing or could offer through a loan.⁴
- MDBs are, for the most part, seen by both the investor and the borrower as ‘honest brokers’ who can impartially help structure a fair financial package and resolve any disputes that may arise.
- Arguably, the participation of an MDB as guarantor in a transaction can generate public goods such as strengthened transparency, governance, and social and environmental impacts, because shareholder-mandated safeguards and procedures must be followed even though the MDB itself is not providing direct financing.⁵
- Guarantees can be linked with technical assistance and other forms of knowledge transfer, just as loans can, and hence are equally convenient vehicles for transmitting one of the main acknowledged value-added benefits of MDB development engagement.

However, there are risks and costs associated with the use of guarantees. Moral hazard issues can arise, wherein the guarantee allows investors to feel little obligation to undertake their own due diligence on the project and the borrower (see Mody and Patro, 1996, pp. 5-6). A borrower who receives 100% coverage, and hence does not face any market scrutiny, has not furthered his ability to subsequently borrow without a guarantee – thus defeating one of the key rationales for guarantee usage. For this reason, most multilateral guarantee projects are ‘partial’ – they cover either (1) only one type of risk (usually political) or (2) only a portion of the financing, but not both.

Another important limitation to guarantees is that they create higher transaction costs for the borrower, as they have to enter contractual relationships with two separate entities (the lender and the guarantor) instead of just one. This is not insignificant, and can offset the financial benefits that guarantees otherwise bring. It should also be noted that, contrary to what one might expect, utilising guarantees

² For example, the 2013 MIGA-EIU Political Risk Survey found that macroeconomic instability and political risk are the top two factors inhibiting foreign direct investment in developing economies (see MIGA, 2014). See also Nolan et al. (2011).

³ Some smaller sub-regional multilateral development banks, such as BOAD, PTA Bank and EADB in Africa, CAF in Latin America, BCIE in Central America and CDB in the Caribbean, have ratings below AAA, and are hence less likely to find guarantees to be a useful instrument.

⁴ This effect also holds true in other sorts of financial arrangements utilised by MDBs, such as syndicated loans.

⁵ It should be noted that not all developing country governments or private sector actors consider these ‘public goods’ to be highly valued. In some cases, safeguards and procedures required by MDBs are rather viewed as impositions by non-borrowing shareholders that add transaction costs.

instead of loans does not enable MDBs to extend their equity capital resources further (although they do recycle capital faster, as noted above). Because of accounting issues that are discussed in detail in Annex 1, guarantees are accounted equivalent to loans in terms of equity capital usage, even though they are not funded and rarely called.

The issue of ‘crowding out’ private providers of guarantees is also a concern, just as it is with development loans provided by MDBs. This is particularly an issue with political risk insurance (PRI), which is offered by a number of private providers (although focusing generally on less risky countries than MDBs).

Finally, guarantees by themselves cannot overcome problems inherent to a poorly designed project or a non-creditworthy borrower. However, MDBs have the personnel, knowledge and relationships to be able to undertake close assessments of a project (including support in project design) and a borrower’s ability to pay what private sector actors cannot easily replicate, particularly in the context of a developing country.

2.3 Guarantee products offered by multilateral development banks (MDBs)

Different MDBs (as well as bilateral and private development financiers) use a variety of terms to describe the guarantee products they offer, but conceptually all guarantees are one of two types: risk guarantees or credit guarantees.

- A risk guarantee covers all or part of the amount of a financial transaction (usually a loan or a bond issue) and is triggered only if the risk specified by the guarantee is the reason why the original debtor does not pay.
- A credit guarantee covers all or part of the amount of a financial obligation and is called regardless of the reasons why the original debtor does not pay.

This section reviews the main characteristics and rationale for (1) partial risk guarantees (or political risk guarantee), (2) partial credit guarantees, and (3) trade finance guarantees, followed by (4) an overview of pricing and contractual issues. A more detailed description of each MDB’s products and usage trends is provided in Annex 1, while further information on trade guarantees can be found in Annex 2.

A guarantee can equally back a direct loan from a commercial financier or a bond issued on domestic or international capital markets. Certain borrowers and types of projects tend to be more appropriate for one or the other debt instrument, just as lenders and bond investors have different preferences for which types of projects to finance, depending on various financial and risk factors. Private borrowers in emerging markets may find domestic bonds to be the most appropriate, as the MDB guarantee provides considerable uplift in local capital markets, while sovereigns tend to utilise guarantees to back international bond issues. Most projects – particularly large infrastructure projects – have tended to use commercial loans, although project bonds are growing in use. A bond has the advantage of being able to be sold off as the project progresses, risks decrease, and the instrument becomes attractive to a different set of investors. However, bond investors tend to seek greater security, and as a result, complex or risky projects have tended to be financed through loans.

2.3.1 Partial risk guarantee and political risk insurance

A variety of partial risk guarantee (PRG) – sometimes called political risk guarantee (PRG) – is offered by all the MDBs reviewed in this report, with the exception of the International Finance Corporation (IFC), which is not permitted to make sovereign loans or accept sovereign guarantees (Table 1). Multilateral Investment Guarantee Agency (MIGA) offers political risk insurance, which is conceptually the same as a PRG, but with the key difference that MIGA's activities are mainly directed at equity investments rather than debt obligations.

Table 1: Key characteristics of partial risk guarantee and political risk insurance by MDBs

Type of risk guaranteed	MIGA	IBRD	IDA	Enclave	AfDB	ADB	IADB
Currency inconvertibility and translation risk	Y	Y	Y		Y	Y	Y
Expropriation	Y	Y	Y	Y	Y	Y	
War, terrorism and civil disturbance	Y	Y	Y	Y		Y	
Breach of contract	Y	Y	Y	Y		Y	Y
Non-honouring of sovereign financial obligations	Y	Y	Y		Y		
Non-honoring of financial obligations by a state-owned enterprise	Y	Y	Y		Y		
Non performance of contractual obligations undertaken by government		Y	Y		Y		
Changes in law / decrees / regulations		Y	Y	Y	Y		
Changes in licensing arrangements		Y	Y	Y			
Frustration of arbitration		Y	Y	Y		Y	
Backstop of government subsidies		Y	Y	Y			
Other political risks							Y ⁷
Eligible guaranteed party							
Government	N	N	N	N	N	N	N
Private	Y	Y	Y	Y	Y	Y	Y
State-owned-enterprise	Y ¹	N	N	N		Y	
Country eligibility	members eligible for IBRD/IDA loans	members eligible for loans	members eligible for IDA credits	members eligible for IDA credits	members eligible for loans	members eligible for loans	members eligible for loans
Eligible guaranteed transaction							
Commercial debt instruments	Y ¹	Y	Y	Y	Y	Y	Y
Equity	Y	N	N	N	N	N	N
Coverage amount							
Outstanding principal	95% ¹	<100%	<100%	<100%	100%	100%	100%
Accrued interest	95% ¹	<100%	<100%	<100%	100%	100%	100%
Equity	up to 90%	n/a	n/a	n/a	n/a	n/a	n/a
% of total project costs limit	n/a	n/a	n/a	n/a	n/a	40% ⁶	50%
Monetary limit	n/a	n/a	n/a	n/a	n/a	400m ⁶	US\$ 150m
Pricing and fees							
with counter-guarantee							
Front-end fee (once off)	n/a	0.25%	n/a	0.25%	n/a	n/a	n/a
Initiation Fee (once off)	n/a	0.15% ²	0.15% ²	0.15% ²	n/a	n/a	n/a
Processing Fee (once off)	n/a	0.50%	0.50%	0.50%	n/a	n/a	n/a
Guarantee Fee (annual)	n/a	0.50%	0.75%	2.00%	LELS ³ + premium ⁴	LELS ^{3,7}	LELS ^{3,8}
Standby-fee (annual)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Pricing and fees							
without counter-guarantee							
Front-end fee (once off)	market based	n/a	n/a	n/a	1.00%	market based	market based
Guarantee Fee (annual)	market based	n/a	n/a	n/a	LELS ³ + premium ⁴	market based	market based
Standby-fee (annual)	market based	n/a	n/a	n/a	0-1.00% ⁵	market based	market based
Currency eligibility							
Foreign	Y	Y	Y	Y	Y	Y	Y
Local	Y	Y	Y	Y	Y	Y	Y

Source: MIGA operational guidelines, summary briefing for IBRD PRG, summary briefing for IDA PRG, ADB PRG product brochure, IDB [Guarantees](#) and IDB [Finance](#). On 'enclave' projects, see Section 3.1.

The principle of a PRG is to insure a borrower – usually private, but in some cases a state-owned enterprise run on a commercial basis – against the risks posed by a government's actions or inactions that may impact its ability to repay the debt (commercial loan or bond). In most cases, the entirety of the debt obligation is covered by the PRG. Specific political risks covered by a PRG are defined on a case-by-case basis. Some common examples include:

- failure by the government to meet a contractual obligation
- expropriation or nationalisation
- restriction on access to foreign exchange
- non-payment of termination payment
- change in relevant laws or regulatory framework.

Because of the nature of PRGs, they tend to be employed most commonly in major infrastructure projects where the government plays an important role, such as energy generation and transmission and transportation. They have frequently been employed in relation to concessions, privatisations and public-private partnerships.

The basic framework is that the investor will borrow from a commercial bank or raise funds by issuing a bond to undertake the necessary work for the project. The PRG insures debt against specified actions taken by the local government that could impact repayment.

2.3.2 Partial credit guarantee

Credit guarantees are designed to insure against non-payment by a borrower for any reason – political, commercial or otherwise. For all the MDBs considered in this report, these guarantees are ‘partial’, meaning that they do not cover the entire amount borrowed but rather only the amount necessary to ensure that the transaction proceeds (Table 2). The rationale behind this is that by not covering the full amount, the guarantee does not generate moral hazard and ensures that the lender still has an incentive to undertake due diligence on the viability of the borrower and use of resources. The creation of full guarantees on bond issues is considered to have the potential to contaminate the market for an MDB’s own bonds. This is for two reasons. First, in smaller, less liquid markets, the MDB bonds and the bonds with a 100% MDB guarantee end up competing for scarce resources among the same investor base. Second, even though a bond may have a 100% MDB guarantee, it will still be priced differently than the MDB’s own bonds, because of the underlying risk of the guaranteed borrower, despite the guarantee. This price difference can cause problems with the yield curve of the MDB’s own bonds.

PCGs can be used equally for sovereign and non-sovereign borrowing, and are intended to (1) improve the financial terms of debt (interest rate and maturity), (2) provide a halo effect (or ‘crowding-in effect’) as private investors feel more comfortable increasing the size of their lending, and (3) help borrowers access markets they may not have been able to enter without the guarantee. As discussed in more detail below, the first of these intended uses is marginal at best. The majority of PCGs issued by MDBs are to cover bond issues on local or international capital markets, although they can also cover a commercial bank loan. In many cases they are used to cover a certain segment of the repayment schedule, often late maturity payments or the first payment on a rolling basis, thus helping extend the overall maturity of the loan or bond.

A specialised version of the PCG is a policy-based guarantee (PBG) offered by the International Bank for Reconstruction and Development (IBRD)/International Development Association (IDA) as well the African Development Bank (AfDB). Rather than providing funding for a specific project or destination, PBGs are intended to help a government to raise resources for budget support through bond issues. They are linked to a series of agreed policy reforms undertaken by the government, analogous to the policy reform matrices employed in a budget-support lending operation (called development policy loan, or DPL, at the World Bank). PBGs are not applicable to private sector borrowers.

Table 2: Key characteristics of partial credit guarantee by MDB

Type of risk guaranteed	IBRD	IFC	AfDB	ADB	IADB
Commercial and non-commercial risk	Y	Y	Y	Y	Y
Eligible guaranteed party					
Government	Y	N	Y	Y	Y
Private	N ¹	Y	Y	Y	Y
State-owned-enterprise	Y	N	Y	Y	Y
Country eligibility	members eligible for loans	developing country for profit companies	members eligible for loans	members eligible for loans	members eligible for loans
Eligible guaranteed transaction					
Commercial debt instruments	Y	Y	Y	Y	Y
Coverage amount					
Outstanding principal	<100%	up to 100%	up to 100%	up to 100%	up to 100%
Accrued interest	<100%	up to 100%	up to 100%	up to 100%	up to 100%
% of total project costs limit	<100%	25-50% ³		25% ^{8,9}	25% ¹¹
Monetary limit		US\$ 100		US\$ 250m ⁹	US\$ 200
Pricing and fees					
	<i>with counter-guarantee</i>				
Front-end fee (once off)	0.25%	n/a	n/a	n/a	n/a
Guarantee Fee (annual)	0.5-0.7% ²	n/a	LELS ⁵ + premium ⁶	LELS ^{5,10}	LELS ⁵
Pricing and fees					
	<i>without counter-guarantee</i>				
Front-end fee (once off)	n/a	market rates	1.00%	market rates	market rates
Guarantee Fee (annual)	n/a	market rates	LELS ⁵ + premium ⁶	market rates	market rates
Standby / Commitment fee (annual)	n/a	market rates	0-1.00% ⁷	market rates	market rates
Currency eligibility					
Foreign	Y	Y	Y	Y	Y
Local	Y	Y ⁴	Y	Y	Y

1. however, it is conceivable that a PCG can be provided to a non-public borrower, provided that indemnity is given to the World Bank by the sovereign government.
2. 0.05% for guarantees with average maturity up to 12 years; 0.06% for maturities of 12 to 15 years, and 0.07% for maturities greater than 15 years
3. 25% for greenfield projects rising to 35% in exceptional small project cases; up to 50% for expansion projects provided investments do not exceed 25% of the total capitalization of the project company.
4. IFC will provide local currency guarantees, but when a guarantee is called, the client will generally be obligated to reimburse IFC in US dollar terms
5. LELS = Loan Equivalent Lending Spread i.e. the lending spread that would have been charged if the Bank made a direct loan
6. the premium reflects the cost of any risks associated with the guarantee structure
7. 0-1.00% for MICs; 0.50-1.00% for all other countries
8. these upper limits only apply in the absence of a counter-guarantee
9. Can rise to 50% if the total project cost is less than US\$ 50 million
10. 40 basis points on LIBOR from July 2011 to December 2013; 50 basis points since January 2014
11. Can rise to up to 40% in small economies

Source: IBRD [Summary briefing for IBRD PCG](#) Front end fees are charged on the guarantee amount and guarantee fees are charged on the disbursed and outstanding guarantee exposure calculated as the present value of the guarantee amount to the earliest call date. [IFC Financial Statements and Loans for IFC's Own Account: A-loans](#). For AfDB the Stand-by fee is charged on the un-disbursed portion of the underlying loan. See [Financial Products offered by the AfDB](#) and [Partial Risk Guarantees and Insurance Products Panel](#). ADB PCG Brochure. Inter-American Development Bank (IADB) [Guarantees and IDB Finance](#) and [Proposed Policy for a Flexible Guarantee Instrument for Sovereign Guaranteed Operations](#).

2.3.3 Trade finance guarantee

A relatively recent but very fast-growing type of guarantee utilised by IFC and the private sector lending departments of the regional MDBs is a guarantee covering credit extended by international banks to local country borrowers for the purpose of financing international trade (Table 3). Trade finance guarantees cover a portion of a bank's portfolio of trade financing, rather than individual transactions. Like a PCG, the guarantee is applicable for all types of risk, but unlike the PCG it is comprehensive, covering the entirety of the selected portfolio. This is a high volume, low return and low risk business for MDBs. Trade finance guarantee programmes became particularly important in the wake of the global financial crisis as many large international banks that offer trade finance backed away from developing country clients due to the tighter capital adequacy rules they faced. Further details on trade finance guarantees are provided in Annex 1, while the remainder of this report focuses on project guarantees.

Table 3: Key characteristics of trade finance guarantees by MDB

	IFC	AfDB	ADB	IADB
Exposure limit (US\$ billions)	5.0	1.0 ¹	1.0	1.0
Commitments 2013 (US\$ billions)	6.5	0.6	1.8 ²	1.2 ³
Number of issuing banks	400+	50+	100+	90+
Pricing	market based	market based	market based	market based
1. The AfDB Trade Finance Program includes three instruments one of which - the Risk Participation Agreement (RPA) - is a guarantee instrument. 2. From ADB's own account. An additional US\$ 2.3 million was cofinanced with commercial banks. 3. Includes US\$ 645 million in A-Loans and US\$ 568 million in guarantees				

Sources: IFC: [Global Trade Finance Program](#), *Financial Statements 2013*, *Product Brochure*. AfDB [Trade Finance Program](#). ADB [Trade Finance Program](#). [About Trade Finance Program](#) *Financial Statements*

2.3.4 Pricing and contractual issues

For all MDBs, the price of all sovereign guarantees is exactly the same as the MDB offers for a loan for the same amount and maturity. The reason for this is the way MDBs allocate their risk capital, as discussed in detail in section 3.2, below. For guarantees to a sovereign borrower, or to a private borrower backed by a sovereign counter-guarantee, this means the guarantee premium cost is the same for all projects and in all countries. The guarantee premium is based on an MDB's own cost of funding plus a mark-up to cover risk and administrative costs, and in some cases varies according to the maturity of the underlying financial obligation being guaranteed. Some MDBs also include other fees apart from the premium (for example front-end, initiation, processing, and standby fees). For private sector recipients, the guarantee premium is market based, including an assessment of country, borrower, and project risk, and hence pricing can vary considerably.

The entity (public or private) that is borrowing resources – or (in the case of MIGA) receiving the equity investment that is being guaranteed – is considered the MDB's 'client' and is responsible for paying guarantee fees to the MDB issuer.

Table 4: Sovereign counter-guarantee requirements by MDB

	IBRD/IDA	IFC	MIGA	IADB	ADB	AfDB
<i>Sovereign counter-guarantee required?</i>	Yes, in all cases	No (gov't permission required)	No (gov't permission required)	Yes: public sector PCG No: private sector (PCG and PRG)	Yes: public sector PCG; all PRG No: private sector PCG	Yes

The exact procedures for paying out a guarantee vary according to different MDBs, but the general outlines are similar. Should a guarantee be called, the MDB will, after a defined period of time (and sometimes after contractually stipulated negotiation procedures), make payment directly to the beneficiary entity (almost always a private financing source) that should have received it from the guaranteed entity (public or private). The MDB will then take on the rights of the beneficiary and seek to obtain payment from the guaranteed entity.

Some MDBs further require that the government where a project occurs provide a sovereign counter-guarantee to the issuing MDB (Table 4). In this case, the MDB has the right to demand full payment from the sovereign to cover the expense of paying out the guarantee, either immediately or as per the terms of a normal sovereign loan. The case of a government providing a counter-guarantee for its own

obligation may seem redundant – the government is in effect counter-guaranteeing against itself. But in some cases (such as IBRD) this is required by MDB Articles of Agreement, and is also viewed by MDBs as providing extra assurance of government commitment. Obtaining a sovereign counter-guarantee for PCGs and PRGs benefiting private sector actors can be complex, and depends in large measure on the confidence the government has in the private entity involved and the strategic importance of the project in question.

3 Trends, obstacles, and reforms for guarantee usage at major multilateral development finance institutions

This section first provides an overview of the project guarantee activity of the World Bank Group and three major regional development banks – the Asian Development Bank (ADB), the Inter-American Development Bank (IADB) and the AfDB – as well as a number of salient points about how guarantees are operationalised. The intention is to provide a snapshot of the recent usage of guarantees as background to the following subsections, which explore key aspects of why guarantees have not been more widely used, and potential innovations that may help scale up their usage. Further detail on how each MDB has employed guarantees is provided in Annex 1.

3.1 Trends in guarantee operations

Despite early expectations that guarantees would be a major activity of the World Bank when it was created in 1944 (see Box 1 below), it was not until the 1980s that the MDBs began guarantee operations. This was driven by relatively low foreign direct investment (FDI) flows and the debt crises of the 1980s, and the belief among the MDBs that new instruments were necessary to stimulate private capital flows to developing countries.⁶ Since that time, guarantee policies have been enacted in all the major MDBs and a specialised guarantee division of the World Bank – MIGA – was established in 1988. Guarantees have become increasingly relevant in development as many emerging economies seek assistance in accessing private sources of finance rather than traditional development loans. Moreover, the scale of many projects is beyond the ability of MDBs to finance directly, hence instruments like guarantees that can leverage external resources are increasingly useful.

Nonetheless, guarantee usage by the MDBs has been quite limited. All MDBs considered here approved a combined total of US\$30 billion in project (non-trade) guarantees between 2004 and 2013 (Figures 1 and 2). This represents only 4.2% of the US\$706 billion in development lending approved by the same institutions over the period. While the share of guarantees has been rising, in 2013 they still only represented 4.9% of the total MDB financing approvals in that year. This includes data from MIGA, which is dedicated solely to guarantees. If one considers only

⁶ See IEG (2009), p. 7.

MDBs that also undertake development lending, the share of guarantees is even lower – just 1.7% of the total approved in 2013.

Box 1: Difficulty of multilateral guarantees: not a new story

Far from being a new financial instrument for development, guarantees were in fact intended to be the original main activity of the World Bank when it was designed during the Bretton Woods conference at the end of World War II. As quoted in a history of the World Bank, US Treasury Secretary Henry Morgenthau wrote a memo to an early proposed draft of the agreement, stating that *'[t]he primary aim of such an agency should be to encourage private capital to go abroad for productive investment by sharing the risks of private investors in large ventures ... The most important of the Bank's operations will be to guarantee loans in order that investors may have a reasonable assurance of safety in placing their funds abroad.'*⁷

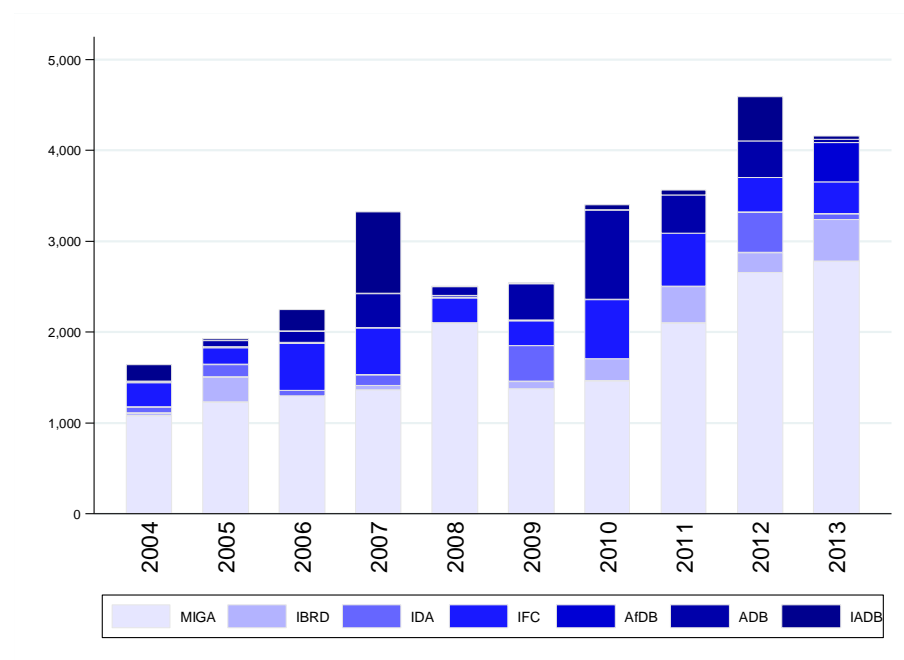
The intention was clearly that the newly created bank would facilitate private capital flows through the use of guarantees, supplemented with direct loans only when necessary. However, this proved unrealistic. The World Bank was viewed with considerable suspicion by the New York financial community, and had to undertake extensive marketing to ensure that it could issue its own bonds. The banking community said that guarantees would 'contaminate' the market for the bank's bonds. As one early staffer stated, *'... it would not be a very good thing for the Bank's credit if a bond of some small country with the guarantee of the Bank would be quoted in the market at a lower rate than bonds of a big country also guaranteed by the Bank. This would cast some shadow on the solvency of the Bank ...'*⁸ Additionally, it was recognised that for many countries, borrowing from a private financier with a guarantee would in the end be more expensive than simply borrowing directly from the World Bank itself.

As a result, the World Bank moved directly into lending when it opened its doors in 1946, and did not revisit the issue of guarantees until the debt crisis years of the 1980s. The two critical issues of (1) the relative cost-effectiveness of guarantees vs loans, and (2) the impact on an MDB's own bonds, have remained relevant in the intervening decades.

⁷ Mason and Asher (1973) p. 18. This episode is also discussed extensively in Kapur et al. (1997), Vol. 1.

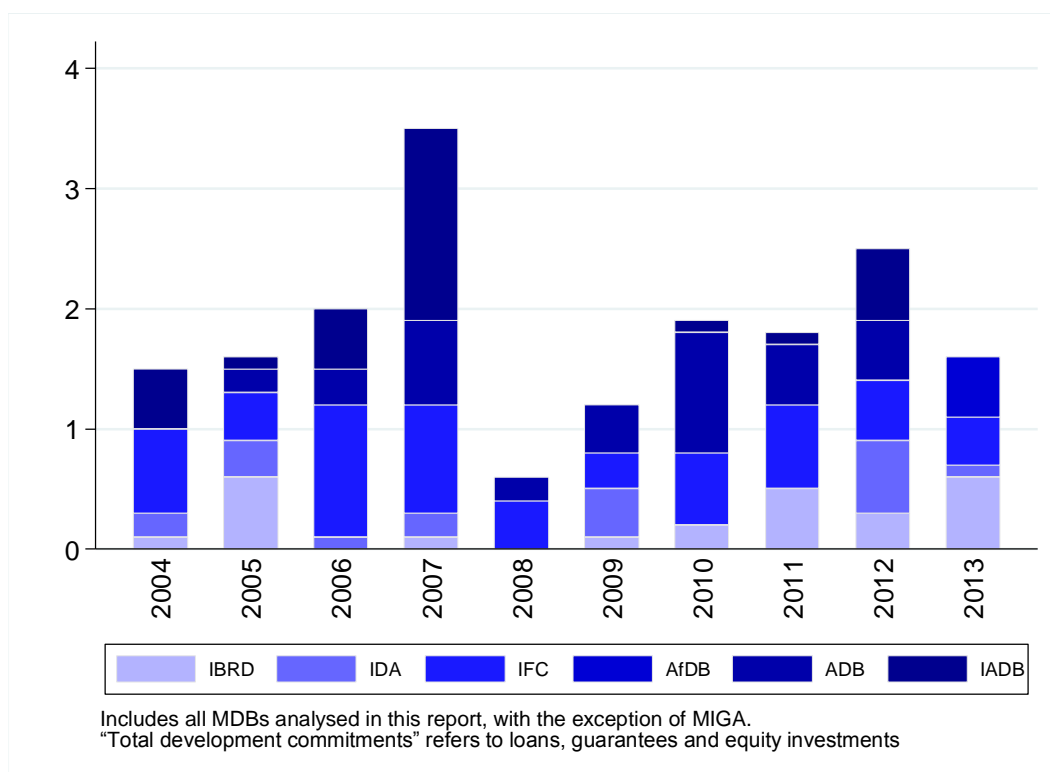
⁸ D. Crena de Jongh, quoted in Mason and Asher, p. 107.

Figure 1: Total volume of non-trade guarantee commitments (US\$ millions)



Source: Author's own. Data included and described in Annex 1

Figure 2: Trade guarantee commitments as % of total development commitments



Source: Author's own. Data included and described in Annex 1

For all MDBs, the use of guarantees has followed a similar pattern in the last 10-15 years: an initial burst of usage in the late 1990s/early 2000s as the instrument was

introduced, followed by a downturn from 2002 to 2007, followed by a sharp upswing as of 2008. This evidently is linked to the overall economic cycle, with the downturn in the mid-2000s due to the abundance of available credit at that time, and the sharp upturn in 2008 resulting from the global financial crisis. Data for 2012 and 2013 indicate, however, that guarantee usage has trended upward even as the global crisis receded, as clients, MDB staff and private financiers become more familiar with the instruments. As guarantees tend to work best in more-developed capital markets, it is unsurprising that the majority of MDB guarantees have been in middle-income emerging economies (Table 5).

Only a very small share of guarantees has ever been called at any of the MDBs (Table 6). This relatively strong track record is partly the result of guarantee operations being a ‘biased sample’ in a sense, as only projects that have borrowed or are close to being able to borrow from private sources are likely to find a guarantee useful in the first place. In addition, a guarantee offered by an MDB may be less likely to be called than one offered by other financial providers, especially guarantees to sovereigns (or counter-guaranteed by sovereigns), as governments may be loath to jeopardise their long-term relationship with MDBs for low-cost funding and technical assistance.

Table 5: Summary by MDB

	Types of Guarantee Used				Sectoral Distribution	Geographic Distribution
	PRG	PCG	PBG	TFG		
MIGA					Relatively stable over time. Infrastructure and finance are the dominant sectors with AMS and the extractive sectors accounting for smaller shares.	Notable shift since 2000 away from the LA&C region towards the ECA and to a lesser extent SSA regions.
IBRD					Primary focus has been on energy projects. Policy based operations are the next largest sector by value.	The ECA (particularly the Balkan countries) and SSA regions have been the principal beneficiaries, particularly over the last 10 years.
IDA						
IFC					The financial sector is the dominant area of operations.	The EA&P region stands out as the largest beneficiary (25% of total) largely due to the fact that China has received 70% more in guarantee financing than any other country.
ADB					Energy projects dominate the guarantee portfolio.	The recent focus (2010 to 2013) of ADB guarantees has been on Thailand, Philippines and South Asian countries like Pakistan and India.
IADB					The financial sector is the dominant area of operations.	Although Mexico has been the principal beneficiary, there appears to be no relationship between country size and the ability to attract guarantee financing.
AfDB					Insufficient data.	Insufficient data.

Table 6: Non-trade guarantee approval and call volume

	IBRD/IDA	IFC	MIGA	ADB	IADB	AfDB
Guarantee volume	US\$5.5 billion	US\$4.3 billion	US\$30 billion	US\$5.6 billion	US\$2.8 billion	UA 484 million
Called volume	US\$250 million	n.a.	US\$16 million	US\$150,000	0	0

Note: IBRD/IDA is 1994-2013; IFC is 2001-2013 (data not available for 2004; pre-2006 includes a small share of trade guarantees), MIGA is 1990-2013; ADB is 1988-2013; IADB is 1997-2013; AfDB is 2002-2013. UA is the AfDB's unit of account.

In terms of policy, the trend clearly has been towards incorporating guarantees as a regular business line for all MDBs in all countries. Initially, guarantees were offered only in countries under the non-concessional window, and then offered just for certain projects in countries under the concessional window, but now all MDBs offer them to all clients (although the ADB and AfDB still fund guarantees from the non-concessional window). Similarly, operational policies on guarantees are increasingly converging with policies for regular loans, to the point where the World Bank's (IBRD/IDA) new policy makes no distinction between guarantees and loans. Other MDBs are going in this direction. The types of guarantees offered has also become more uniform, particularly with MIGA now able to offer a type of PCG and all MDBs (apart from MIGA) offering trade finance guarantee products.

The organisation of teams in charge of guarantees remains somewhat unsettled at most MDBs (IFC and MIGA being the main exceptions), due in part to the nature of the product. Country operations teams are unfamiliar with many technical aspects of guarantees, and hence are not adept at promoting them to clients. As a result, either treasury or private sector offices have taken the lead in most cases. While this improves the ability of MDBs to explain the benefits and trade-offs of this more sophisticated instrument to clients, it also means that guarantees are not 'mainstreamed' into the regular suite of financial products – instead, a specialised team must be called in for each transaction. This is a particular issue for the public sector, as MDB staff accustomed to dealing with public sector clients do not tend to have specialised financial knowledge of guarantees.

Collaboration between different MDBs in the use of guarantees has been relatively limited. The few cases that do exist relate mainly to the same MDB providing both loans and guarantees to a project. The World Bank Group in particular faces coordination issues among the different windows offering guarantees – IBRD/IDA, IFC and MIGA (as highlighted in the Independent Evaluation Group's (IEG's) 2009 review). This is all the more pressing as MIGA recently began offering a PCG-like instrument that competes with IBRD/IDA. However, several instances of collaboration within the World Bank Group have proved successful, for example the Bujagali Hydroelectric Plant in Uganda (2007), which received loans from IFC (US\$130 million), a PRG from IDA (US\$115 million), and PRI from MIGA (US\$115 million). Another example of internal collaboration is the AfDB's support for a wind farm in Kenya, comprising loans from AfDB, a concessional ADF guarantee, and private sector financing. Two instances of collaboration across MDBs include (1) joint trade finance by ADB and IFC in 2011 to support Pakistan's import of textile machinery, and (2) ADB, MIGA and the Islamic Development Bank jointly providing guarantees and loans for Uzbekistan's natural gas industry in 2012.

3.2 Obstacles to scaling up guarantees and options to overcome them

Since multilateral institutions first began employing guarantees in the late 1980s, there has been considerable excitement over their potential as an innovative financial tool for development purposes. However, the reality has not lived up to the hype. As described above, the use of guarantees for project financing has remained quite limited (as opposed to trade finance guarantees, which have grown quickly). This section discusses some of the key factors limiting the use of guarantees by MDBs, and considers some potential ways to overcome them.

It should be clearly stated at the outset that expectations for an increase in guarantees at MDBs should be modest. MDBs face a number of major impediments to using guarantees more extensively, linked to their organisation, capital structure, back office infrastructure, operational policies, and staff skill sets. Many of these issues, combined with the financial realities of the products and the projects to be funded, in turn impact the attractiveness of MDB guarantees for borrowers. However, policy reforms do have the potential to accelerate the growth of guarantees, embedding their use into the ‘mainstream’ of development finance instruments in the minds of both MDB staffers and developing country clients (public and private).

3.2.1 Equity capital usage and pricing

A fundamental problem holding back greater usage of guarantees is the fact that all MDBs book them in exactly the same way as loans for the purposes of risk capital allocation. As noted by the Camdessus Panel on water infrastructure, ‘... guarantees ... are treated on fully the same basis as loans, in other words, as if a guarantee were a loan exposure for 100% of the amount. This discourages the use of guarantees.’⁹ Booking guarantees 1:1 with loans negatively impacts incentives to use guarantees through two linked channels: risk capital usage (from the point of view of both the borrower and the MDB) and pricing (from the point of view of the borrower).

The main financial underpinning of all MDBs – just as with any bank – is their equity capital, which is made up of (1) paid-in capital contributed by shareholders, and (2) accumulated reserves.¹⁰ For each financial operation (mainly loans, but also equity investments and guarantees), an MDB must allocate a certain amount of its equity capital to ‘back up’ the operation. Loans are usually provisioned at somewhere around 30% of equity capital – that is, if the loan is for US\$100 million, it will be provisioned by US\$30 million of equity capital.¹¹ In this way, the value of operations an MDB can undertake at any given time is limited as a function of its level of equity capital. In the interests of protecting their AAA bond rating and safeguarding shareholder capital, MDBs are very conservative with their usage of equity capital. The equity-to-loans ratio of most MDBs is in the 25-35% range, far above most commercial institutions, which are closer to 10%.¹²

⁹ Camdessus, 2003, p. 26.

¹⁰ This is variously termed ‘risk capital’ or ‘economic capital’, but the meaning is the same. It is distinct from callable capital, which is committed by shareholders but not actually paid in – a feature unique to MDBs that does not exist with private banks or financial institutions.

¹¹ This ratio varies by MDB and by type of loan. Non-sovereign guarantee loans are usually provisioned at a higher rate than sovereign loans, because they are considered riskier. Equity investments are provisioned at a much higher rate, usually between 80% and 100%.

¹² A number of arguments can be made for or against this conservative management of equity capital – see for example Humphrey, 2014. The World Bank recently lowered its target E/L ratio to 20%.

MDBs provision for project guarantees at exactly the same rate as they provision loans,¹³ despite the fact that guarantees are unfunded – that is, the MDB needs the liquidity only if the guarantee is called, whereas the resources for a loan must be raised and paid out in all cases. The rationale is that the risk of a guarantee being called is exactly the same as for a loan to go into default, and that in any case all contingent liabilities must be provisioned for fully in the interests of financial prudence.¹⁴ From the interviews it emerged that the fact that guarantees have a significantly lower call rate than loans in arrears or default has not had any impact on this policy.

The first implication of the 1:1 treatment of guarantees to loans is that the use of guarantees does not mean the financial resources of an MDB can be stretched further, either on an aggregate basis or in terms of individual country exposure limits. It may intuitively seem that an unfunded instrument (guarantee) would use up less MDB resources, and thus more resources can be put to use elsewhere, but that is not the case under current policies. The ‘set-aside’ funds created by IBRD/IDA and AfDB have added an incentive related to country programming limits, but they do not address the country exposure or aggregate portfolio issues.

The second implication is that pricing for loans and guarantees is also the same, since MDB pricing is for the most part based on the use of equity capital and cost of funding. For all MDBs, the fee for a guarantee is identical to the contractual spread on a loan,¹⁵ plus fees. For a short time in the 1990s, the IADB offered a slightly reduced price to guarantees to incentivise the use of the instrument, but no guarantees were issued under that pricing structure (due mainly to the unfamiliarity of guarantees at that time to both staff and borrowers) and the IADB now uses equivalent pricing to loans.

As a result, a borrower seeking resources for a development project faces the choice of a loan or a guarantee, with the same impact on its available lending envelope from an MDB, and the same cost structure. At the same time, a borrower using a guarantee faces higher transaction costs from having to deal with a third party (financer and MDB) compared to a loan (just MDB). In addition, most internal approval procedures that pertain to project loans also apply to guarantees, meaning lengthy rounds of review of project design, objectives, safeguards and the like.¹⁶ Therefore, a guarantee will be attractive only if it leads to (1) improved financial terms and/or (2) additional short- or long-term benefits to the borrower. As discussed below, these are sufficiently attractive in relatively few cases.

A further non-trivial obstacle to scaling up guarantee usage is the lack of awareness of and knowledge about the instrument on the part of MDB staff as well as borrowers. MDBs are fundamentally lending institutions, and their policies, procedures, incentives and internal culture – developed over the decades since their founding – are all geared towards lending. For example, an IEG report on the World Bank Group’s experience with guarantees noted that internal incentives strongly favour direct lending as opposed to guarantees, and that staff expertise is limited.¹⁷

¹³ IFC provisions for trade guarantees at a lower rate than project guarantees (25%), whereas all other MDBs currently provision trade guarantees at the same rate as other guarantees and loans.

¹⁴ The reasoning is laid out by Mody and Patro (1996). Interviews undertaken for this report at the IADB, IFC, ADB and AfDB suggest similar thinking at those banks, and in fact their policies are identical.

¹⁵ The contractual spread is the difference between an MDB’s own cost of funding and the amount at which it lends to clients. It is reset periodically, depending on the MDB’s financial situation, administrative costs and targeted net income generation level.

¹⁶ Procurement rules are in some cases somewhat less onerous than for loans. Trade finance guarantee programmes have specialised and highly accelerated procedures due to the low-risk nature of trade transactions.

¹⁷ IEG (2009), pp. 50-51.

3.2.2 Financial impact of guarantees

By all accounts from development agency staff, the positive financial impact of the guarantees of all multilaterals discussed here is offset in the majority of cases by the cost of the instruments paid by the borrower, which is the key factor in limiting the use of multilateral guarantees for development. The reasons behind this are complex but revolve around the weak benefit assigned to guarantees and specific incentives facing investors/lenders. These difficulties are likely to ease only slowly over time as local and international markets become more comfortable with multilateral guarantees, and domestic capital markets deepen.

Investors face a number of issues in valuing guarantees issued by multilateral development institutions. In relation to bonds backed by guarantees, the major bond rating agencies have traditionally given limited ‘uplift’ from a guarantee – normally a maximum of two or three notch improvements (three if the issuer is below investment grade prior to the guarantee and two if above). However, the agencies have tightened this in recent years, in particular related to public sector borrowers.¹⁸ Standard and Poor’s new policy, announced in May 2013, gives no uplift at all to sovereign borrowers with only a partial (as opposed to 100%) guarantee.¹⁹ As most MDBs do not give 100% guarantees, this eliminates the value of guarantees to sovereign borrowers in international bond issues.

Moreover, the investor base for an international issue is fragmented: certain sets of investors normally seek high-risk, high-yield emerging market risk, while other, more conservative, investors prefer standard AAA paper. An emerging market issue with an MDB guarantee falls in neither category and thus has no natural investor base. MIGA’s recent innovation of issuing a 95% guarantee to Hungary and then ‘stripping’ it into two separate instruments (the 95% MIGA risk and the 5% Hungary risk), and marketing them separately, is one way to address that, but the other MDBs considered here are not permitted to use this technique, due to the risk of moral hazard discussed in Section 2.3 above.

Hence, the most useful situation for partially guaranteed bond issues is in developing domestic capital markets, where the strength of the MDB rating can have a greater impact, and the investor base finds the resulting product more attractive. Capital markets in developing countries tend to be populated by quite conservative investors and are usually inaccessible to most companies except the local blue chips (who do not find guarantees useful because they themselves are usually AAA or AA in the local market and hence have no need for rating improvement). In this context, an MDB guarantee can be sufficient to bring a medium-sized company enough uplift to open up the investor base much more broadly. Companies on the cusp of investment grade are those most likely to find guarantees useful. This also explains why the majority of guarantees are in more-developed countries, which have capital markets at a sufficient level of depth to make guarantees viable for local bond issues. By contrast, MIGA – which mainly guarantees equity investment as opposed to debt – has tended to have a higher share

¹⁸ Argentina’s default in 2001, and the government’s subsequent failure to promptly repay the World Bank for its called guarantee, led to a cascade of losses that investors had apparently expected to be covered by the World Bank. Even though the particular characteristics of this guarantee (‘reinstatable’) are no longer used, the experience is frequently mentioned as one factor reducing the comfort of private investors with multilateral guarantees.

¹⁹ See Standard and Poor’s (S&P), 2013, pp. 3-4. The Methodology section states, ‘The Multiple-Credit-Dependent Obligations (MCDO) criteria are not applied to sovereign issues. In brief, the MCDO model relies on the present value of future cash flows from the primary obligor and the partial guarantor, incorporating the terms of the partial guarantee and assumptions regarding default rates. Although the math may suggest a higher rating, the approach does not mesh with reality for sovereigns.’ S&P bases this interpretation on the experiences of sovereign defaults of Brady bonds as well as the Argentina experience mentioned above. S&P’s approach is the most stringent of the main rating agencies, and all MDB staff interviewed felt that this was excessively conservative and not reflecting the security provided by MDB guarantees.

of its operations in low-income countries compared to the other MDBs analysed here.

Staff at all MDBs emphasised repeatedly that guarantees are more about establishing access over the longer term for bond issuers, as opposed to reducing the cost of funding on the transaction in question. The limited uplift given by rating agencies, and hence lower yields by investors, end up being washed out by the fees charged by the MDBs themselves, resulting in little or no net financial gain. This is true equally for borrowings from commercial banks as for bond issues, and for private as well as public sector borrowers. For borrowers seeking loans from commercial banks, the main use is to allow MDBs to provide local currency financing in markets where they cannot easily hedge currency risk to make direct loans themselves.

As a result of the above factors, development guarantees tend to be attractive only to a relatively small set of borrowers with very specific goals:

- Mainly private borrowers who see the MDB ‘halo effect’ as capable of increasing the comfort of lenders/investors and hence mobilising larger amounts of resources, well beyond the guaranteed amount (also interpreted as ‘crowding-in’ effect).
- Public and private bond issuers seeking to establish access to capital markets. Public borrowers are more likely seeking access to international capital markets, while private sector borrowers (usually those on the cusp of investment grade) are usually targeting domestic capital markets in more-developed emerging market countries.
- Private sector borrowers seeking access to local currency financing in countries where MDBs are not able to easily lend in local currency themselves.

3.3 Options to increase guarantee usage by MDBs

On the basis of the interviews for this study the factors limiting the use of financial guarantees by MDBs come down to (1) equity and pricing policies on the part of the institutions themselves, and (2) the perceptions and incentives facing potential borrowers/investors who will provide the guaranteed resources. Some options exist and are being piloted at different MDBs to address these factors, although all also come along with significant trade-offs, and may not be viable depending on the financial and developmental priorities of shareholders. The reforms discussed below have the potential to increase guarantee usage at the margins, but are unlikely to lead to a major reorientation of MDB activities away from lending and towards guarantees in the near term.

Offer 100% guarantees or allow ‘stripping’. Many bond investors find ‘partial’ guarantees much less attractive, and as noted above, at least one rating agency no longer gives any uplift at all for sovereign partial guarantees. IFC, IADB and ADB are permitted to guarantee 100% principal and interest on an exceptional basis, while the other institutions are not. Changing policy to allow full ‘wrap-around’ guarantees (as private monoline insurers²⁰ offered prior to the global financial crisis) has the potential to greatly increase the financial impact of the instrument, and hence demand for its use. Allowing MDBs to ‘strip’ a bond into a guaranteed and non-guaranteed component, as MIGA recently piloted, could have a similar impact. The trade-offs, however, are considerable: moral hazard for borrower and

²⁰ Monoline insurance is a specialised insurance offering coverage for default on the principal and interest of bonds and related securities. Monoline insurance companies were badly hit during the global financial crisis, particularly due to their exposure to bonds backed by real estate mortgage assets.

investor, shielding the borrower from market discipline and thus reducing long-term access impact, and potentially creating problems for the MDB's own bonds.

Scale up set-aside funds. The set-aside fund created by the World Bank (for IBRD and IDA guarantees), in which 75% of a guarantee is marked against a special fund rather than country lending allocation, has been moderately successful in increasing demand for these products among sovereign borrowers. The AfDB has a similar mechanism, and the IADB is considering one. However, these funds are by nature of limited size and cannot by themselves stimulate significant increased demand. Additionally, the changing criteria of rating agencies towards MDBs – with greater attention placed on country portfolio concentration – means that MDBs will have to ensure these funds do not lead to country exposure problems, as the countries that are best placed to use sovereign guarantees tend to have fairly large loan exposure with the MDBs already.

Change the equity capital allocation for guarantees. Some MDBs have considered reducing the equity capital allocation required for partial/political risk guarantees, while partial credit guarantees would still be marked 1:1 to loans. The rationale for this is that the risks inherent to PRGs are by definition much more limited, clearly defined, and directly impacted by government action. As a result, PRGs are considered much less likely to be called than a PCG, which can be triggered for any reason. Treasury departments in MDBs and some shareholders have expressed strong reservations about such a move due to the risk of building up excessive contingent liabilities that could become correlated in the event of a regional or global shock. Trade finance guarantees are another possible candidate for a lower equity capital allocation, since they are very short-term, standardised and repetitive transactions. Currently, IFC allocates one quarter the equity capital to trade guarantees as for other guarantees and loans, but ADB, IADB and AfDB maintain the 1:1 here as well.

Allocate capital dynamically over the life of a guarantee. One could consider changing the equity capital allocation over the life of a guarantee, instead of making a single, unchanging allocation. As a guarantee is in force, the risks embedded within it change, usually decreasing over the life of the transaction. It would be theoretically possible to shift capital allocation dynamically as these risks evolve in a guarantee (and, for that matter, in a regular loan). MIGA is reportedly considering such a move, although no details are currently available. MDB officials are reluctant to consider such a change, however, as it would lead to extremely complex pricing structures for a product that many government officials and MDB staff already find difficult to understand fully. That is, if the capital allocation were to change, this would also change the pricing of the guarantee; as a result, guarantee fee prices would constantly be changing for each operation (since all operations have their own inherent risks over time). The result would be extremely complex. One 'middle-ground' solution could be to have a simplified dynamic allocation allowing for a limited number of changes over the life of a guarantee. No MDBs have yet attempted such a dynamic capital allocation system, either for loans or guarantees.

Unilaterally reduce pricing, irrespective of equity capital usage. MDBs keep guarantee pricing on par with loans to reflect the opportunity cost of using each instrument since the equity capital usage is the same (even though a guarantee is unfunded). It would be possible to simply set prices lower for guarantees, and in return either accept higher loan charges and/or reduced income. The IADB did this briefly in the mid-1990s with little success, but that may have been because of the lack of familiarity with what was then a new instrument. No other MDB has tried this technique for public sector guarantees. Should shareholders decide that guarantees are a critically important instrument for developmental reasons, such a

pricing shift would be the most obvious way to scale up their usage. This would be most applicable to only certain classes of borrowers, however, and is not a viable substitute for many of the regular development lending projects undertaken by MDBs.

Improve incentives and staff training on guarantees. MDBs may want to experiment with additional incentives to individual staff members as a way to promote guarantee usage, similar to those used for example by IFC to promote loan syndication. In addition, many MDB staff are simply not familiar with the guarantee product, and would benefit from intensive training on the technical details and what types of projects would be most appropriate for the instrument. Together these could be useful techniques to scale up guarantees, although the more structural financial issues discussed above must be addressed first if they are to have a meaningful impact.

3.4 Potential implications of greater guarantee usage

Despite the many difficulties in expanding guarantee operations at MDBs outlined above, it is clear that the trend is headed upwards, albeit more slowly than many observers had expected and hoped. Thus it is worth considering the implications of greater guarantee usage by MDBs. A number of issues would need to be addressed:

Financial management and risk. A much greater use of guarantees would have important implications for the way in which MDBs manage their liquidity and risk. Because guarantees are unfunded, this would imply a lower level of necessary liquidity, but at the same time sufficient liquidity would be needed on hand in the event that several (correlated) guarantees are called simultaneously or in close succession. This is further compounded by the fact that many guarantees are issued for local currency obligations in markets where MDBs cannot quickly issue bonds themselves. Moreover, rating agencies are increasingly expecting MDBs to maintain large liquidity cushions to back up their AAA ratings, and this will have to be addressed if liquidity policies evolve due to greater guarantee usage. Another issue related to rating agencies is a much higher emphasis on the concentration of MDB portfolios in a few countries. Because of their characteristics, guarantees tend to be issued in countries with more-developed capital markets (the exception being MIGA, as noted above), markets which also tend to have fairly large loan portfolios with the MDBs. This would have to be carefully monitored to avoid excessive country exposure. Reinsurance – already in use at IFC and ADB – can be useful in helping manage exposure risks.

Safeguards. Currently, projects benefiting from MDB guarantees must essentially face the same environment, social and financial safeguards as regular project loans (although with some modifications related particularly to procurement). While this poses few issues for public sector borrowers, it may need rethinking if MDBs scale up guarantees for private sector borrowers. The World Bank Group has taken steps in this direction, creating a unified set of performance standards for all private sector borrowers (covering IFC, IBRD, IDA and MIGA). Different safeguard and project review arrangements may also be needed for guarantees, as they are more sensitive to changing conditions in financial markets and may be compromised by the traditional MDB loan approval process.

Staffing and capacity building. MDBs – with the single exception of MIGA – are designed to make project loans, mainly to public sector borrowers. As a result, the staffing skills and organisational culture developed over decades have been geared towards these operational goals. Guarantees require a very different set of skills, experience and outlook to successfully design and implement. Staff need to be well versed in the capacity, incentives and expectations of the private sector actors that

are by definition involved in guarantee transactions, and also experienced enough to understand the particular projects, clients and market conditions that will make a guarantee viable. While IFC and private sector teams at the regional MDBs have been growing in size and expertise, greater usage of guarantees would require a quantum leap forward in this direction. Intensive training for government officials and private sector actors in emerging markets would also be necessary, such that the advantages, disadvantages and risks inherent in guarantees compared to loans are well understood and taken into account before moving an operation forward.

Development impact. The goal of utilising guarantees more extensively has much to be said in its favour, as outlined in Section 2.2 above, but MDBs must also pay close attention to how well the instrument is capable of achieving a broad range of development goals. Because guarantees are by definition more closely linked to the activities and incentives of the private sector than are standard MDB loans, it is highly likely that many projects with potentially high development outcomes but with less clear attraction to private sector investors would not work well with guarantees. The unbalanced sectoral and geographic distribution of guarantees outlined in Section 3 suggests that certain borrowers, projects and countries may not be able to attract investors, even with an MDB guarantee. Hence achieving the development goals of MDB shareholders may require (1) stronger incentives to attract investors to these projects, and/or (2) the continued use of more traditional lending products in some areas.

4 Guarantees for development and official development assistance (ODA) classification: a review

Previous sections reviewed the case of guarantees issued by multilateral development banks, whose amounts of guarantees mobilised are on average larger than bilateral donors. This section builds on this evidence and considers options for DAC members and organisations reporting to the DAC to account for guarantees for development.

It is also timely to reflect on how to measure guarantees for development and whether counting guarantees against ODA targets may incentivize their use by DAC members. In the debate to identify a more accurate, comprehensive and inclusive system for measuring and monitoring official external development finance post-2015, in December 2012 the DAC High-Level Meeting mandated the DAC Secretariat to elaborate a proposal for a new broader aggregate, i.e. ‘total official support for development’ (TOSD) – supplementary to ODA – to capture various development finance mechanisms not yet reported in a systematic and consistent way across members (OECD, 2014), as well as to explore ways of representing both ‘donor effort’ and ‘recipient benefit’ of development finance. Guarantees for development are not flows per se – and hence cannot be counted as ODA unless they are called and utilised.

The DAC Secretariat has submitted a series of proposals on measuring guarantees from the perspective of both providers and recipients (Mirabile et al., 2013; DAC-WP-Stat, 2013; OECD, 2014) and this section aims to critically assess and compare options at stake.

This section outlines and reviews (1) the current conditions for ODA eligibility of guarantees and implications for counting guarantees as ODA, and (2) options for capturing the provider’s effort in offering guarantees currently under discussion. The analysis of this report concentrated on multilateral development banks: further analytical work would be required to review modalities adopted by bilateral agencies (not via their development banks) to issue guarantees for development.

4.1 Current conditions for ODA eligibility of guarantees and implications for counting guarantees as ODA

4.1.1 Criteria for ODA eligibility

Guarantees can be classified as ODA only if their characteristics meet (at least)²¹ the following criteria:

- the project the guarantee provided for must have economic development and/or enhanced welfare in developing countries as its main objectives (the development purpose of official assistance to be ODA eligible);
- resources must be provided via central, state or local government agencies at their own risk and responsibility²² (the official dimension); and
- they must materialise as a flow so guarantees must be called and paid to be ODA-eligible.

The criteria are such that guarantees are rarely captured in the ODA figures. And even if a guarantee meets the development objective and is called, the OECD Creditor Reporting System does not track and distinguish guarantees for development. They are recorded as *debt relief operations* under a separate line. In other words, we cannot measure and have any indication of the volume of guarantees, even called, that are also ODA-eligible.

Contributions to the GuarantCo project (under Private Investment Development Group, PIDG) were the only example of specific contributions of DAC members to guarantees schemes recorded in the OECD Creditor Reporting System (for example for Switzerland in 2012, Sweden and the United Kingdom in 2011).

4.1.2 Implications of counting guarantees as ODA

Some DAC members are concerned that the current ODA reporting system does not encourage the use of market-based financial instruments (e.g. guarantees and equity), which could leverage more public and private investment, in particular in better-off developing countries (OECD, 2014).

Recording guarantees when they are called means that a guarantee becomes ODA-eligible only when the project fails and its development impact is probably the lowest, and not when the guarantee corrects market failures and enables investment.

This approach does not recognise any budgetary allocation made by DAC members. Normally, some sort of budget provision is expected to be set aside when a guarantee is made, representing an assessment of the likelihood of default, thus reducing the donor country's financial room for manoeuvre for other projects, and the opportunity cost of this instrument. In their paper, Severino and Ray (2009) argue that incentives are low not only for the use of these instruments but also for further innovation.

The next section reviews key issues for measuring guarantees and the latest position of DAC members, where applicable.

²¹ For ODA eligibility, resources are those channelled to countries in the DAC list of ODA recipients and must be concessional (minimum grant element of 25%).

²² The Reporting Directives on ODA classification clarify that official transactions are those 'undertaken by central, state or local government agencies at their own risk and responsibility, regardless of whether these agencies have raised the funds through taxation or through borrowing from the private sector'.

4.1.3 How to measure guarantees

OECD (2014) identified four different measures for assessing the size of guarantees for development:

- The amount mobilised by a guarantee: the entire face value of the instrument being guaranteed (*e.g.* loan, equity), rather than just the share of this value covered by the guarantee (the guarantee may be partial).
- Gross exposure: the amount the guarantor will pay to the investor if the risk covered materialises, regardless of reinsurance.
- Net exposure: the net exposure reflects the amount the guarantor will have to pay that cannot be recovered via reinsurance.
- Total cost of the project: this measure reflects the total amount of resources mobilised by the project – the amount of resources the guarantee has leveraged – on the assumption that the project may not have been implemented without the guarantee. This approach assumes that the guarantee has been decisive in mobilising additional resources, although the counterfactual (no project would have taken place without the guarantee) may be difficult to assess on a systematic basis.

Solution proposed by DAC members. In the discussion that followed the presentation of the Survey of the DAC Secretariat on guarantees (Mirabile et al., 2013), the definition of the net ‘amount mobilised’ was considered appropriate for future data collection. The net measure would better represent the guarantor risk (reflecting the contingency liability in the guarantor’s balance sheets) and ensure a lower degree of double counting. Some DAC members have highlighted that ‘amounts mobilised’ should be included in the TOSD measure – or in an additional separate measure – only if causality between the official effort and the funds mobilised can be demonstrated. This may be the case for guarantees where a direct link between the instrument and the private capital mobilised exists (guarantee agreement) (DAC WP-Stat, 2013). However, and once again, its assessment may not be straightforward on a systematic basis.

4.1.4 Risk of double counting

First, double counting may occur when the guarantee is measured by the total amount mobilised and more than one guarantor is involved (‘total amount mobilised’ refers to the instrument being guaranteed and not to the amount of the guarantee itself, which could be partial only).

Second, there is a potential risk of double counting a donor’s effort if a guarantee is measured both when it is provided and when it is called (*i.e.* when it is recorded as debt relief).

4.1.5 DFIs may have a double mandate – both developmental and commercial

Disentangling the development component (which is a *conditio sine qua non* for ODA eligibility, see also previous sections) may not be straightforward. As an example, projects which benefited by a guarantee may have achieved high development impact (such a project by a private sector company that created jobs, enhanced local workers’ skills or led to infrastructure development, etc.), even though it may have had mainly a commercial/profit-oriented motivation. In the survey conducted to measure guarantees from the perspective of recipient countries (Mirabile et al., 2013), the DAC Secretariat – whose reach is, however, relatively minor – circumvented this issue by taking an institutional rather than a project approach. In other words, they considered as *guarantees for development* all the

guarantees issued by institutions with a development mandate, notably aid agencies, DFIs and IFIs.

Solution proposed by DAC members. DAC members suggested TOSD be measured as *‘finance extended with a developmental purpose with an additional measure consisting of amounts mobilised’*. This would imply inclusion of loans and equity by development banks and DFIs, and exclusion of guarantees and most export credits (possibly with the exception of associated financing).

4.2 Options for counting guarantees for development

Measuring guarantees for development will require a different statistical approach because guarantees are not a flow, unless they are called. The main element for measuring guarantees for development should take into account the opportunity cost for the bilateral agency and/or DFIs to issue guarantees, especially at a time when aid budgets are shrinking in some DAC member countries. Three options for capturing the provider’s effort in offering guarantees are now under discussion and were submitted to DAC members for review and discussion in November 2013. Comments by DAC members have been limited and mainly concentrated on the first option.

Mirabile et al. (2013) stress in their survey that information on individual guarantees is usually classified as commercial-in-confidence and survey responses from individual countries could not be published or released. Confidentiality may be an issue for project-level data – limiting the level of detail of a future database – but not for an aggregate measure.

The section concludes with two other potential ways of counting guarantees: counting credits and debits to provisioning accounts, net of fees received; and measuring the leverage effect, as suggested by Roodman (2014) and Mirabile et al. (2013)

4.2.1 Options submitted by the DAC Secretariat

Option 1: Government support to guarantee-extending institutions.

This option measures the government funding constituting the capital base to issue guarantees. The capital base is *considered the enabling factor for agencies to issue guarantees and could be a proxy of the provider effort*.

The main advantage of this approach is its narrow data requirements. In discussion with DAC Secretariat, it emerged that this was the preferred option (and the only one discussed) by DAC members in the informal Working Party (WP) on Statistics in November 2013, because of its simplicity.

The proposal also has several disadvantages. First, it would apply to bilateral agencies and not to development banks (multilateral or bilateral). In the latter case, the capital base is the share of equity capital allocated to back up guarantees. Second, the DAC Secretariat argues that, by measuring the capital available to cover risks, it may not be possible to disentangle the issuance of other instruments beyond guarantees at the same time as measuring the contribution for each recipient country. However, this would apply to the case of bilateral agencies only, as risk assessments analyses by instruments are common practice among MDBs. Third, many if not all bilateral DFIs (not banks) are expected to operate in a quasi-commercial way, and would typically not receive special allocations of government capital merely for guarantees. In the same vein, it may not be possible to account for government support to guarantees when these are provided by multilateral development agencies (unless guarantees are attributed to each donor on the basis

of its replenishment contribution, such as in the case of AfDB); a similar argument applies to loans via MDBs. The only exception would be MIGA (or, as noted above, GuarantCo) because guarantees are one of its core activities, so donor contributions to the organisation is a good proxy of its guarantees via the multilateral organisation (excluding overhead costs). Also in this case, as with loans, however, the contribution of each donor to each recipient country cannot be measured.

Option 2: Risk taken by the guarantor.

This proposal is expected to measure the risk taken by the guarantor:

- First, the *level of exposure* is measured by the maximum amount the guarantor would have to pay in case of default by the borrower (which corresponds to the *net exposure*).
- Second, the *probability of default* is based on (1) the types of risk being assumed – commercial or political (the latter more difficult to assess) – and the country context; (2) currency; (3) period covered.

No comments were received from DAC members at the informal WP on Statistics in November 2013 when this proposal was first submitted.

While information on the *level of exposure* is available for each donor, data requirements and context specific information to assess the *probability of default* would require a significant statistical effort. Furthermore, each donor is expected to apply different parameters on (1)-(3); therefore, comparability of this measure across donors would be compromised.

Option 3: ‘Concessionality’ of guarantees.

There are currently several proposals about how loans could be captured in a new ODA definition: the direct expenditures incurred by donors, the grant equivalents (where feasible), or the face value of selected types of investments. All these measured would help incentivise the use of non-grant financial instruments with significant leveraging potential. A guarantee priced below market rates implies a financial subsidy, and the difference between the premiums actually charged by the public institution and those the market would charge could be referred to as the ‘concessionality’ of guarantees.

One way to estimate guarantee concessionality would be to estimate the fair premium needed to guarantee the full capital cost insured, based on each guarantee’s specific risk profile, which obviously varies both by country and type of investment. This stream of benefits (say 4% per annum for 10 years) could then be converted into a net present value (NPV) using an appropriate market-related discount rate. If, to simplify the arithmetic, we assume that the capital value is \$100 million and the actual risk 4% for each of ten years, and ignore upfront costs, at a 5% discount rate this generates an NPV of over \$30 million.

One of current DAC Secretariat proposals considers the OECD-Trade and Agriculture Department (TAD) country risk classification and minimum premium rates for export credit guarantees to be used as as benchmarks of market rates. The market rate would incorporate the country risk, so this measure would be comparable across providers. There are, however, a few characteristics of guarantees (e.g. local currency, risks covered) that would not be captured by this benchmark, requiring further analytical work, and it may not be straightforward to obtain comparable pricing.

4.2.2 Other options

Option 4: Count credits and debits to provisioning accounts, net of fees received.

This method takes into account the risk capital allocation of funds set aside to absorb possible payouts (i.e. to pay out the guarantee if it is called) and, in the case of bilateral agencies (not banks), ‘could be a good proxy for the true financial cost of guarantees’ (Roodman, 2014). In principle, this information should be captured by audits in each agency and would allow for classification by recipient country. This accounting method for guarantees for development may also create the incentive of overprovision, at least in the short term (Roodman, 2014), even though we envisage its impact to be limited.

Option 5: Measure leverage effect.

Assessment of the donor’s effort can also include the calculation of the *leveraging* effect, i.e. the *ratio between the amount mobilised and the donor effort* (Mirabile et al., 2013). In the case of a guarantee, however, the donor effort should embed the risk taken by the institution. The denominator (i.e. the donor effort) could take at least three forms with different information requirements and risks of over/underestimating the leveraging effect.

1. Net exposure. If the probability of the guarantee being called is small, the donor effort may be overestimated.
2. Net exposure multiplied by the probability of default. The bias of the previous indicator is addressed by calculating a project-specific probability of default.
3. Amount of capital immobilised (provision). In the case of bilateral agencies (not banks) a certain amount per dollar is transferred into a ‘reserve’ in case of default. If the guarantee is not called, this approach overestimates the donor effort and reduces the leverage effect.

However, there is no agreement on measuring the leverage ratio of public resources for private sector activities (which may have not taken place without public subsidy/support) and/or the catalytic effect of public resources. This information would be a better fit as a separate memo item than as a measure for guarantees (potentially already captured by its numerator, i.e. the amount mobilised). Further analytical work will be undertaken by the DAC Secretariat after September 2014.

Table 7: Options for counting guarantees for development

Options for counting guarantees as ODA		Description	Pros	Cons
	Current rule	Guarantees are captured under ODA only when they are called	It measures the actual financial burden for the agency ODA captures flows only; this methodology is coherent with the ODA reporting system	Failure is rewarded (guarantees are counted when they are called) with potential disincentives to financial prudence There is no reward for committing to payouts When called, guarantees for development cannot be tracked as they are measured as debt relief operations
Options by the DAC Secretariat	Government support to guarantee-extending institutions	This option measures government funding to constitute the capital base to issue guarantees. The capital base is considered the enabling factor for agencies to issue guarantees and could be a proxy of the provider effort.	The set of data required to track this measure is small	It may not be possible to disentangle the issuance of other instruments beyond guarantees. Information required by this option may not be captured by administrative systems in some DFIs, especially multilaterals This measure may not be appropriate for DFIs, which are self-financing (i.e. they do not receive governments' contributions), and for measuring donors' effort to guarantees via multilateral agencies (except for MIGA).
	Risk taken by the guarantor	This proposal is expected to measure the risk taken by the guarantor by assessing the level of exposure and the probability of default.	It captures actual exposure Information on the <i>level of exposure</i> is available (net exposure)	There is no comparability across donors
	'Concessionality' of guarantees	The OECD/TAD country risk classification, and minimum premium rates for export credit guarantees, are to be used as a benchmarks of market rates	Figures are comparable across donors Benchmark data is available	A few characteristics of guarantees (e.g. local currency, risks covered) that would not be captured by this benchmark require further analytical work. 'Concessionality' of guarantees should be coherent with the on-going proposal on 'concessional in character' for loans
Other options	Count credits and debits to provisioning accounts, net of fees received	This method valorises the provision of funds set aside to absorb possible pay outs	It is a good proxy for the true financial cost of guarantees Information should be available in auditing reports	There are incentives, albeit minor, for overprovisioning
	Leveraged amount	This method measures the extent to which donors' effort has mobilised additional resources.	It assesses the extent to which donors' effort catalyses other forms of finance.	No agreement has been reached on how the leverage effect should be measured. This measure would better represent as a separate memo item.

At the same time, Roodman (2014) has argued that there would not be any justification for a different treatment of guarantees for development as other sources leverage other resources (as, for example, infrastructure development is expected to mobilise additional private capital).

Table 7 and Table 8 outline advantages and disadvantages of each option for counting guarantees for development and review each option on the basis of two criteria (data availability/ease of measurement and comparability across donors). Based on this assessment, the two most credible and feasible options for counting guarantees are:

- Count credits and debits to provisioning accounts, net of fees received. It is the most correct measure of the opportunity cost for the donor (with minor disadvantages).
- Government support to guarantee-extending institutions, because of its easy measurement when it comes to most of the bilateral agencies.

Table 8: Comparison of options for measuring guarantees

	Current rule	Government support to guarantee-extending institutions	Risk taken by the guarantor	Concessionality of guarantees	Count credits and debits to provisioning accounts, net of fees received	Leveraged amount
Data availability/ease of measurement	No	Yes	Partial	Partial	Yes	n.a.
Comparability across donors	Yes	Yes	No	Yes	Yes	n.a.

5 Conclusions

A few key messages emerge from the analyses of the models of MDBs (IDA/IBRD, MIGA, ADB, IADB, AfDB) in issuing guarantees for development and the implications for these donors of scaling up this instrument.

First, guarantees have several characteristics that bring advantages over the more traditional lending operations of MDBs: they can target certain specific classes of risk, they bring investors in contact with developing country borrowers, and they can help ‘crowd in’ other funding sources. Additionally, the maturity of guarantees is usually considerably shorter than that of standard long-term MDB loans, meaning MDBs can recycle their equity capital more quickly into new development projects. However, guarantees may incur moral hazard, higher transaction costs for the borrower, and ‘crowding out’ of private providers of guarantees.

Second, guarantees have become more relevant in MDB operations, but their usage still remains relatively low – only 4.5% of total financing by MDBs in 2013. The instrument experienced an initial burst of usage in the late 1990s/early 2000s when it was introduced by MDBs, followed by a downturn in 2002-2007, followed by a sharp upswing as of 2008. This evidently is linked to the overall economic cycle, with the downturn in the mid-2000s due to the abundance of available credit at that time, and the sharp upturn in 2008 resulting from the global financial crisis. Data for 2012 and 2013 indicate that guarantee usage has trended upward – even as the global crisis receded – as clients, MDB staff and private financiers have become more familiar with the instrument. As guarantees tend to work best in more-developed capital markets, it is unsurprising that the majority of MDB guarantees have been in middle-income emerging economies.

Third, MDBs face a number of major impediments to using guarantees more extensively, linked to their capital structure, financial and operational policies, and staff skill sets. MDBs provision for project guarantees at exactly the same rate as for loans, so the use of guarantees does not mean the financial resources of an MDB can be stretched further. Moreover, the cost of MDB guarantees often washes out any improved financial terms to the borrower from guarantee, due to incentives facing investors, realities of capital markets, and limited ‘uplift’ given to guarantees by the bond rating agencies.

Fourth, a series of policy reforms may help expand the use of guarantees at MDBs. They include the following: changing policy to allow full ‘wrap-around’ guarantees (as private insurers offered prior to the global financial crisis); using set-aside equity capital funds at MDBs, and providing incentives to staff to encourage their use; reducing the equity capital allocation required for certain classes of guarantees (particularly partial/political risk guarantees); and unilaterally reducing pricing for guarantees. All of these options, however, come with developmental and financial trade-offs.

Fifth, expanding use of guarantees would have implications for the way in which MDBs manage their liquidity and risk. Because guarantees are unfunded, this would imply a lower level of necessary liquidity, but at the same time sufficient liquidity would be needed on hand in the event that several (correlated) guarantees are called simultaneously or in close succession. Additionally, MDBs – with the exception of MIGA – are designed for lending, and new skill sets, organisation and back office processes would be needed if guarantees were to grow significantly.

The second part of this report reviewed options for counting and recognising guarantees for development under ODA or TOSD, as well as the official positions of DAC members on how guarantees should be counted and reported to DAC.

Measuring guarantees for development will require a different statistical approach because guarantees are not a flow, unless they are called. The main element for measuring guarantees for development should take into account the opportunity cost for the bilateral agency and/or DFIs to issue guarantees, especially at a time when aid budgets are shrinking in some DAC member countries. Among the different options, the two most feasible ones for counting guarantees for development are (1) count credits and debits to provisioning accounts, net of fees received (the most correct measure of the opportunity cost for the donor with minor disadvantages), and (2) government support to guarantee-extending institutions (easy measurement when it comes to most of the bilateral agencies).

Further analytical work would be required to better understand models to issue guarantees as well as on the implications of scaling up these financing instruments by bilateral donors, which has not been covered in this review, with greater granularity than outlined in Annex 1. Finally, while guarantees are generally considered a driver of investment – being an instrument to correct for market failures (especially moral hazard issues) – there is very limited evidence available to support this view. Further analyses on the development impact of issuing guarantees would better inform the debate on the opportunity of scaling up this type of instrument.

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Annex 1: Mapping guarantee usage among the major multilateral development finance institutions²³

This section provides a detailed description of the guarantee activities of each of the MDBs considered in this report. The strategy here is primarily descriptive rather than analytical, with information provided systematically, for each MDB, on overall trends, geographic and sectoral distribution, institutional arrangements, and innovations. The intention is to offer background information that can provide useful context for other aspects of this report as well as for researchers and policy makers investigating this issue.

1.1 International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA)

The public sector lending windows of the World Bank began issuing guarantees in 1983 to attract co-financing on Bank-funded projects. The World Bank issued a formal policy on guarantees in 1994, detailing the characteristics and procedures for the two main instruments: PCG and PRG.²⁴ Initially, guarantees were eligible only in non-concessional borrowing countries from the IBRD lending window. In 1997, a policy reform permitted the IBRD window to additionally offer PRGs for ‘enclave projects’ (those that are expected to generate foreign currency revenues) in poorer concessional (IDA) countries.²⁵ A further innovation was introduced in 1999 with the creation of the PBG for IBRD borrowers, based on certain conditions and currently capped at a total maximum exposure of US\$2 billion. Neither PBGs nor PCGs have been available for IDA countries (they are eligible for PRGs only, to a total exposure maximum of US\$500 million), although this may change as a result of ongoing operational policy reforms (see below).

PCGs and PBGs are intended to directly support government access to finance, while PRGs are geared towards private sector projects. This contrasts with other MDBs, which use PCGs and PRGs equally to support both public and private sector borrowers. PBGs function in a similar fashion to PCGs – supporting public

²³ To inform this section, interviews were conducted in May and June 2014 with the following organisations: World Bank (2 staff - 1 in treasury and 1 in infrastructure); IFC (4 staff - 1 trade finance, 2 regional operations, 1 risk management); IADB (4 staff - 1 trade finance, 2 operations (1 public, 1 private), 1 treasury); ADB (1 staff in operations); AfDB (3 staff - 1 risk management, 1 operations, 1 treasury).

²⁴ World Bank (1994).

²⁵ IDA PRGs are to be used only in cases where sufficient support is not available for enclave PRGs by IBRD, MIGA and IFC. See World Bank, 1997.

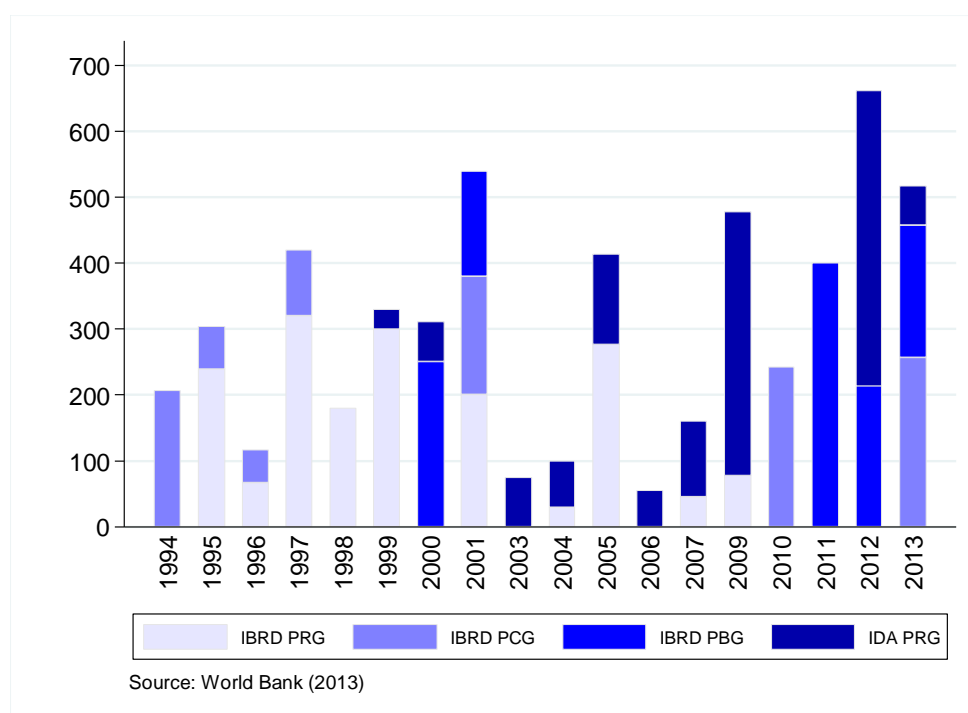
sector financing – but the resources are for general government spending rather than a specific project, and they are linked to a matrix of policy actions agreed on between the Bank and the borrower government. PRG operations are the only instance where the IBRD and IDA windows directly support private sector activity, which within the World Bank Group is usually left to IFC and MIGA. The rationale is that the PRGs support these projects only by insuring the obligations of the public sector that may impact these projects, and for which the government is willing to provide a counter-guarantee. All IBRD/IDA guarantees require sovereign counter-guarantee from the government where the project takes place.

Guarantees commitments by type. Between 1994 and 2013, IBRD/IDA issued a total of 43 guarantees, of which approximately US\$4 billion went to IBRD countries and slightly less than US\$1.5 billion to IDA countries. PRGs have been much more extensively used compared to PCGs in terms of total volume (US\$3.2 billion vs US\$1.2 billion) as well as in terms of number of operations (26 PRGs vs 9 PCGs) (Figure 3). Only five PBGs have been issued thus far, although over US\$800 million in PBGs have been issued in the period 2011-2013, pointing to a possible upswing in the use of that guarantee modality.²⁶

Evolution over time. The trend in guarantee use over time reveals a clear pattern, which is largely mirrored by other development banks: a relatively quick increase in guarantees in the late 1990s and early 2000s followed by a decline in the mid-2000s and then a resurgence of use from 2009 onward. This appears to be counter-cyclically linked to trends in international capital flows to emerging markets over the period: guarantees were used intensively during years with relatively restricted capital flow conditions in the late 1990s and post 2009 (from emerging market and global financial crises, respectively), while their use generally declined during the boom years in the mid-2000s. To date, only one guarantee has been called, by Argentina in 2002 for US\$250 million.

²⁶ According to interviews with World Bank staff, this is in large part due to a demonstration effect: following the successful example of Serbia in 2009 (US\$400 PBG), the neighbouring Balkan countries of Macedonia and Montenegro subsequently requested the instrument.

Figure 3: IBRD/IDA guarantee commitments by type, 1994-2013 (US\$ millions)



Apart from the impact of economic cycles on guarantee usage, institutional reforms have played a role as well. IBRD/IDA – similar to all development banks – books guarantees exactly in the same way as loans, which for a variety of reasons (discussed in more detail in section 3, above) limits the demand for guarantees by borrowers. To help mitigate this, IDA in 2004 changed the way it counted guarantees against individual country borrowing limits such that they now count as 25% of a loan. That is, a country can for example chose to either borrow US\$25 million or take out guarantees for US\$100 million. The remaining 75% of the guarantee amount is counted against a special set-aside fund that is created with reserve capital. The success of this led IBRD to follow suit in 2010, and the set-aside fund can now run up to US\$2 billion. It is important to note that this does not allow IBRD to extend its overall equity capital usage.

Geographic distribution. The Europe and Central Asia region has been a particular focus of guarantees, constituting the highest total guarantee value of all regions in only 10 operations (Figures 4 and 5). Four of these have been relatively large PBGs in the Balkan region (Serbia, Macedonia and Montenegro), which according to IBRD staff is partly due to the demonstration effect and increased awareness of the product on the part of governments in the region. Fourteen operations took place in the Sub-Saharan Africa region, all of which were in low-income IDA or blend countries apart from one PCG (US\$242.7 million to Botswana) (Figure 4). Outside of Africa, only two IDA countries have received a guarantee (US\$60 million PRG in Bangladesh and US\$42 million PRG in Laos). All other guarantee operations were in middle-income IBRD countries.

Latin America has used only four guarantee operations and none since 2005. One of these – a policy-based guarantee to Argentina – was called during the country’s debt crisis and represents IBRD/IDA’s only called guarantee to date. Demand for guarantees in Latin America thereafter bottomed out. But interest in the region has reportedly been picking up again, most notably at the national and sub-national levels in Brazil. South and East Asia have utilised guarantees only minimally,

which World Bank staff attribute to, among other reasons, the reluctance of governments to provide counter-guarantees and to generate contingent liabilities backstopping private sector activity. Since all IBRD/IDA guarantees require a government counter-guarantee, this is a major obstacle for guarantee expansion.

Figure 4: Geographic distribution of IBRD/IDA guarantee commitments, 1994-2013 (US\$ millions)

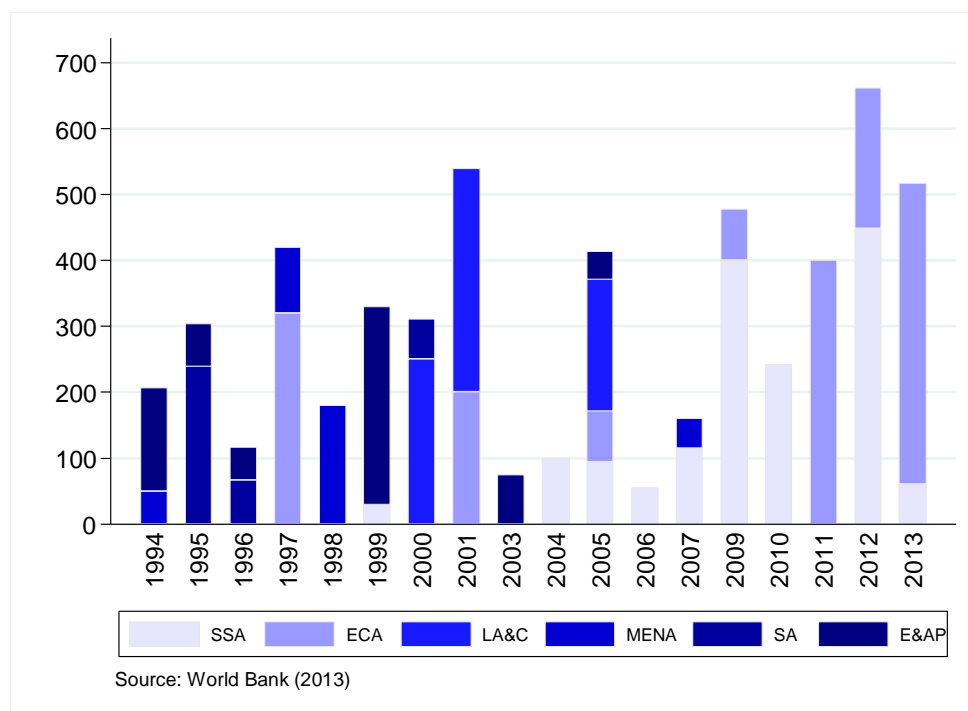
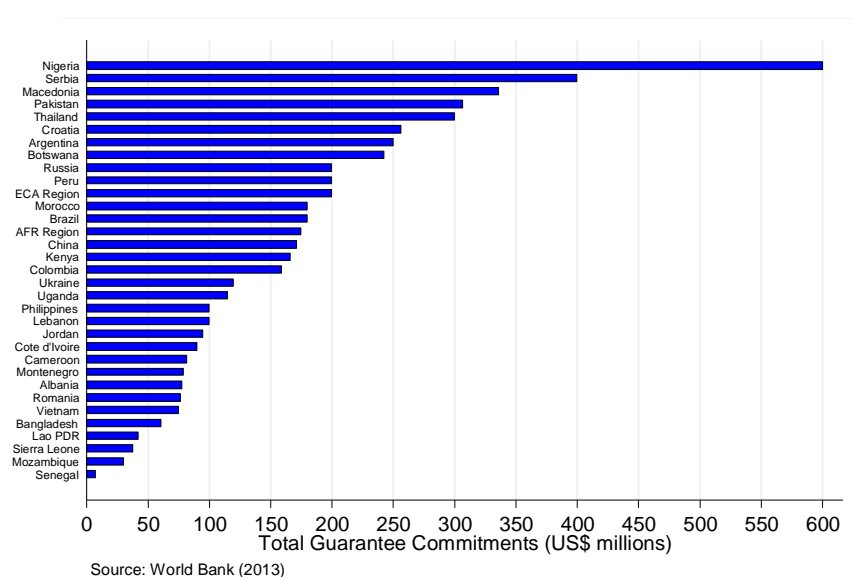


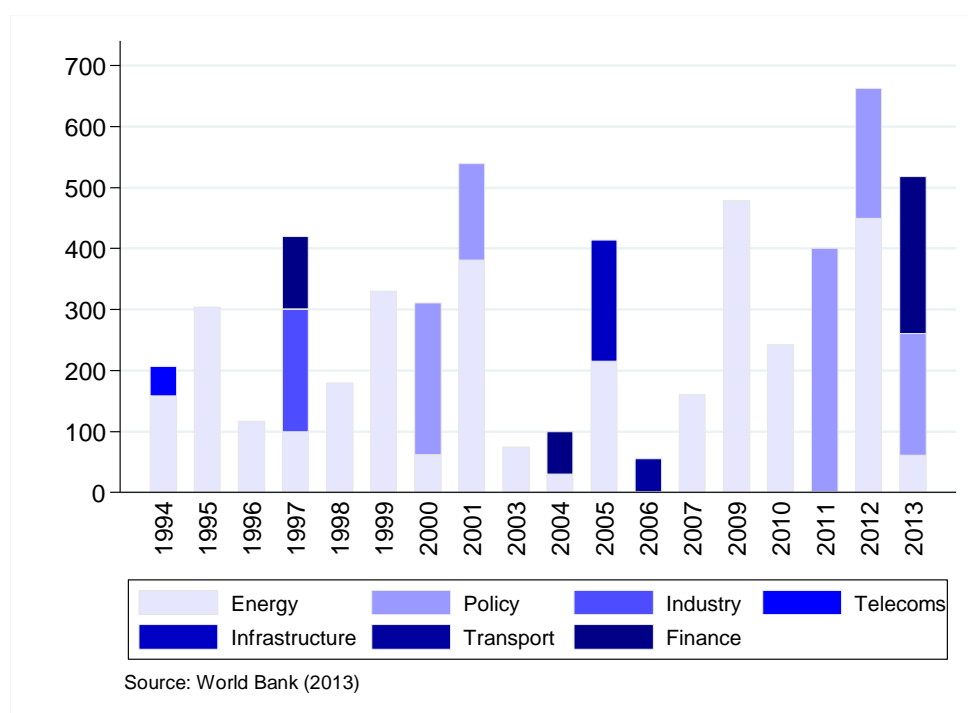
Figure 5: By country distribution of IBRD/IDA guarantee commitments, 1994-2013 (US\$ millions)



Sector distribution. Electric power generation and distribution projects have accounted for over half of IBRD/IDA guarantees, of which 18 were PRGs and 6 were PCGs (Figure 6). Power projects have been a particular focus of IDA-funded guarantee operations as this sector amounts to 10 of the total 15 IBRD/IDA

guarantees (other sectors are resource extraction, transport, and capital markets development). Policy-based operations (PBGs) accounted for another 22%, for only five transactions of relatively large size. IBRD has also experimented with the creation of PRG facilities (three in total: Ukraine US\$120 million, Russia US\$200 million, and Peru US\$200 million), which guarantee portfolios of financial exposure to certain sectors (exports, forestry, and small and medium enterprises (SME) financing, respectively). However, most IBRD and all IDA guarantees continue to be project-based. While PBGs have mainly backstopped international bond issues, PCGs and PRGs are now used almost exclusively to support commercial bank borrowings. The share of borrowing backed by the guarantee varies greatly by transaction, and can in some cases (notably for project finance) be quite small to allow the transaction to move ahead. In most cases IBRD/IDA PCGs cover less than 50% of the transaction.

Figure 6: Sectoral distribution of IBRD/IDA guarantee commitments, 1994-2013 (%)



Institutional arrangements. Responsibility for guarantee operations at IBRD/IDA is for the most part housed in the Sustainable Development Department, in the Financial Solutions Unit, which comprises about 15 technical specialists. These are informally the ‘owners’ of the guarantee product within the bank and are in almost all cases brought in by the regional and sectoral teams when a guarantee transaction is being designed and negotiated. World Bank Treasury also has staff working on guarantees, in particular the PBG instrument that backs major international bond issues. This division of labour arose informally, and staff indicate that organisational changes may occur as part of the broader World Bank Group restructuring that is currently underway.

Reforms and future trends. IBRD and IDA are currently in the midst of a major transition in regards to their guarantee policy, which was approved in late 2013 and took effect in July 2014. Under the new policy, guarantees are fully streamlined into the regular IBRD/IDA financing process, with no separate policies governing their usage. Instead, guarantees and loans are treated essentially the same, as simply two ways to access financing for an investment project (‘Investment Project

Financing’, or IPF) or for budget support (‘Development Policy Financing’, or DPF). The new policy is intended to ‘harmonize to the fullest extent possible Bank guarantees with Bank loans, reducing restrictions and perceived gaps under the stand-alone Bank guarantee policy.’²⁷

The new policy contemplates a number of other reforms to guarantee usage as well. Notably, it will provide greater flexibility in designing instruments to meet the needs of the more stringent Basel III requirements and increasing complexity and segmentation of potential investors. To encourage more hybrid structures and innovation, IBRD/IDA will no longer have a distinction between PRGs and PCGs but rather between the kinds of risks guaranteed. Additionally, guarantees would be able to be backed by trust fund resources; while these will still follow general Bank requirements as well as the trust fund’s own rules, this could allow for greater financial and structural flexibility, which could be useful in certain cases. A third major change will be to allow policy-based guarantees in IDA countries that are considered to be at low or moderate risk of debt distress. It remains to be seen how these changes will play out in practice – both in terms of operational effectiveness and demand for the instrument – but collectively these appear to be positive steps in ‘mainstreaming’ guarantees into regular usage by IBRD/IDA. If the experience seems broadly successful, one may expect the other major regional MDBs to follow this example in the near future.

1.2 International Finance Corporation (IFC)

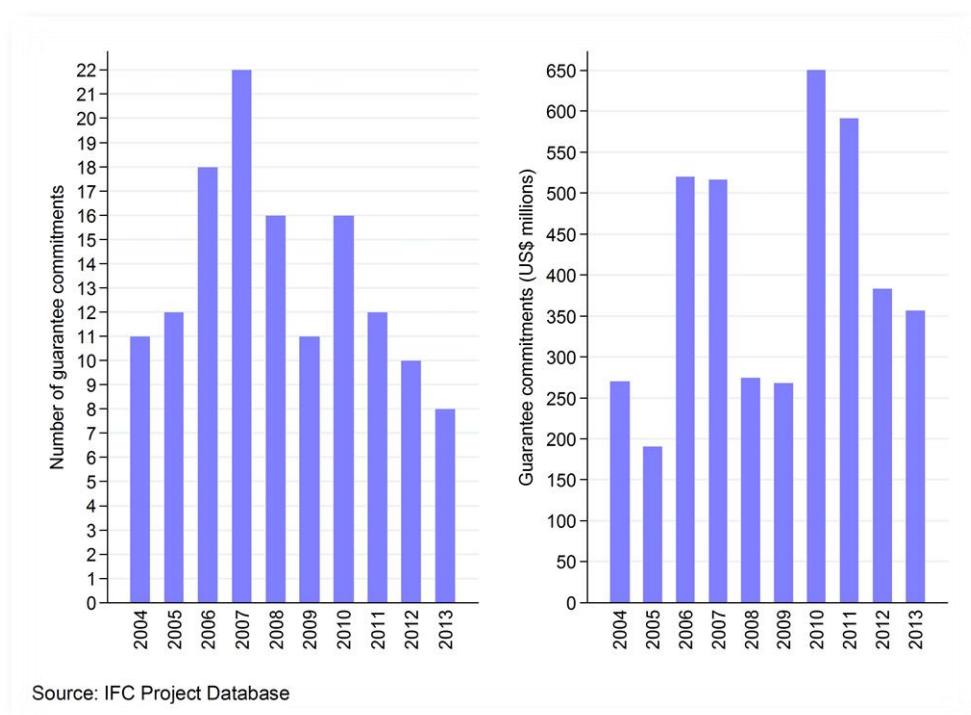
IFC – the World Bank Group’s private sector lending arm – first started issuing guarantees in 1982 and created a formal policy on guarantee instruments in 1988 (revised in 1997). IFC only issues PCGs, which offer comprehensive coverage of all causes (political or otherwise) of non-compliance with a financial obligation, including bonds and commercial loans as well as other obligations such as bills of exchange or carbon credits. It does not require a sovereign counter-guarantee for its PCGs and utilises market-based pricing that varies by country, project and individual borrower in question. In contrast to other MDBs, IFC has increasingly emphasised risk-sharing guarantees that cover a portfolio of borrowing (usually in the financial sector), rather than PCGs for individual projects.

According to interviews with IFC operational staff, IFC’s guarantees normally range from 25% to 50% of the amount for a bond issue, or even lower (as low as 10%) if the issue is in a domestic capital market where IFC’s uplift impact will be higher. Bank loans can be guaranteed for up to 100%, although the amount is usually lower. IFC never guarantees bond issues of up to 100% as it sees its intervention as introducing issuers to the capital market and hence wants the markets to assess the issuer to some degree (and not just consider IFC risk, as with a 100% guarantee). Staff indicated that the majority of guarantees were to backstop bond issues as opposed to bank loans, although exact data were not available. A particular focus of IFC project guarantee activity is on borrowers raising funds in local markets and in local currencies, rather than on international borrowing. By one estimate, well over 90% of IFC’s current guarantee activity is for local funding – similar to the private sector guarantee activity of other MDBs.

Evolution over time. As of end FY2013, 10.3% of IFC’s total portfolio of outstanding financial exposure was in guarantees, the majority of which are in the Global Trade Finance Program (GTFP) rather than project PCGs. While GTFP commitments have grown very rapidly in recent years, project guarantees from IFC have remained relatively flat (Figure 7).

²⁷ World Bank, 2013, p. 2.

Figure 7: IFC non-trade guarantees commitments, 2004-2013



Geographic distribution. Over the period 2004 to 2013, the East Asia & Pacific region received the highest share of guarantee operations, the vast majority of which are in China (Figures 8 and 9). Notably, South Asia has by far the smallest share of guarantees, with only one (US\$1.75 million) issued to India in that period, while Bangladesh and Sri Lanka have been issued with just one (US\$18 million) and two (US\$20 million) respectively. Considered by income level, 18.7% of guarantees by value committed during 2004-2013 were in poorer IDA or blend countries, while the remainder were in middle-income IBRD countries. Guarantee operations with a global reach are playing an increasingly larger role in IFC's operations. These global programmes are mainly to facilitate financial flows, but also include one related to power generation and another related to the 'Clean Development Mechanism'.

Figure 8: Geographic distribution of IFC non-trade PCGs, 2004-2013

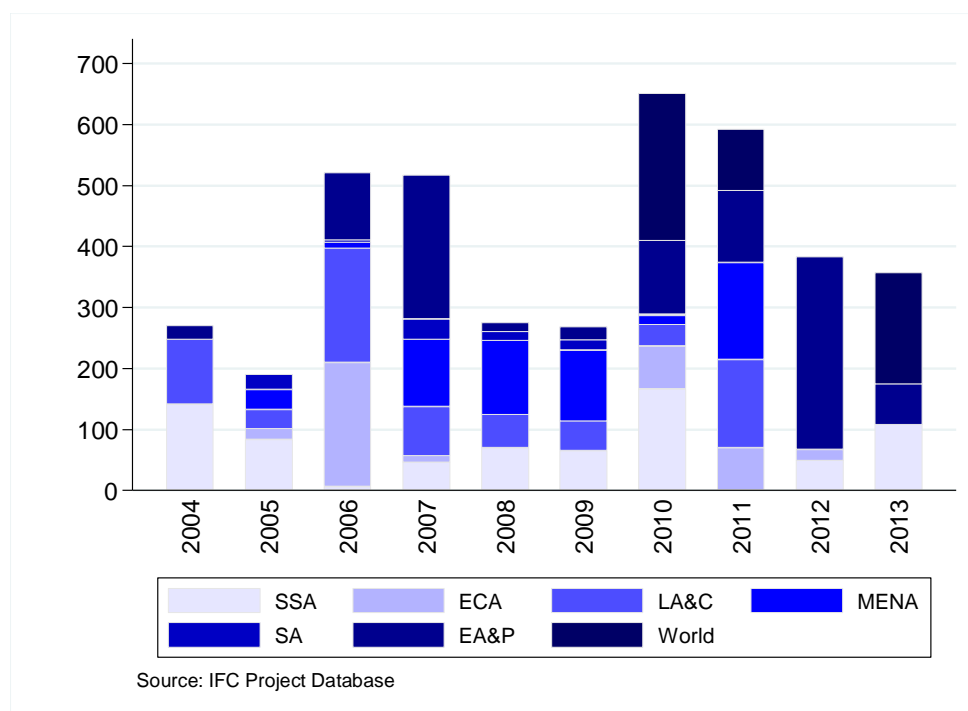
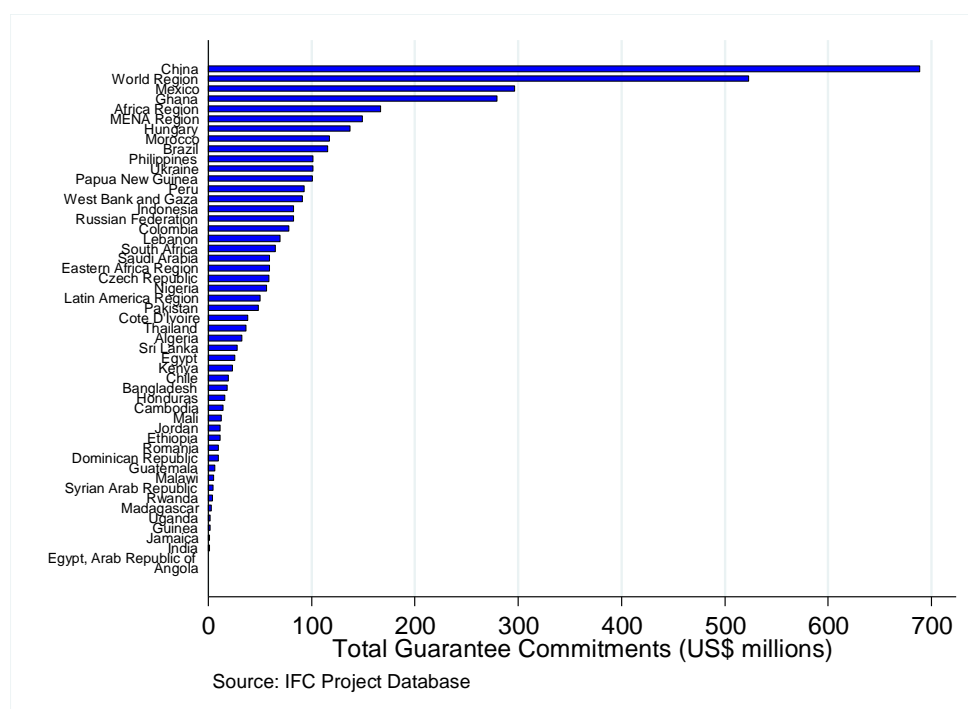


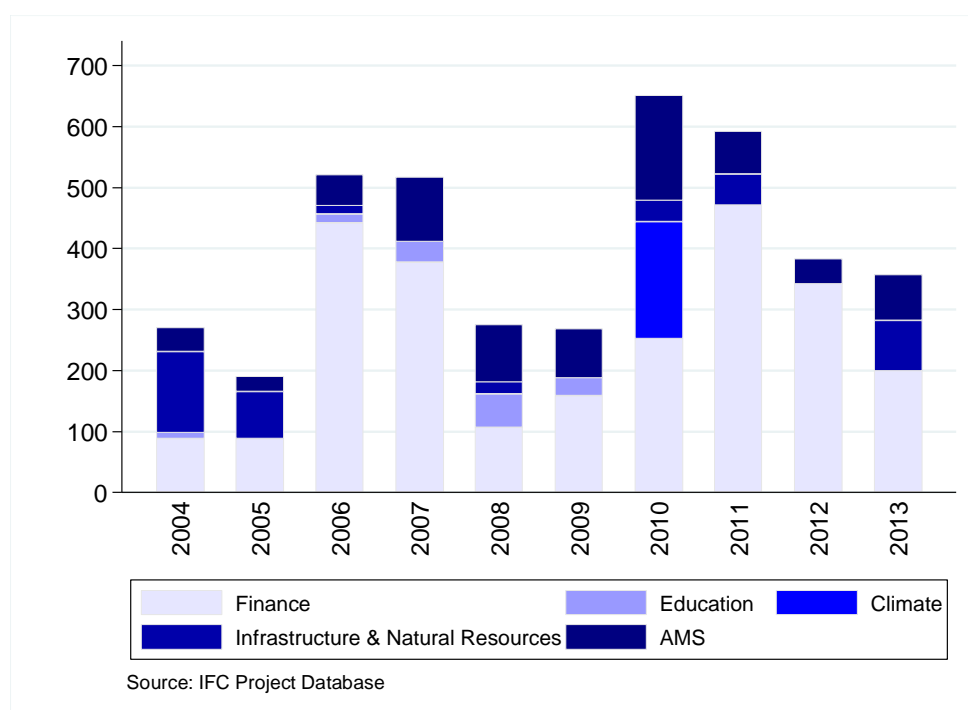
Figure 9: IFC guarantee cumulative guarantee amounts by country, 2004-2013



Sector distribution. Of the US\$4.3 billion project guarantees issued between 2004 and 2013, over half (63%) were in the finance sector, which reveals the heavy emphasis of IFC's guarantee programme in this sector (Figure 10). The remainder were divided among several other sectors, although it is notable that IFC has only

issued one guarantee for transportation infrastructure projects in recent years, and only two for energy and power projects. This contrasts strongly with the sectoral distribution of guarantees by IBRD/IDA as well as ADB, which are much more focused on project finance, particularly for power generation. According to interviews, IFC focuses on the financial sector in its guarantee programme because it is easy to find investors willing to take on the risks; infrastructure projects are seen as highly risky and uncertain, while the banking sector in most countries is a relatively better-known quantity, with frequent bond issues in the local market and oversight by regulatory authorities.

Figure 10: Sectoral distribution of IFC non-trade PCG commitments, 2004-2013 (%)



Institutional arrangements. Guarantee operations are managed through the regular investment teams in the three areas of Finance, Infrastructure and Manufacturing/Agriculture, supported in all cases by staffers from the Treasury Client Solutions group, who are product specialists in guarantees.

Reforms and future trends. Currently, IFC has no plans to reform its policies on guarantee usage, but it is considering operational innovations that could make project PCGs more attractive to borrowers and lenders. One is the deployment of a credit-risk transfer, which functions as a type of synthetic securitisation in which IFC can take a customised slice of less attractive mezzanine (or subordinated) risk on a financial institution's loan portfolio, while the senior risk and equity slices are taken on by the private sector, giving capital relief to the financial institution. This type of operation was undertaken for the first time in early 2014.²⁸ Another option IFC is exploring is to modify rules in a way that allows investors to recover their full share of a default before IFC recovers any, thus making the guarantee more attractive to creditors. While this is not a major obstacle, it could provide an additional marginal incentive by making guarantees more attractive to lenders. And lastly, IFC has said it intends to ramp up coordination with other branches of the

²⁸ A \$US90 million PCG structured in this way catalysed \$US2 billion in financing to emerging markets. See IFC 2014.

World Bank Group – MIGA and IBRD/IDA – in its guarantee operations, in line with the broader reforms currently underway at the World Bank Group.

1.3 Multilateral Investment Guarantee Agency (MIGA)

Created in 1988, MIGA is the only multilateral development finance institution dedicated solely to issuing guarantees, and is one of the five institutional pillars of the World Bank Group. Worldwide, 180 countries are members of MIGA (25 industrialised countries and 155 developing countries), compared to 188 members of the World Bank's main lending organisation (IBRD). After a relatively slow start, MIGA has grown rapidly since the late 1990s, and especially since 2010. MIGA issued US\$2.8 billion in guarantees in FY2013, and ended the fiscal year with a gross portfolio of US\$10.8 billion (of which US\$6.4 billion was on its own balance sheet and the remainder reinsured).

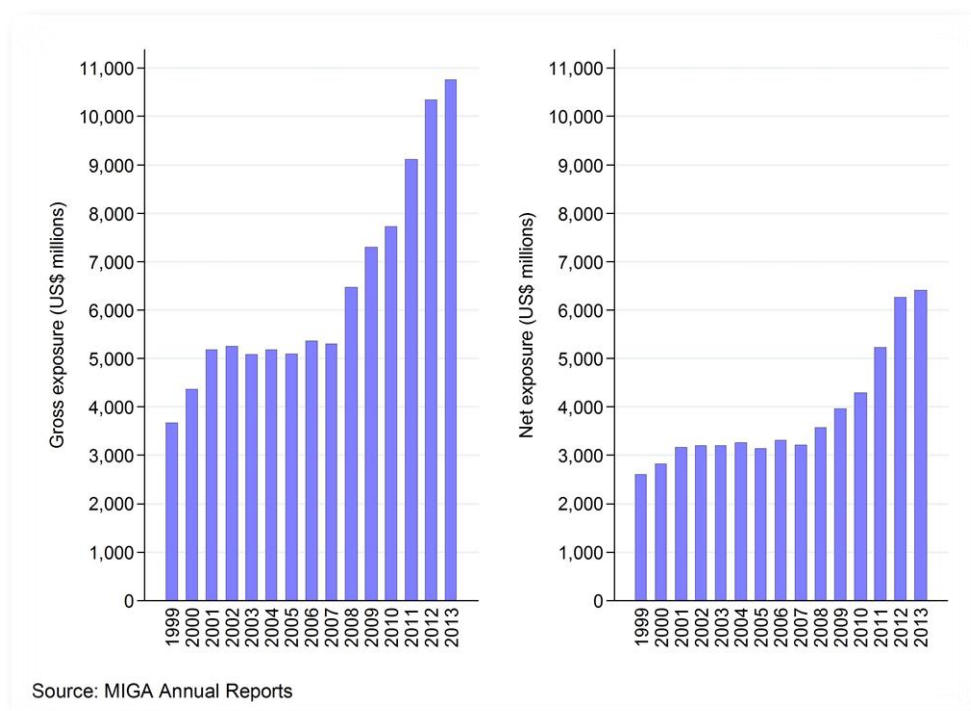
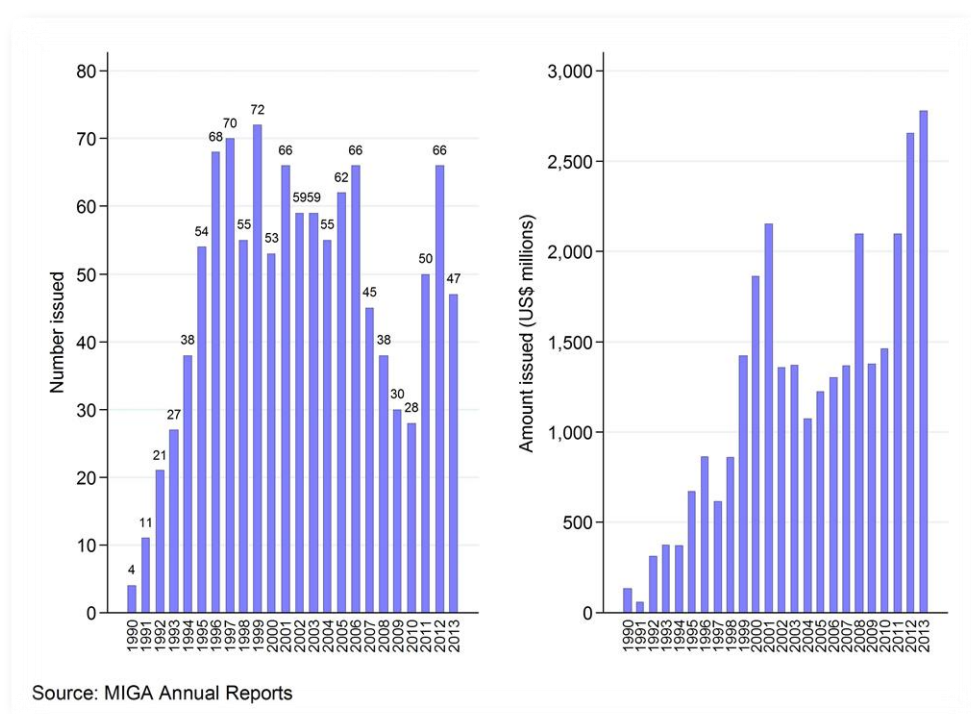
MIGA was created with the specific and sole purpose of providing PRI for cross-border FDI. Eligible FDI transactions were limited to equity or equity-linked investments (as opposed to commercial loans or bonds), and were insured against political risks including war or civil conflict, expropriation, breach of contract, and currency restrictions. Only new projects (not expansions or privatisations) were eligible. The restrictive mandate limited the ability of MIGA to expand, due to a relatively small pool of eligible transactions and the existence of commercial providers of similar types of insurance.

In 2009, MIGA reformed its convention to broaden its product offer, in particular through the creation of the Non-Honouring of Financial Obligation (NHFO) instrument (expanded to include state-owned enterprises in 2013). NHFO covers borrowings made by sovereign or sub-sovereign entities against non-repayment. As with standard PRI, NHFO covers private sector actors against loss, but in this case they are lenders (mainly commercial banks) or bond-holders, rather than equity investors, and a governmental institution is the borrower. This new instrument is much closer in nature to the PCGs offered by IBRD/IDA for sovereign borrowers, but in MIGA's case does not require a sovereign counter-guarantee and is priced on a market basis.

Evolution over time. As a result of the new NHFO as well as other operational changes undertaken in the 2009 reform, MIGA has since grown rapidly (Figure 11), with more and higher-value operations than predicted by its own FY12-14 strategy. In FY13, 64% of MIGA's US\$2.8 billion in operations was generated by products that would not have been possible prior to the 2009 reform, including (1) US\$829 million of NHFO (30% of total), (2) US\$179 million stand-alone PRI coverage of debt (6%), (3) US\$754 million for coverage of existing investments (27%), and (4) US\$298 million of short-term business interruption coverage (11%).²⁹ Interest in the NHFO instrument has grown steadily, and in 2013 MIGA issued its first NHFO covering a sovereign bond issue (for Hungary), a business line it intends to expand going forward.

²⁹ See MIGA (2014).

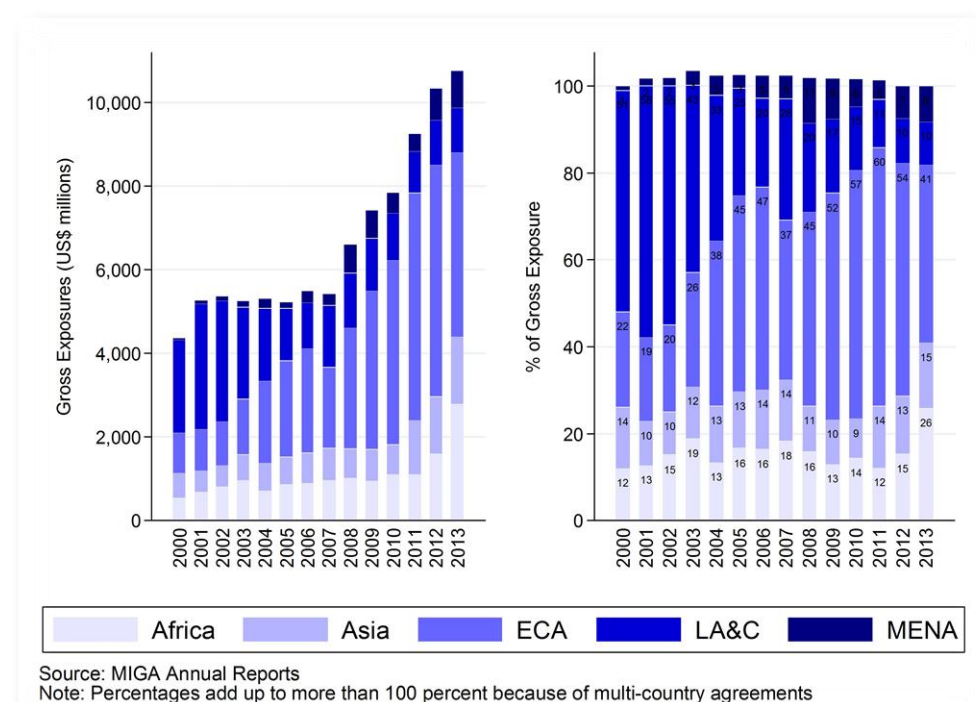
Figure 11: MIGA guarantee issuance, 1990-2013



One unique aspect of MIGA's business is the extent to which it seeks reinsurers for a portion of its guarantee portfolio. For example, of the US\$2.8 billion in guarantees issued in FY13, US\$1.3 billion was ceded to MIGA reinsurance partners, and of the US\$10.8 billion gross guarantee portfolio, US\$4.4 billion was ceded to reinsurers. These insurers are both private companies and official agencies supporting MIGA's activities through their own balance sheet. This permits MIGA to continue expanding guarantee activities despite the limitations posed by its own capital structure.

Geographic distribution. Since 2000 there has been a notable shift in the regional focus of MIGA's operations (Figure 12). In the early 2000s, Latin America and the Caribbean region accounted for more than half of MIGA activity, but this has since declined sharply to only about 10% of the outstanding portfolio and 3% of new project volume in FY13. By contrast, Europe and Central Asia has risen from about one fifth to roughly half (40-60% in FY11-13) and Sub-Saharan Africa's share has more than doubled to 26% of portfolio and 54% of the volume of new operations in FY13. Guarantee activity in Asia and the Middle East/North Africa has also grown, but not as sharply. A relatively high share of MIGA's activity takes place in less-developed and riskier countries, as opposed to more-developed middle-income countries. In FY13, nearly three quarters of the volume of MIGA operations were in IDA-eligible countries, and 41% of the volume was in conflict-affected countries. MIGA's PRI activity, in particular, is focused on countries with risk ratings below investment grade (BB and below). MIGA has a stated operational priority in targeting IDA and conflict-affected countries, as well as achieving a better regional balance in its operations (see MIGA 2014, pp. 7-10). Working in lower-income countries is in some senses easier for MIGA, because its main business is to guarantee equity investment rather than debt. As discussed in Section 3 above, guarantees for debt tend to be more frequently attractive in larger middle-income developing countries.

Figure 12: MIGA's gross exposure by region, 2000-2013

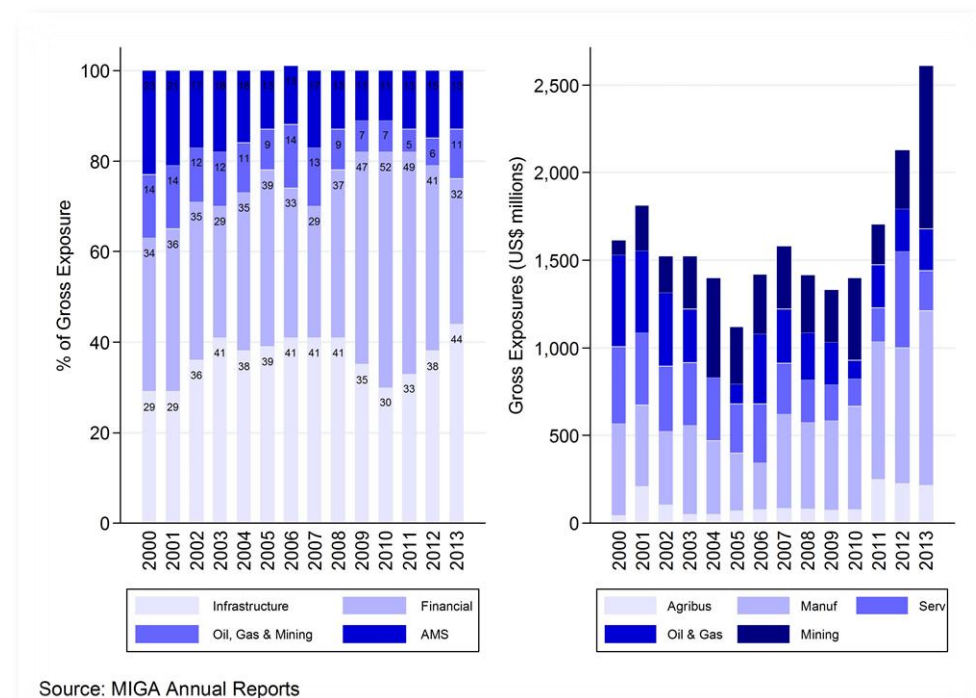


Sectoral distribution. By contrast, the sectoral shares of MIGA's gross exposure have remained relatively stable over time, with the infrastructure and financial sectors dominating (Figure 13). The infrastructure sector's share grew to 41% in 2008, declined slightly in 2009 and 2010, and has since recovered. The financial sector was the beneficiary of the decline in infrastructure guarantees, expanding its share of gross exposure to 52% in 2010 from a low of 29% in 2007, which suggests that MIGA like many of the world's central banks was active in its efforts to inject liquidity into the financial system during this period. Within the smaller agriculture, manufacturing and services,³⁰ and extractive industries sectors, the mining

³⁰ Includes tourism, construction and other services.

subsector has been the main mover with its portfolio growing by 177% on an annual basis to US\$0.9 billion in 2013.

Figure 13: MIGA's gross exposure by sector, 2000-2013



Institutional arrangements. The fact that MIGA is focused exclusively on guarantees gives it certain organisational advantages over other MDBs. As one staffer at another MDB commented, ‘At MIGA everyone lives and breathes guarantees’, whereas most staff at MDBs have little understanding of what guarantees are or how they should be used. MIGA’s operational focus ensures clarity of organisational purpose as well as an ability to design the organisation to best suit the use of guarantees, rather than adapting a guarantee instrument onto an organisation designed mainly for lending operations. Administrative costs³¹ are much lower as a share of the total portfolio than at other MDBs. For example, every US\$1 in administrative costs supported US\$256.7 in gross portfolio at MIGA in FY13, compared to US\$83.9 at IBRD.

MIGA is also able to leverage its shareholder capital further than MDBs since it uses a more granular approach to capital allocation based on individual project risk and market-based pricing. In FY13, every US\$1 in MIGA capital supported US\$5.41 in guarantees on MIGA’s books, compared to about US\$3 for most of the major MDBs. At the same time, it has the governmental access and reputation of being part of the World Bank Group, which enables it to be quite effective in mediating disputes and limiting guarantee calls. Since inception, only six guarantees have been called for a total of US\$16 million in claims. MIGA also benefits from the ‘umbrella’ of IBRD’s AAA bond rating, which gives MIGA guarantees more credibility with private actors than it might otherwise have, since it has no bond rating of its own.

Reforms and future trends. MIGA has ambitious growth expectations of 10% annually in the coming years, based on increased demand following the 2009 operational reforms. No major reforms are expected going forward, but MIGA is

³¹ Administrative costs at different organisations are rarely directly comparable, but do nonetheless give a sense of scale.

launching pilot initiatives. One involves the ability to ‘strip’ a guaranteed bond into two separate instruments – the part guaranteed by MIGA (up to 95% of the face value) and the remainder based on the risk of the issuer. This would allow the two instruments to find their ‘natural’ investor base. Additionally, MIGA is currently experimenting with an exposure exchange arrangement with IBRD wherein the two organisations exchange exposure on their books to maximise the overall World Bank Group balance sheets and shareholder capital usage. Lastly, the creation and growth of the NHFO instrument and the ongoing restructuring at the World Bank Group may require greater coordination between MIGA and its sister institutions (IFC, IBRD and IDA), which has until recently been limited.

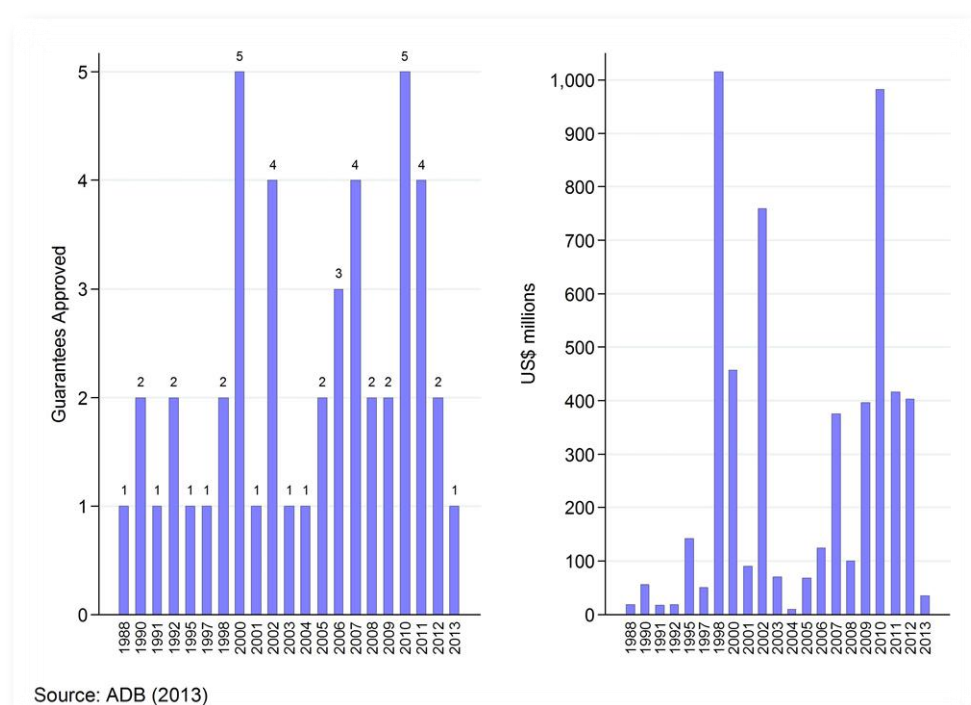
1.4 Asian Development Bank (ADB)

ADB first issued a guarantee in 1988, and its policy on guarantees for development was last updated in 2006. Similar to both the IADB and AfDB, ADB can finance both private and public sector entities out of its non-concessional lending window, and therefore it is able to offer guarantees equally to governments and private business. It offers both PCGs and PRGs,³² and although it does not have a specific policy-based guarantee, such an instrument could be issued as a conditional PCG (although it never has, to date). PRGs are mainly intended for private investors or institutions, although a public institution running on a commercial basis can also benefit. PCGs to public sector borrowers require a counter-guarantee from the respective government, while PCGs to the private sector do not require a counter-guarantee (PRGs generally come with a government counter-guarantee, due to the political nature of risk).

ADB only issues guarantees out of its non-concessional Ordinary Capital Resources (OCR) window, although it can direct guarantees to lower-income concessional countries. Unlike those from World Bank Group entities and AfDB, PCGs from ADB can cover up to 100% of principal and interest in special cases. However, it is preferred to only guarantee the amount necessary to mobilise the financing for a project. Since ADB launched a trade finance programme in 2004 it has grown rapidly, covering US\$4 billion in finance in 2013.

³² In the case of ADB, ‘PRG’ stands for ‘political risk guarantee’ rather than ‘partial risk guarantee’ as at IBRD, IDA, IADB and AfDB. The instrument is fundamentally the same.

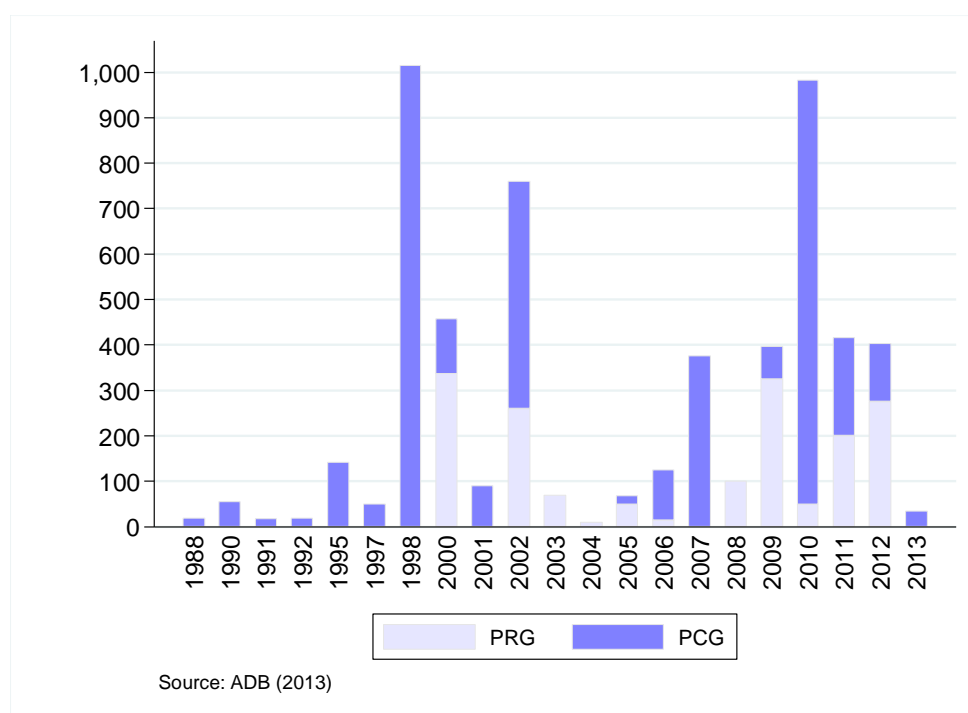
Figure 14: ADB non-trade related guarantees, 1988-2013



Evolution over time. Between 1988 and 2012, a total of 46 guarantees were approved for US\$5.6 billion, of which 21 were sovereign-guaranteed and 25 non-sovereign. All guarantees are issued out of the non-concessional OCR lending window, although US\$2.1 billion were in concessional ADF countries. The use of guarantees rose sharply in the wake of the Asian financial crisis of the late 1990s, then tapered off in the mid-2000s, and rose again sharply in 2010-2012 – a pattern similar to the other institutions analysed in this report (Figure 14). The value of guarantees approved since 2010 is 32% of all guarantee value since ADB began guarantees in 1988. As with IFC, and for the same reasons, a large majority of ADB guarantees cover borrowing in local currency, which facilitates ADB's ability to provide local currency financing in countries where loans are impractical.

By instrument, 30 PCG operations have been approved since 1988, compared to 16 PRGs, and the value of value PCGs is also much higher, a trend that has remained relatively constant for the past decade (Figure 15). More non-sovereign operations have been approved by ADB (25 compared to 21 sovereign), but their total value is lower (US\$2.3 billion vs US\$3.3 billion sovereign). Of the 46 operations approved, only one (a PCG) has been called, for a total payout of US\$150,000.

Figure 15: ADB non-trade related guarantees by instrument, 1988-2013



Geographic distribution. The recent focus (2010-2013) of ADB guarantees has been on Thailand, the Philippines and South Asian countries such as Pakistan and India (Figures 16 and 17). Staff attributed this to a variety of factors, including the Southern Asia team's particular concentration on promoting guarantees as a useful instrument in recent years. Southeast Asian countries have used guarantees in previous years, and will likely continue to do so. However, the strong demand for energy generation projects – especially coal-fired power plants – is a limitation because ADB cannot finance these projects. The Pacific region has relatively little FDI and projects are much smaller, meaning scale can limit the usefulness of guarantees in that region. This may call for the creation of a regional guarantee facility rather than individual operations, although ADB does not currently have plans to implement such a facility.

Figure 16: ADB non-trade related cumulative guarantee amounts by region, 1988-2013

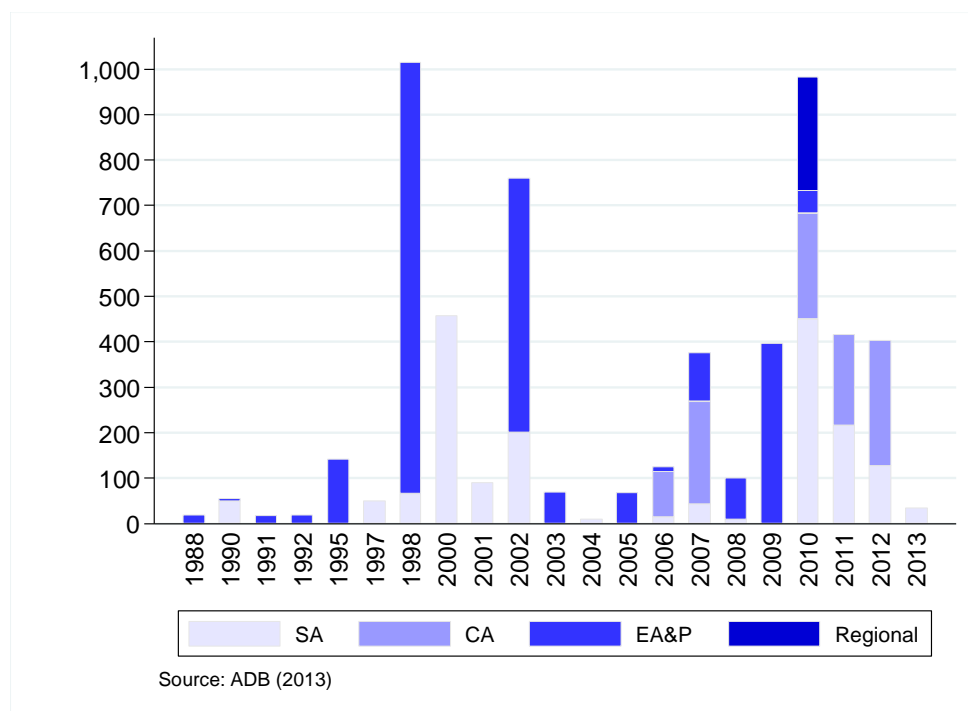
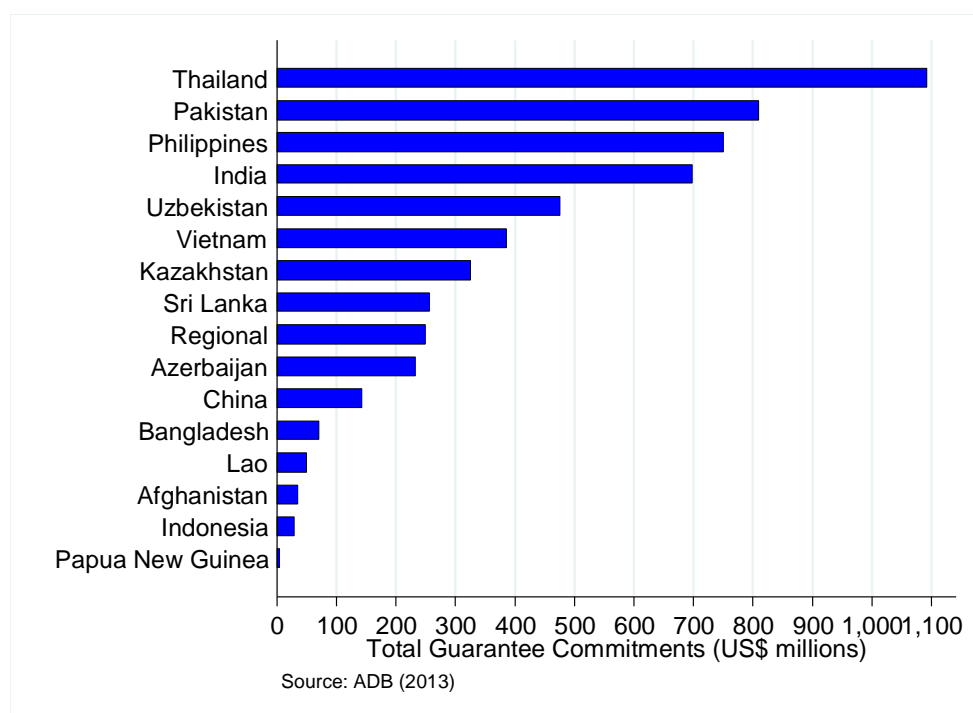
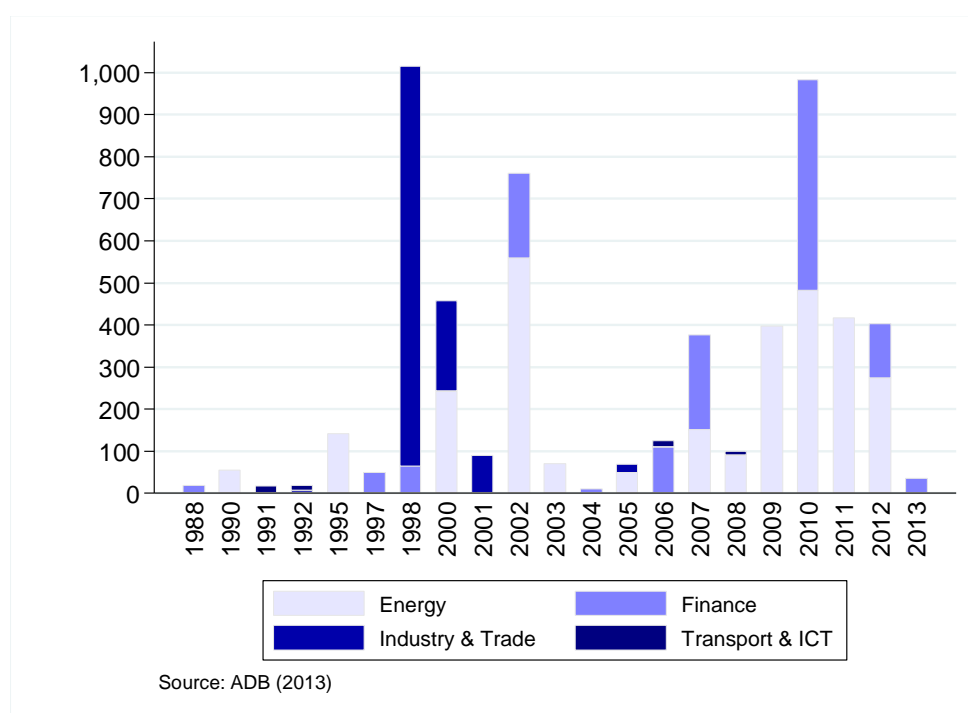


Figure 17: ADB non-trade related cumulative guarantee amounts by country, 1988-2013



Sector distribution. ADB has a high share of guarantees oriented towards major infrastructure projects, in particular electric power generation (Figure 18). This is similar to IBRD/IDA and (to a lesser extent) MIGA, but different from IFC and IADB. Of the 11 guarantees approved between 2010 and 2012, for a total of US\$1.8 billion, two thirds of the guaranteed value (US\$1.2 billion) went to electricity generation projects, while the remainder was directed towards the financial sector (mainly for portfolios of loans to SMEs). This trend has held true since the start of ADB's guarantee programme, with a preponderance of projects in energy, followed by the financial sector, and others in industry and transport infrastructure.

Figure 18: ADB non-trade related guarantees by sector, 1988-2013



Institutional arrangements. The responsibility of guarantees is in the hands of a small team (two full-time staff) in the Guarantees and Syndications Unit of the Private Sector Operations Division, which in 2012 was relocated from the Office of Cofinancing. Due to the nature of guarantees – involving extensive interaction with private sector investors – this was seen as a more logical institutional setting, in contrast to the more official orientation of other co-financing operations. The unit is the single focal point on guarantee operations for both private and public sector operations, which may help generate awareness of the product among both staff and government officials.

Reforms and future trends. ADB has begun to experiment more widely with the use of reinsurance on its guarantee portfolio: moving part of a transaction off its own portfolio to a third-party insurer (private or public). The trade-off of reinsuring operations is that while ADB gives up some of the income it would normally earn, it can engage in a much larger transaction than it otherwise could. A new policy modification further incentivises the use of reinsurance by granting relief in the amount of equity capital ADB must set aside to back each guarantee transaction. Previously, ADB had to set aside the full amount of equity capital, regardless of reinsurance, but now it gains 95% equity capital relief for reinsurance with AAA reinsurers (like bilateral aid agencies such as SIDA, Australian Department of

Foreign Affairs or DfID) and 80% for AA- or above (including some other bilateral donors and many private insurers). This reduces the amount of equity capital that must be allocated, freeing up more operations both in a country portfolio and at the aggregate level.

A second innovation that had been contemplated was the use of the ADF concessional lending window to issue guarantees, as can the concessional windows of the World Bank, IADB and AfDB. A policy proposal in this direction was developed, but the recent discussions at ADB around merging its concessional and non-concessional lending windows have put that on hold, and are likely to make the issue moot.

1.5 Inter-American Development Bank (IADB)

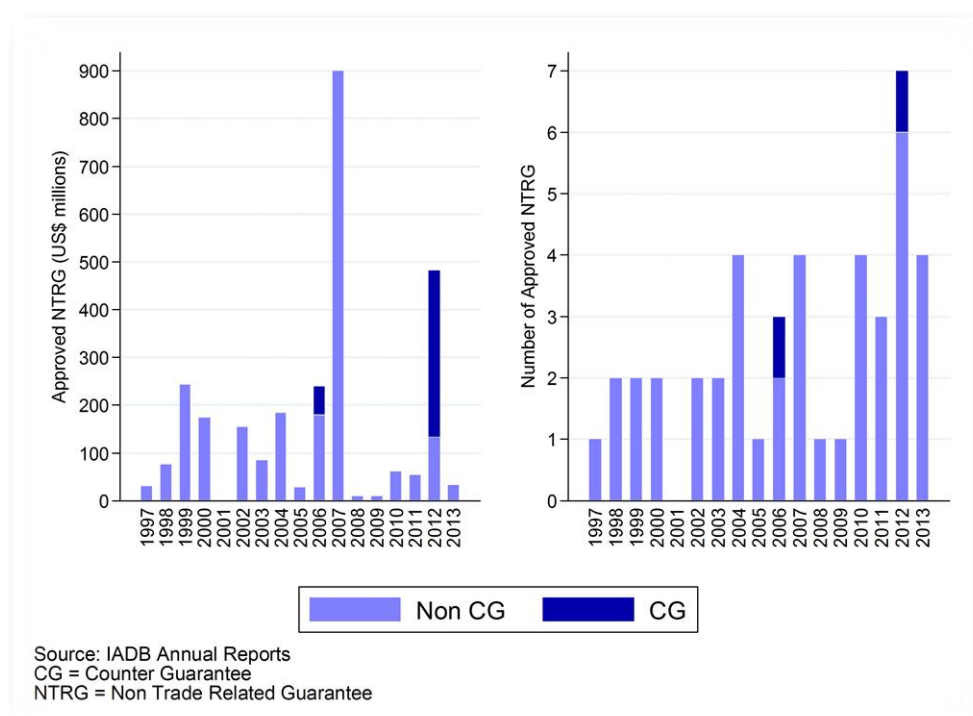
The IADB first implemented a policy on guarantees in 1995, which covered both PCGs and PRGs. The instrument was principally intended for private sector operations, although policies for public sector borrowers were also included.³³ In line with that goal, the great majority of operations between 1995 and 2013 have been with the private sector. Guarantees offered to sovereign borrowers require a counter-guarantee from the government to the IADB, while those to the private sector do not. The IADB has not used guarantees extensively in its operations. In 2012, non-trade guarantee commitments represented only 4.5% of total commitments.

Only three guarantees have been issued to a public sector borrower in the history of the IADB: two PCGs to Peru (US\$60 million) and Guyana (US\$2.5 million) in 2006, and a policy-based guarantee (PBG) to Panama (US\$350 million) in 2012. All other guarantees have been to private sector borrowers without a sovereign guarantee. As can be seen in Figure 19, the volume of IADB guarantees has fluctuated widely in recent years, with two spikes, the first in 2007³⁴ (likely attracted by the drying up of capital markets at that time) and the second in 2012 (driven by the large Panama PBG that year). Up to the end of 2013, no IADB guarantee had ever been called. By all accounts, the use of guarantees for sovereign borrowers was strongly and negatively impacted in Latin America by the Argentina default in 2001 and the resulting call on an IBRD guarantee. Nonetheless, the IADB has opened the door to providing guarantees as part of a sovereign debt restructuring in its new guarantee policy (2013).

³³ IADB, 2013, p. 6.

³⁴ This spike was caused by a number of large-scale private sector projects including toll roads in Mexico (\$US400 million), an energy project in Brazil (\$US200 million), a financial sector guarantee in Peru (\$US100 million), and a regional road project (US\$200 million).

Figure 19: IADB non-trade related guarantees, 1997-2013



Geographic distribution. Mexico and Brazil – the two largest IADB borrowing member countries that have the deepest capital markets – have received by far the most number of guarantees, accounting for nearly half of the total issued since 1997 (Figure 20). For the rest of the regional members, there appears to be no relationship between the size of the country and the ability to attract guarantee financing. Panama, which also has a highly liquid and dynamic capital market, ranks third in terms of volume. Borrowers in less-developed regional member countries have not found guarantees to be a useful instrument. This is due to the fact that IADB guarantees are most appropriate for borrowers seeking access to local currency financing on domestic bond markets, which automatically limits the use of the instrument to countries with reasonably well-developed capital markets. Cost savings are limited or non-existent for borrowers seeking commercial bank loans or international bond issues (as discussed in the subsequent section), meaning guarantees are of little use in those cases.

Figure 20: IADB guarantee amounts by country, 1997-2013

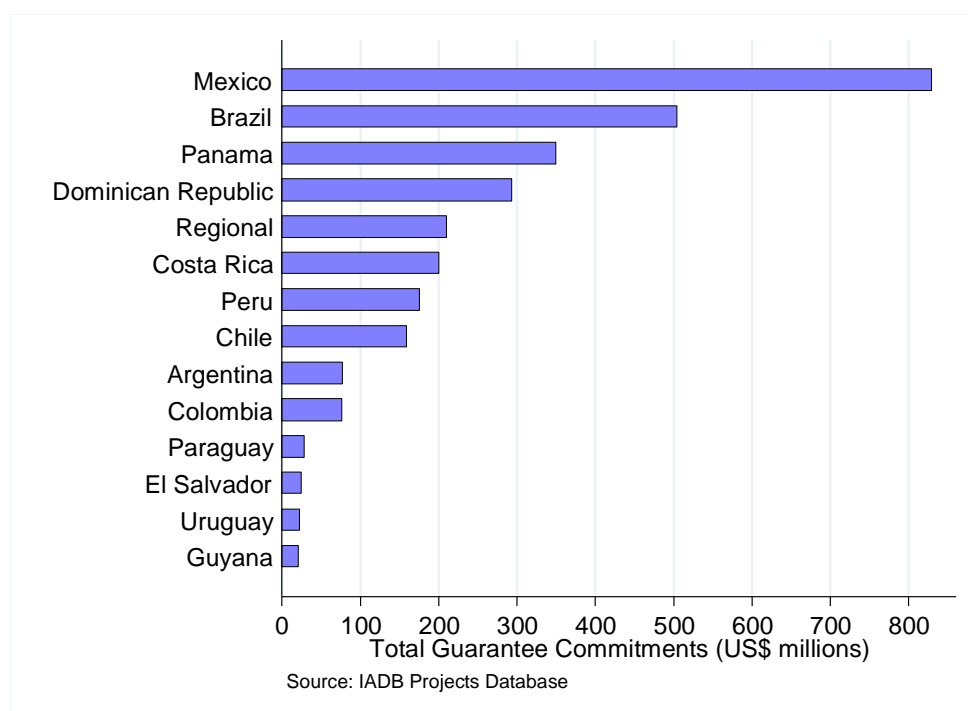
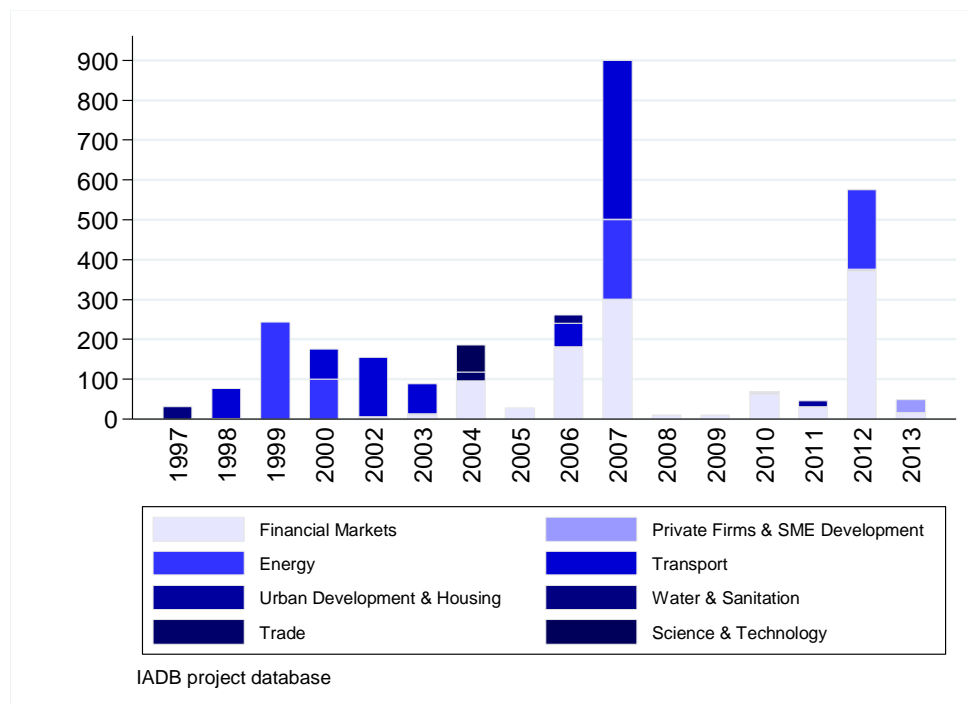


Figure 21: Sectoral distribution of IADB guarantees, 1997-2013



Sector distribution. The distribution of IADB guarantees has been overwhelmingly to the financial sector in recent years, covering portfolios of on-lending for SMEs, low-income housing, green financing and general finance (Figure 21). In terms of instruments, staff interviews indicate that the majority of private sector guarantees since 2010 are for bond issues in local currency, and as a result have been mainly directed at non-tradable sectors that generate revenue in local currency. By contrast,

all three public sector guarantees have been to support commercial bank borrowing, not bond issues. Since 2010, the IADB has issued 15 PCGs (totalling US\$160.3 million) and one PBG (US\$350 million), and no PRGs have been employed. According to operations staff, the PRG is viewed as a less useful instrument by borrowers.

Institutional arrangements. Organisationally, the IADB staff who manage private sector and trade guarantees are housed in the Private Sector Vice-Presidency, in the Structured and Corporate Finance Division. The IADB is currently considering ‘merging out’ its private sector activities to a separate balance sheet institution (possibly building on the existing but small Inter-American Investment Corporation), which could entail a reorganisation of the guarantee staff within a new institution. The public sector wing of the IADB does not have any dedicated staff for guarantees, and this may possibly be a cause of the very limited use of public sector guarantees thus far. Guarantee operations originate out of the Capital Markets Division. In light of the apparent renewed emphasis on public sector guarantees embodied in the new policy (see next paragraph), a dedicated staff may be required going forward if operations ramp up.

Reforms and future trends. The IADB reformulated its policy for sovereign guarantees in late 2013, the first update since the guarantee policy was established in 1995. Policies for guarantees are now established from both the Ordinary Capital lending window for middle-income countries, and the Fund for Special Operations (FSO) lending window for less-developed countries (from which only 4 out of 26 member countries have access). The update also formalises the creation of a policy-based guarantee (PBG), which was used on an exceptional basis for Panama in 2012 for the first time. As with policy-based lending, PBGs were limited to 30% of total lending to each country over 2011-2014. The policy also opens the door to covering 100% of principal and interest in some cases for a sovereign guarantee. Because the policy implementation has just started, it is not yet clear whether it will have a significant impact on generating greater interest in guarantees among sovereign borrowers in light of the very limited use of the instrument thus far.

1.6 African Development Bank (AfDB)

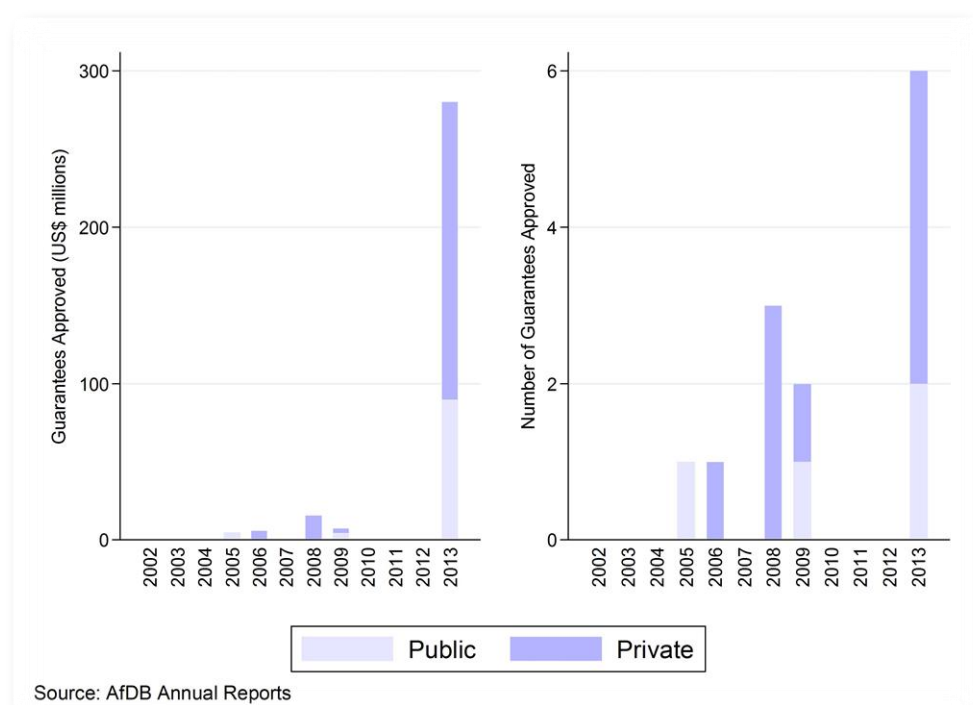
The AfDB launched a pilot programme for guarantees in 2000 with a cap of UA 750 million³⁵, and issued the first in May 2000. A formal guarantee programme focusing on PCGs was introduced in 2004, and a PRG followed in 2012. By and large, the AfDB follows the policies of IBRD/IDA with respect to the requirements and conditions linked to its guarantees, including the set-aside fund for 75% of country exposure.

Evolution over time. The AfDB guarantee programme remains relatively small, with only seven guarantees approved between 2002 and 2012 totalling just US\$34 million (Figure 22).³⁶ However 2013 saw the approval of six guarantees – two public and four private – amounting to US\$280 million in total.

³⁵ UA is the AfDB’s unit of account.

³⁶ Staff interviews indicate that a guarantee instrument will form part of AfDB’s financial package of support for the Lake Turkana Wind Farm project in Kenya, along with a loan syndication. The \$US20 million PRG is funded out of the ADF concessional window, and had not been finalised at last report.

Figure 22: AfDB guarantees, 2002-2012



Institutional arrangements. The AfDB has no dedicated staff focusing on promoting guarantee instrument usage in operations, despite the fact that it has had a formal guarantee policy in place since 2000. This reflects both the very small size of guarantee operations thus far and the fairly limited emphasis the bank has placed on their usage thus far. The *de facto* lead person for guarantees is based in the Treasury, although the private sector team is also attempting to build expertise in guarantee usage (including a recent guarantee as part of a larger syndication project for a wind farm in Kenya).

Although guarantee usage by the AfDB has been minimal, the bank did undertake one transaction that is unique among the MDBs reviewed here. In 2009, the bank approved a policy-based PCG as part of a debt-restructuring operation for the Seychelles. The US\$10 million instrument is a 16-year rolling, non-reinstatable guarantee. A rolling guarantee is ‘rolled over’ from one guarantee payment date to the next – as long as it is not called – until the agreement expires. MDBs have generally avoided utilising guarantees for debt restructuring for fear that they could open themselves up to legal difficulties involving creditors.

Annex 2: Guarantees for trade finance

International trade transactions are regularly carried out using instruments such as a letter of credit (LC) and similar financial products. These instruments guarantee the seller (exporter) that payment will be made once it has documented evidence of delivery. In regular transactions (Figure 23), a seller obtains an LC from the bank of the buyer (the issuing bank) on the basis of the sales agreement with the buyer, who is a client of the issuing bank. The LC is an agreement between the seller and its bank (the confirming bank), and the buyer and its bank (the issuing bank). After supplying the buyer with the good or service, the issuing bank then makes payment to the seller regardless of whether or not the buyer has made funds available for payment.

The LC and similar instruments transfer risk from the seller to the issuing bank based on trust that is built up through existing relationships. The issuing bank trusts that the client of the confirming bank will make good on its commitment to deliver goods or services, and the confirming bank trusts that the client of the issuing bank will make good on its commitment once the goods or services have been delivered.

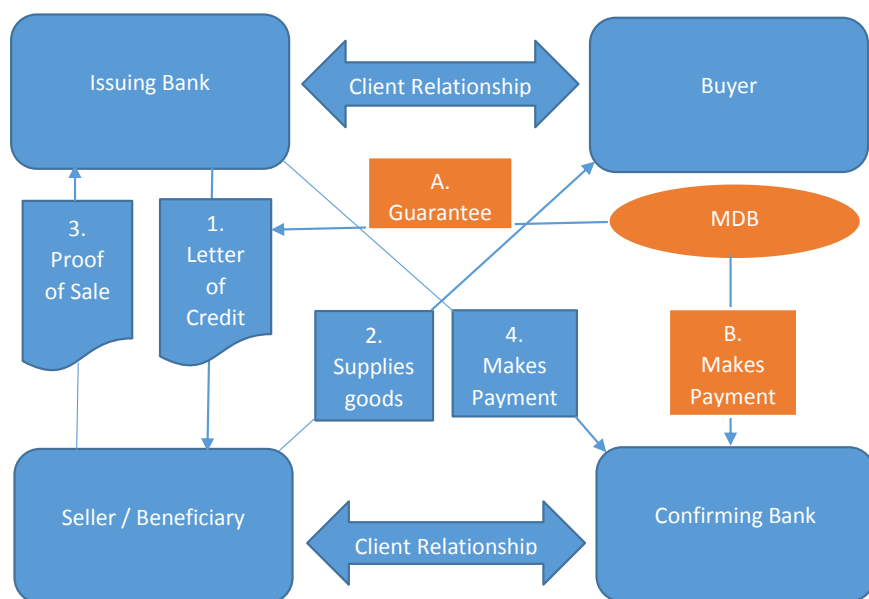
Banks in developing countries do not enjoy these relationships with banks in other countries or with their clients. Therefore it is difficult for an importer in a developing country to import goods without making payment up front. It is similarly difficult for an exporter in a developing country to access export finance, because the buyer on the other side of the transaction cannot obtain an LC from its own bank, which the exporter can use as collateral for short term financing from its own bank. In other words, there is a market failure due to asymmetric information. Neither bank knows enough about the other and its clients to be involved in a trade finance transaction involving an importer or an exporter in a developing country.

MDBs can play a role in correcting this market failure by guaranteeing the LCs issued by the bank of an importer (Figure 23). Under trade finance guarantee programmes, the MDB will guarantee LCs issued by banks (both issuing and confirming) that have qualified for the programme through appropriate due diligence. In the event that an issuing bank reneges on its obligation to make payment, the MDB will step in and make payment to the confirming bank of the seller (beneficiary). Therefore the seller and its bank has comfort (or collateral) against the risk of the buyer not paying, and secondly comfort against the risk of the buyer's bank failing to meet its payment obligation under the LC through the guarantee of the MDB.

While MDBs had considered various ways to facilitate trade transactions in the past, it was the European Bank for Reconstruction and Development's (EBRD) model for trade finance, begun in 1999, that accelerated the process. The EBRD created a system by which banks are pre-qualified for the programme and 100% of the transactions are guaranteed (unlike project guarantees). This model involves

having the MDB board approve a certain ceiling on the programme, but then allowing individual transactions to be approved very quickly (under 48 hours) by management, without requiring further board review. Other MDBs have generally followed the EBRD model in creating their programmes.

Figure 23: Trade finance schematic with and without guarantee



The IFC Global Trade Finance Program (GTFP) is considerably larger than those of the regional MDBs. GTFP began operations in 2006 and has grown very quickly, totalling nearly 40% of IFC commitments in FY2012. Unlike PCGs, GTFP guarantees usually cover 100% of a designated portfolio and are usually short-term instruments (less than six months, though allowable for up to three years) that roll over multiple times. While the programme has been highly successful in growing quickly with low risks to IFC capital, the extent of its developmental impact has been questioned. The World Bank IEG's review of the GTFP pointed out that while the programme dedicated 74% of operation value to low-income countries in FY06, that share had declined steadily to only 8% in FY12.³⁷ While the overall volume of financing to lower-income countries had not declined, the vast majority of new business as the GTFP has grown has been in middle-income countries. To strengthen development impact, the IEG report recommends increasing the share of trade financing to lower-income, higher-risk countries.³⁸

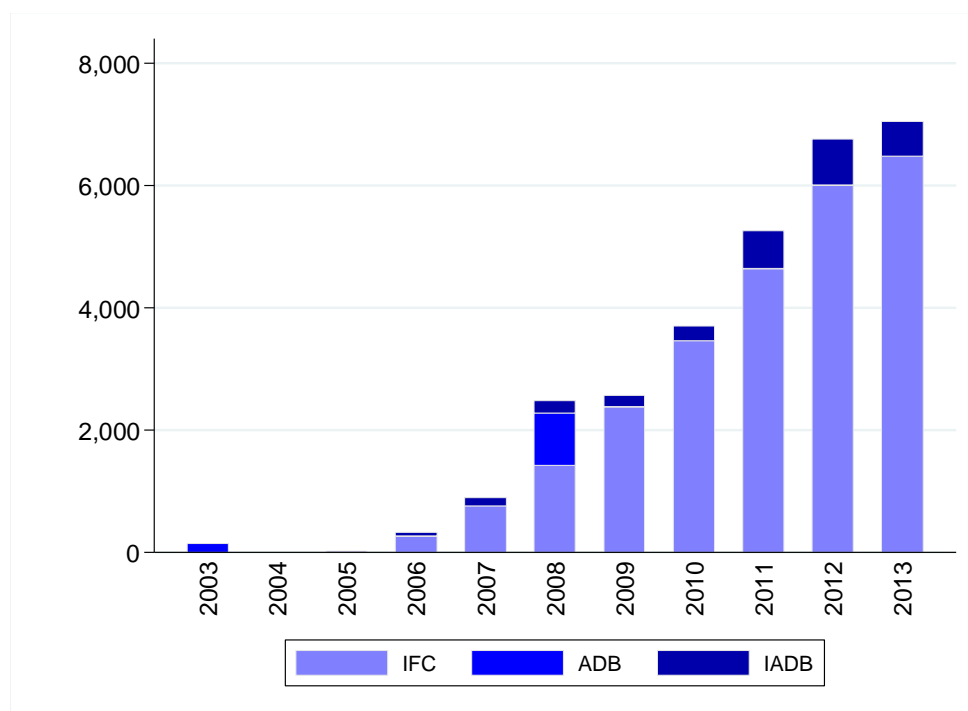
ADB launched its trade finance program (TFP) in 2003, approving US\$150 million that year and a further US\$850 million in 2009. Between 2009 and 2013, the TFP has supported over US\$16 billion in transactions using both guarantee and funded products. Credit guarantees account for 75% of current TFP transactions, with the remainder made up of Risk Participation Agreements (covering 50% of bank risk for trade transactions) as well as the Revolving Credit Facility to make direct loans to banks for trade transactions.

³⁷ IEG, 2013, p. 23.

³⁸ IEG, 2013, p. 71.

The IADB's Trade Finance Facilitation Programme (TFFP) covers 100% of eligible transactions, offering Standby Letters of Credit between member country banks and international issuing banks to support eligible trade transactions. Unlike IFC, the IADB's TFFP issues loans as well as guarantees for trade, and of the total US\$1.2 billion in TFFP financing in 2013, US\$645 million was in loans and US\$555 million was in guarantees. As of early 2014, 21 out of 26 member countries had local banks participating in the programme. Volume of approvals is very high, but because the guarantees are short term (maximum 180 days), this high approval level has less of an impact on the overall guarantee and loan portfolio as longer-term non-trade guarantees.

Figure 24: Trade finance commitments (IFC, ADB, IADB) 2003-2013



Source: IFC, ADB, IADB Annual reports

The AfDB initially joined IFC's GTFP, but in 2013 the AfDB launched its new Trade Finance Programme. Guarantees are expected to represent about 70% of total transactions, with loans making up the remainder. In the first five months of implementation (July to December 2013), the programme issued US\$450 million in trade finance guarantees. The programme's goal is to support over US\$10 billion in trade transactions during the first four years of activity.



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