

MODERNIZING THE WORLD BANK'S
OPERATIONAL POLICY ON GUARANTEES:
APPROACH PAPER

OPERATIONS POLICY AND COUNTRY SERVICES

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ABBREVIATIONS AND ACRONYMS

AFR	Africa Region
BDM	Banking and Debt Management
BP	Bank Procedure
CAS	Country Assistance Strategy
CODE	Committee on Development Effectiveness
DPL	Development Policy Lending
DSF	Debt Sustainability Framework
ED	Executive Director
EM	Emerging Market
ERPA	Emission Reduction Purchase Agreement
FDI	Foreign Direct Investment
FEU	Finance, Economics and Urban Development
FY	Fiscal Year
GDP	Gross Domestic Product
HIPC	Heavily-Indebted Poor Country
IBRD	International Bank for Reconstruction and Development
ICR	Implementation Completion Report
IDA	International Development Association
IEG	Independent Evaluation Group
IFC	International Finance Corporation
IPP	Independent Power Producer
ISR	Implementation Status and Results Report
MDRI	Multilateral Debt Reduction Initiative
MIGA	Multilateral Investment Guarantee Agency
MOU	Memorandum of Understanding
NCBP	Non - Concessional Borrowing Policy
OP	Operational Policy
OPCS	Operational Policy and Country Services
ORAF	Operational Risk Assessment Framework
PBG	Policy-Based Partial Credit Guarantees
PCG	Partial Credit Guarantees
PPIAF	Public-Private Infrastructure Advisory Facility
PPP	Public Private Partnership
PRG	Partial Risk Guarantees
PRI	Political Risk Insurance
PRSP	Poverty Reduction Strategy Paper
RMI	Political Risk Mitigation Instrument
TRE	Treasury
SDN	Sustainable Development Network
SOE	State-owned Enterprise
WBG	World Bank Group

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APPROACH PAPER

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APPROACH PAPER

EXECUTIVE SUMMARY

1. **This Approach Paper outlines a comprehensive reform of the World Bank's operational policy on guarantees.** Mobilizing private sector financing for infrastructure and other investments needed for sustainable development and poverty reduction is a core task of the World Bank Group (WBG). Bank guarantee operations are a small share of the Bank's portfolio, but they have been effective in mobilizing greater private financing for critical projects and programs. Management believes that there is further potential for guarantees to mobilize private sector financing for development purposes. For this reason, the Approach Paper reviews a comprehensive set of operational policy issues and presents a possible approach to revising key operational policy provisions. It reflects guidance provided by members of the Committee on Development Effectiveness (CODE)¹ and is intended to be the basis for consultations with external stakeholders. Following the consultations, Management will present to the Board a full policy paper which will attach a new draft OP/BP 14.25, *Guarantees*.

2. **Modernizing the Bank's operational policy on guarantees is part of a broader agenda to realize the potential of Bank guarantees.** This paper focuses on the operational policy issues regarding guarantees, which Management considers an important part of a broader agenda to realize the full potential of the instrument. Management has taken or is exploring a number of complementary actions to address obstacles to the greater use of guarantees. This broader agenda will be developed as part of the upcoming WBG Infrastructure Strategy FY12-15.² Possible complementary actions include the following, many of which have already been initiated: (a) counting guarantee exposures only partially against the Bank's total possible lending to a country, in order to incentivize client demand; (b) internal corporate review processes of guarantees aligned with those for lending operations; (c) options for scaling up preparation of public-private partnership (PPP) projects which benefit from guarantees, including by providing greater resources for project preparation; (d) improved development and deployment of staffs with the required specialized skills; and (e) strengthened WBG coordination and collaboration, including on outreach to clients on the financial solutions the WBG can provide.

3. **Guarantees are currently one of the Bank's three development finance instruments, distinct from and complementary to investment lending and**

¹ CODE is a standing committee of the World Bank's Board of Executive Directors. Its mandate is to monitor and assess the Bank Groups' effectiveness in fulfilling its development mandate.

² The members of CODE have endorsed the concept note for the infrastructure strategy paper. See *World Bank Group Infrastructure Strategy Update—Issues and Concept Note*, CODE2011-0030/1, June 15, 2011.

development policy lending³. There are essentially three guarantee options under the Bank’s guarantee instrument: (a) partial risk guarantees (PRGs), which cover debt service defaults on commercial debt, normally for a private sector project, when such defaults are caused by a government’s failure to meet specified contractual obligations to the project; (b) partial credit guarantees (PCGs), which cover debt service defaults on a specified portion of commercial debt, normally for a public sector project; and (c) policy-based guarantees (PBGs), which are partial credit guarantees to help borrowers access external financing for general budgetary borrowing associated with policy and institutional reforms. All options are available to IBRD-eligible countries, but currently only PRGs are available to IDA-only countries. All World Bank guarantees require the member’s counter-guarantee.

4. **Operational policy reforms are needed to adjust the guarantee instrument in light of significant market developments and lessons learned from past guarantee operations.** The emerging markets have dramatically expanded since the 1990s, when the Bank’s guarantee operational policies were largely established. As a result, market access has significantly improved for many developing countries, particularly middle income countries. This suggests that demand for Bank guarantees may increasingly be found lower down the income spectrum or for transactions in complex or new sectors such as clean energy. Lower income and higher risk countries continue to need guarantees for mobilizing private resources to meet their large development financing requirements, particularly for energy and infrastructure. The Bank can be a strong guarantor for reasons that include its special relationships with governments and its capacity to absorb and spread risks as a large multilateral institution with a highly diversified portfolio.

5. **Private financing would help meet large development financing needs, but it is critical that commercial borrowings are adequately assessed and managed.** Ensuring prudent borrowing and appropriate debt management is particularly critical for lower income countries which have lower institutional capacity and less experience with commercial borrowing. Historically, developing countries have been more vulnerable to debt crises. While they demonstrated improved resilience during the recent global financial crisis, in the case of IDA-only countries part of this can be attributed to the significant HIPC and MDRI debt reliefs they had received, which was necessitated by previous unsustainable debt accumulation. Capital inflows can bring important investment and growth benefits, but this can only occur if the countries have appropriate institutions and adequate capacity to absorb and manage the resources.

6. **The proposed policy reforms aim to streamline and consolidate the guarantee policies and remove restrictions which unnecessarily constrain the use of guarantees.** The policy reforms will streamline and consolidate the current policies which are distributed across a sizable number of Board papers, clarifying or removing certain policy provisions, rationalizing or integrating others, and harmonizing policy provisions that vary unnecessarily among guarantee options and across IBRD and IDA

³ A fourth, “Program for Results” lending, is currently under development.

countries. The thinking on investment and policy-based lending has evolved since the establishment of the guarantee policies, necessitating a further alignment. The existing cross-references to other operational policies in OP/BP 14.25 will be minimized in order to produce a more self-contained policy framework, modeled on OP/BP 8.60 (Development Policy Lending).

7. **There are two main areas of reforms, the proposed extension of PCGs and PBGs to IDA-only countries and the alignment of the guarantee policies with lending policies.** The Approach Paper offers some 17 proposals, which are summarized in the table at the end of the Executive Summary. The expansion of eligibility for PCGs and PBGs to IDA-only countries would remove a major restriction in the guarantee policy. Many of the proposed reforms would further align the provisions on project-based guarantees (PRGs and PCGs) with those on investment lending, and similarly policy-based guarantees with development policy lending. Other important proposals include the risk coverage of PRGs and the financial leverage of guarantees.

8. **The proposed extension of PCGs and PBGs to IDA-only countries would be subject to such countries' prudent debt management.** There would be new eligibility requirements for IDA-only countries which would set a minimum acceptable level of debt vulnerability and capacity for debt management. The purpose is to ensure that the Bank facilitates commercial borrowing by IDA-only countries only when it is done in a sustainable manner. Various options are proposed which differ with respect to the eligibility criteria and the degree of consistency with the Bank's Non-Concessional Borrowing Policy (NCBP). Management recommends the approach which would require low risks of debt distress and adequate debt management capacity for IDA-only countries. In addition, Management proposes that such countries can become eligible for PCGs even if the new country level requirements are not met, if the underlying project supported by the PCG is expected to have strong financial returns and be able to service the guaranteed debt. Management believes this approach represents the most appropriate balance between the potential benefits and risks of extending partial credit guarantees to IDA-only countries. For partial credit guarantees to IBRD-eligible countries, IBRD's country creditworthiness and eligibility criteria would continue to be the same as for investment lending.

9. **Project-based guarantees would be further aligned with investment lending through the proposed clarification of safeguard policies, revision of the sector policy requirement and the incorporation of additional financing.** These proposed reforms would reduce a potential bias against the use of project-based guarantees. The Bank's safeguard policies apply to all projects supported by guarantees. The proposal is to fully align the requirement for the supervision of compliance with that for projects supported by investment lending. The proposal is for supervision of safeguard policies to normally end with completion of the underlying project, which is typically the case for investment lending. The Approach Paper also proposes to align the sector policy requirements for project-based guarantee operations with investment lending operations, and to explore the possibility of additional financing for project-based guarantees, which currently exists only for investment lending.

10. **The Approach Paper proposes to substantially rationalize the current eligibility requirements for PBGs and further align them with development policy loans (DPLs).** The proposals are to remove provisions that limit PBGs to external financing and require a strong track record of country performance. The removal would help align PBGs with DPLs and also with project-based guarantees, neither of which is subject to such provisions. The current requirement that PBGs must result in improved market access (greater volume of financing or longer maturities) would be retained, but the definition of improved market access would be broadened to include significant financial leverage, lower financial terms for the unguaranteed portion of the borrowing⁴, access to new sources of financing, or a combination thereof. The resulting PBG would be treated as a DPL option that is subject to streamlined additional requirements. It would be possible to formally integrate a PBG in a programmatic DPL series.

11. **For PRGs, the Approach Paper proposes a new principle for appropriate risk coverage.** The current policy states that a PRG can cover risks that are specified as government contractual obligations to a project. This statement would be retained but would be augmented by a new requirement that PRG risk coverage needs to be based on efficient allocation of risks between the public and private parties, in accordance with standard practices for project finance and as appropriate for specific project circumstances. This new principle would bring greater focus on whether a risk to be covered by the PRG is one that the government is best able to control, manage or bear. It would retain flexibility in the use of PRGs while establishing a clear principle for determining the appropriateness of the risk coverage.

12. **For all guarantee operations, the Approach Paper proposes that financial leverage be a major consideration in providing the guarantee.** Financial leverage is a standard measure of the extent to which the Bank guarantees mobilize private financing, which is a core objective of guarantee operations. Current guarantee policy requires that the Bank provide guarantees to the minimum extent necessary but it does not include an explicit requirement on leverage. By making this requirement explicit, each guarantee operation would be required to assess financial leverage, taking into account project and country circumstances and prevailing market conditions. A relatively low level of financial leverage would need to be justified by other significant and critical benefits to the country.

13. **With regards to Bank procedures, there is a need to clarify and strengthen supervision and evaluation requirements and more fully align procedures with ILs and DPLs.** The review finds that the internal processing requirements for guarantees are broadly comparable to their IL and DPL counterparts. The proposal on the supervision requirements of the Bank's safeguard policies mentioned above would address a major difference in project supervision requirements. Management plans to adopt for project-based guarantees the risk-based approach of recent IL reform initiatives, including the Operational Risk Assessment Framework (ORAF). There is a need to clarify the required

⁴ Lower financial terms refers to the implied "stripped" spread on the unguaranteed portion of the borrowing (which thereby adjusts for the effects of the protection that the Bank guarantee provides) being equal to or lower than a comparable sovereign reference spread.

content and timing of Implementation Status Reports (ISRs) and Implementation Completion Reports (ICRs), which will address weaknesses in the timely production and systematic monitoring of these reports.

14. Management intends to explore further innovations to the use of guarantees.

In a second phase of the review, Management intends to explore the possibility of extending guarantees to hedging products. Also, Management is exploring ways in which guarantees can support the financing of low-carbon projects in developing countries, possibly by guaranteeing upfront payments for the carbon revenues of such projects.

15. Alongside the revisions of the guarantees operational policy, Management intends to develop tax transparency policies and procedures for World Bank guaranteed operations. These policies are expected to be consistent with the intent of the policies that are adopted by the Board for MIGA, IFC and Treasury operations.

16. This paper serves as a basis for external consultations with relevant parties, including local and foreign investors and financiers; private and public suppliers of risk mitigation instruments; and non-governmental organizations, research institutions and government agencies. In particular, Management seeks to consult stakeholders on the following issues:

- What are your views on how the guarantee instrument can best help developing countries meet their development financing needs?
- Do you agree that the proposed policy reforms will enable better and more effective use of the Bank guarantee instrument, in a wider range of circumstances?
- Do you agree with the proposal to introduce partial credit guarantees (PCGs and PBGs) to IDA countries but only if they meet eligibility criteria which would ensure that the resulting debt is prudently managed and sustainable?
- Do you agree with the proposals further to align the policy requirements of Project-based guarantees for investment including by aligning supervision responsibilities for Bank safeguard policies?
- Do you agree with the proposals further to align the policy requirements of Policy-based guarantees with those for DPLs?
- Do you agree with the proposal to explore the possibility of extending guarantees to support low-carbon projects to combat climate change and also for hedging products?
- What other suggestions or comments do you have?

GUARANTEE POLICY REFORM OPTIONS

<i>Current Policy</i>	<i>Proposed Approach</i>	<i>Major Considerations</i>
Partial Risk Guarantees		
Issue A1: Appropriate Risk Coverage		
<ul style="list-style-type: none"> Current policy provides little guidance on the appropriateness of the risks to be covered by a PRG, and hence also by the government. 	<ul style="list-style-type: none"> Introduce a new principle that PRG risk coverage need to be based on efficient allocation of risks between the government and private parties. 	<ul style="list-style-type: none"> The proposed new principle would retain flexibility in the use of PRGs while establishing a clear principle for the appropriateness of coverage. The proposed new principle is based on the standard approach to efficient risk allocation in project finance. The new principle would supplement the existing policy on PRGs; PRGs would continue to cover debt service defaults that are caused by government's failure to meet its contractual obligations to a project.
Issue A2: Priority between IBRD Enclave Guarantees and IDA PRGs		
<ul style="list-style-type: none"> IDA PRGs may be used only if the project is ineligible for an IBRD enclave guarantee and if support from IFC and MIGA is unavailable. 	<ul style="list-style-type: none"> Option one: Maintain policy provision. Option two: Remove policy provision and make the choice between an enclave guarantee and an IDA PRG on a case-by-case basis. 	<ul style="list-style-type: none"> Option one assumes that IDA's opportunity costs are higher than those for IBRD, but this may not always be the case. Option two, which allows for an informed country-based judgment, is Management's preferred choice.
Issue A3: Enclave Guarantees and Foreign Exchange Earnings		
<ul style="list-style-type: none"> Countries are required to generate foreign exchange earnings outside the country in order to be eligible for an enclave guarantee. 	<ul style="list-style-type: none"> An enclave guarantee operation would be <i>normally</i> expected to generate foreign exchange outside the country. 	<ul style="list-style-type: none"> The proposed revision would express a clear preference for foreign exchange earning projects, but would also allow for projects that generate domestic revenues and meet additional credit enhancing requirements articulated in a recent staff guidance from Management (December 2009).
Issue A4: PRG Operations with PCG-like Features		
<ul style="list-style-type: none"> Current policy does not provide for hybrid PRG-PCG guarantee structures, which are PRG operations which include coverage for government's credit-related commitments. 	<ul style="list-style-type: none"> An operation would be allowed to provide both PRG and PCG types of coverage for a private party, if it satisfied all the operational provisions for each type of coverage. 	<ul style="list-style-type: none"> The credit guarantee provided by the government for borrowing by a private project would need to clearly justified, based on an assessment of the associated benefits and costs.
Partial Credit Guarantees		
Issue B1: Eligibility for PCGs for IDA-only countries		
<ul style="list-style-type: none"> PCGs are not available to IDA-only countries. 	<ul style="list-style-type: none"> Option one: IDA-only countries would be eligible for PCGs if they have low risks of debt distress and adequate debt management capacity. Option two: IDA-only countries would be eligible for PCGs if they have low to moderate risks of debt distress. Option three: Option one plus exemptions for projects with significant financial returns; the associated borrowing is not a significant risk to 	<ul style="list-style-type: none"> Under option one, the impact of the reform may be quite limited given that only a very few IDA-only countries may satisfy the proposed eligibility requirements. Under option two, there may be significant risks that the Bank facilitates unsustainable commercial borrowing. Option three, Management's preferred choice, has the potential to substantively expand the use of PCGs in IDA-only countries by incorporating project-level considerations, while also establishing clear country-level eligibility criteria to ensure prudent borrowing.

<i>Current Policy</i>	<i>Proposed Approach</i>	<i>Major Considerations</i>
	debt sustainability; and there are adequate arrangements to ring-fence project revenues.	
Issue B2: Eligibility of Countries Undergoing Debt Restructuring		
<ul style="list-style-type: none"> For PCGs, the Bank does not guarantee sovereign international borrowings in countries undergoing external debt restructuring until the country completes a debt restructuring agreement with commercial lenders and has in place a macroeconomic framework acceptable to IBRD. 	<ul style="list-style-type: none"> It is proposed to remove this restriction. 	<ul style="list-style-type: none"> This provision is obsolete given that the portion of the debt covered by the Bank's partial credit guarantee is not subject to rescheduling or restructuring. However, typically the Bank would not consider it prudent to extend guarantees when there is an ongoing major debt restructuring.
Issues Common to Project-Based Guarantees (PRGs and PCGs)		
Issues C1: Guarantees Facilities		
<ul style="list-style-type: none"> There are no explicit policy provisions governing guarantee facilities. 	<ul style="list-style-type: none"> Option one: Incorporate new provisions on guarantee facilities, which would require that each guarantee facility operation be presented to the Board together with an assessment of the capacity of the domestic implementing agency; a robust subproject pipeline; and at least one guarantee operation. Option two: Continue the current approach of not treating guarantee facilities as a policy matter and instead issue Management guidance. 	<ul style="list-style-type: none"> Option one is Management's preferred choice as it directly addresses the key shortcomings of previous PRG facilities, none of which have succeeded in issuing guarantees. While option two appears to be more flexible, necessary flexibility can also be incorporated under option one, e.g., by allowing for variation in the structure of the implementing agency.
Issues C2: Guarantees Series		
<ul style="list-style-type: none"> There are no explicit policy provisions governing guarantee series. 	<ul style="list-style-type: none"> Incorporate new provisions on guarantee series, which would allow for streamlined Board presentation for future operations in the series. 	<ul style="list-style-type: none"> This proposal would formally incorporate in the policy what the Board has already approved in the context of the Nigeria Electricity and Gas Improvement Project (2009).
Issues C3: Application of Safeguard Policies to Guarantees		
<ul style="list-style-type: none"> The Bank's guarantee policy lacks clarity regarding the specific end point for the Bank's responsibility for supervising environmental and social safeguard policies. 	<ul style="list-style-type: none"> Clarify in the guarantee policy that Bank supervision of the environmental and social safeguard policies would apply only up to the physical completion of the underlying project. 	<ul style="list-style-type: none"> The current policy already makes a distinction between supervision of pre and post-project completion, and the proposed reform would further clarify this distinction. In March 2011, the Board approved a similar approach to carbon finance operations, whereby supervision would end at completion of the low-carbon projects. The proposed reform would further align supervision responsibilities between guarantee and investment lending operations, where supervision for the latter essentially ends upon project completion.

<i>Current Policy</i>	<i>Proposed Approach</i>	<i>Major Considerations</i>
Issues C4: Requirements regarding Satisfactory Sector Policies		
<ul style="list-style-type: none"> Current guarantee policy requires a satisfactory sector policy framework for IDA PRGs but makes no such requirement for any other project-based guarantees. 	<ul style="list-style-type: none"> Revise the policy provision on satisfactory sector policies, in accordance with the results of the ongoing revisions of the operational policy for investment lending, and apply to all project-based guarantee operations. 	<ul style="list-style-type: none"> The current policy governing the use of investment lending does not explicitly require a satisfactory sector policy framework and instead it requires that investment lending operations “be anchored in country/sector policy analysis.” As a matter of Bank practice for project-based guarantee operations, staff review and assess whether the country’s sector policy is supportive of the achievement of the project development objectives.
Issue C5: Additional Financing		
<ul style="list-style-type: none"> Current guarantee policy does not include provisions for additional financing. Additional financing (OP 13.20) applies only to investment lending. 	<ul style="list-style-type: none"> Explore introducing additional financing operations for Bank guarantees, as part of the Guarantee Modernization exercise. 	<ul style="list-style-type: none"> Although the focus of discussions so far has been on the applicability to guarantee series, provisions for additional financing would be developed in the context of all guarantee operations. Additional financing for guarantee operations would adopt an approach consistent with the approach for investment lending, and therefore in accordance with the results of the ongoing revisions of the operational policy for the latter.
Policy-Based Guarantees		
Issue D1: PBG Coverage of Domestic Financing		
<ul style="list-style-type: none"> PBGs are limited to foreign private financing for external financing needs. 	<ul style="list-style-type: none"> Allow PBGs to be used for both domestic as well as external financing. 	<ul style="list-style-type: none"> This policy change would align PBGs with DPLs and with other Bank guarantee options and would lift an important restriction on the use of PBGs. A PBG backing longer maturity domestic sovereign debt could broaden choices and contribute to the very important development of domestic capital markets.
Issue D2: Requirement for a Strong Track Record		
<ul style="list-style-type: none"> PBGs currently require a strong track record of country performance. 	<ul style="list-style-type: none"> Remove the requirement for a strong track record of performance. 	<ul style="list-style-type: none"> A strong track record of performance was meant to strengthen the market signaling value of the Bank’s endorsement of the country’s performance and creditworthiness. There has been little evidence that the requirement for strong track record has enhanced the impact (market signaling) of the PBG. PBGs would continue to be subject to DPL operational policies, which include the requirement that the country’s reform program and the commitment to the program be assessed against the country’s track record.
Issue D3: Requirement for Improved Market Access		
<ul style="list-style-type: none"> PBGs can be used only if it improves the country’s market access, as measured by greater volume of private financing or lengthened maturity. In addition to improving market access, a PBG must be “financially efficient,” as measured by financial leverage or improved financial terms. 	<ul style="list-style-type: none"> Management proposes to continue requiring “improved market access” for PBGs but to broaden the definition of improved market access to include greater financial efficiency and access to new sources of private financing, allowing for the consideration of trade-offs. 	<ul style="list-style-type: none"> Currently a PBG cannot be used in countries which already have some level of market access (as currently defined) even if it results in significant financial leverage or improved financial terms. The proposed policy revision would broaden the applicability of PBGs, by allowing them to be used for countries with some level of market access if there are clear and significant gains in financial efficiency.

<i>Current Policy</i>	<i>Proposed Approach</i>	<i>Major Considerations</i>
Issue D4: Alignment of PBGs with DPLs		
<ul style="list-style-type: none"> The operational policies for PBGs (OP 14.25) and DPLs (OP 8.60) are distinct and separate. 	<ul style="list-style-type: none"> Structure PBGs as DPLs with streamlined additional requirements. 	<ul style="list-style-type: none"> With the proposed policy revision, it would be possible to formally link PBGs and DPLs in a programmatic series supporting the same medium term reform program. PBGs would continue to satisfy all the eligibility conditions for DPLs under OP 8.60. The borrower would choose a PBG over a DPL by assessing the benefits of improved access and comparing the incremental costs of the former compared to the latter. PBGs could either be retained in OP 14.25 or it could be newly incorporated in OP 8.60 as an option under DPLs.
Issue D5: PBG Eligibility for IDA-Only Countries		
<ul style="list-style-type: none"> PBGs, like PCGs, are not available to IDA-only countries. 	<ul style="list-style-type: none"> Option one: IDA-only countries would be eligible for PBGs if they have low risks of debt distress and adequate debt management capacity. Option two: IDA-only countries would be eligible for PBGs if they have low to moderate risks of debt distress. Option three: Delay the extension of PBGs to IDA-only countries until lessons can be learned from using PCGs in these countries. 	<ul style="list-style-type: none"> On balance, Management considers option one to be the preferable choice. Option two has potentially significant risks that the Bank would facilitate unsustainable borrowing. Option three would result in missed opportunities to help countries with their development financing needs and would seem overly cautious given that it would not extend PBGs to even those IDA-only countries which have low risks of debt distress and adequate debt management capacity. Option one has the added advantage of applying the same country eligibility criteria as under the preferred choice of option three for the proposed extension of PCGs to IDA-only countries.
Issues Common to All Guarantees		
<ul style="list-style-type: none"> Current guarantee policy does not include a specific requirement on leverage, and instead requires that the Bank provide guarantees to the minimum extent necessary to mobilize private financing. 	<ul style="list-style-type: none"> State in the policy that financial leverage is a major consideration in providing Bank guarantees. 	<ul style="list-style-type: none"> Financial leverage is a standard measure of the extent to which the Bank's guarantee mobilizes private financing, which is a core objective of guarantee operations. The analysis of each guarantee operation would include a discussion of financial leverage, taking into account project and country circumstances and prevailing market conditions. A relatively low level of financial leverage would need to be justified by the presence of other financial benefits (such as lengthened maturities, improved terms of non-guaranteed borrowing, and access to new sources of private financing) which are significant and are more critical for addressing the needs of the country.

MODERNIZING THE WORLD BANK'S OPERATIONAL POLICY ON GUARANTEES

APPROACH PAPER

I. INTRODUCTION

1. **This Approach Paper outlines a comprehensive reform of the World Bank's operational policy on guarantees.** Mobilizing private sector financing for infrastructure and other investments needed for sustainable development and poverty reduction is a core task of the World Bank Group (WBG). Bank guarantee operations are a small share of the Bank's portfolio, but they have been effective in mobilizing greater private financing for critical projects and programs. Management believes that there is further potential for guarantees to mobilize private sector financing for development purposes. For this reason, the Approach Paper reviews a comprehensive set of operational policy issues and presents a possible approach to revising key operational policy provisions. It reflects guidance provided by members of the Committee on Development Effectiveness (CODE)¹ and is intended to be the basis for consultations with external stakeholders. Following the consultations, Management will present to the Board a full policy paper which will attach a new draft OP/BP 14.25, *Guarantees*.

2. **Many developing countries seek to attract private sector financing to address huge financing gaps** between investments needed for poverty reduction and sustainable development and the limited funding available from their own resources and official sources.² Private financial flows to developing countries, which peaked at \$1.1 trillion in 2007 and fell to \$521 billion in 2009, have by-passed many high-risk countries and sectors (except for some directed to extractive industries).³ Mobilizing private sector financing for development purposes continues to be a core WBG task. To this end, Bank guarantees and complementary instruments such as MIGA's political risk insurance and IFC guarantees are important, in addition to the lending and analytical support provided by the Bank and IFC to support private sector development.

3. **Guarantees have been effective in mobilizing private sector financing but have further potential.** In Management's assessment, in line with the IEG report,⁴ guarantees have been effective in leveraging Bank resources, in particular facilitating the flow of investments to high risk sectors and countries and in supporting large and complex infrastructure projects in countries where they might not otherwise have been

¹ CODE is a standing committee of the World Bank's Board of Executive Directors. Its mandate is to monitor and assess the Bank Groups' effectiveness in fulfilling its development mandate.

² In a background paper for the G20, the MDB Working Group on Infrastructure estimates that actual spending on infrastructure in developing countries amounts to roughly one-half of the average annual spending of about \$1 trillion needed in 2010-2020. In the Africa Region, for which more complete data are available, the funding gap is estimated at one-third of annual spending needs of \$93 billion.

³ See *Global Development Finance: External Debt of Developing Countries*, World Bank, December 14, 2010.

⁴ Independent Evaluation Group, op. cit..

possible. Furthermore, guarantee operations have helped countries carry out important reforms, establish themselves in commercial credit markets, and raised the developmental value of projects by ensuring compliance with the Bank's environmental and social safeguard policies. However, the actual use of guarantees have not matched their demonstrated effectiveness due to a number of obstacles, including an outdated and fragmented operational policy framework; public-private partnership (PPP) projects which benefit from guarantees but which are challenging, costly and time-intensive to develop; the need for specialized skills; and the importance of WBG coordination and collaboration. As a result of such challenges, guarantees have largely remained a relatively small share of the IBRD and IDA portfolios. Since the 1994 Board Paper *Mainstreaming of Guarantees*, IBRD has approved only 24 guarantee operations with a total guarantee commitment amount of US\$3.5 billion, and IDA has supported only 13 guarantee operations with a total guarantee commitment amount of US\$1.0 billion.⁵

4. **Management is developing a broad WBG agenda for unlocking the potential of Bank guarantees, of which the reform of the Bank's operational policy, which is the subject of this Approach Paper, is one important ingredient.** Management is preparing a WBG Infrastructure Strategy FY12-15 which will outline the broader agenda,⁶ which will include the proposed modernization of the operational policy as one of many components. This broader agenda, which is outlined in paragraph 24, is expected to focus on addressing the key obstacles identified so far, by improving staff incentives and skills; providing adequate resources for developing PPP projects; and enhancing client outreach and WBG coordination. Management expects that the implementation of this broader agenda, combined with the proposed policy reforms outlined in this paper, will enhance the potential of Bank guarantees to serve member countries' needs.

5. **The update of operational policy proposed in this paper is intended to enable better use of the Bank guarantee instrument in a wider range of circumstances.** Management has concluded that a comprehensive review of the policy is necessary to strengthen, streamline, and increase the applicability—in short, modernize—the Bank's guarantee instrument. The overall objective is to facilitate the greater use of guarantees for mobilizing private financing for development purposes, while also ensuring adequate management of the risks associated with borrowing on commercial terms.

6. **This Approach Paper reviews the guarantee operational policy and presents options for modernizing the policy to facilitate its effective use in developing countries.** The paper incorporates guidance provided by the Bank's Committee on Development Effectiveness (CODE).⁷ It is intended to be the basis for consultations with external stakeholders on the key issues and reform options. A full policy paper, with a

⁵ Of the 37 IBRD/IDA guarantees and facilities approved, not all of the guarantees have reached financial close (issuance of a guarantee to a creditor) and none of the facilities has provided actual guarantees.

⁶ Members of CODE have endorsed the concept note for the infrastructure strategy paper. See *World Bank Group Infrastructure Strategy Update—Issues and Concept Note*, CODE2011-0030/1, June 15, 2011.

⁷ CODE is a standing committee of the World Bank's Board of Executive Directors. Its mandate is to monitor and assess the Bank Groups' effectiveness in fulfilling its development mandate.

revised operational policy statement attached, will later be presented to the Board for approval.

7. **This Approach Paper is organized in six sections.** Following this introduction, Section II presents an overview of the Bank’s guarantee instrument. Section III sets out the case for modernization of the instrument, based on the evolving demand of our clients for risk mitigation instruments and the Bank’s limited ability to respond under current operational policy. It also provides an overview of ongoing work on other parts of the agenda to realize the potential of Bank guarantees. At the center of the paper is section IV which discusses operational policy issues and possible options for revising the guarantee policy. Section V discusses the possible revisions of Bank internal procedures in line with the proposed policy reforms. Finally, Section VI outlines possible next steps for discussion by CODE members.

II. OVERVIEW OF BANK GUARANTEES

8. **The WBG offers various loans, guarantee and insurance instruments to help a diverse range of public and private sector clients mobilize private financing.** Each WBG institution uses its financing instruments in accordance with its distinct mandate to serve the needs of its different clients. Coordination between the institutions is needed in cases where the Bank, IFC, and MIGA could potentially support the same private sector project. Collaboration serves to make the best use of complementarities between the institutions’ different instruments, specifically in the joint support of large private infrastructure projects, and to exploit synergies in identifying potential projects and marketing guarantee and political risk insurance instruments.⁸

9. **World Bank (IBRD and IDA) guarantees serve to help our clients mobilize sustainable private financing for development projects and for meeting development finance requirements.** Whereas the Bank’s typical financing approach is to directly provide loans, credits or grants, guarantees help a government mobilize commercial debt financing and private investments for development purposes. Most member countries require private financing to achieve their development objectives, closing the often large gap between investment needs, particularly for infrastructure, and their own public resources and public funding from bilateral and multilateral sources. Bank and other publicly supplied guarantees come into play where affordable private financing is otherwise unavailable in the volumes or with the maturities required for long-term investments.

10. **Guarantees are one of three development finance instruments the Bank currently offers** (see Table 1).⁹ Investment lending and development policy lending contribute directly to the financing of public or private sector projects or to meeting a country’s general development financing requirements. Bank guarantees catalyze private debt financing to those ends. They do so by sharing with private lenders the risk of debt

⁸ Annex C elaborates on WBG coordination and collaboration.

⁹ A fourth, “Program for Results” lending, is currently under development.

service default or specific sovereign risks that may cause a default.¹⁰ Bank guarantees cover risks only to the extent necessary to obtain the required private financing. All require a sovereign counter-guarantee, comparable to the requirement of a sovereign guarantee for Bank lending to sub-sovereign and non-sovereign borrowers. Should a counter-guarantee be triggered, the country’s resulting payment obligations to the Bank would have preferred creditor status.

Table 1: Development Finance Instruments

What is supported?	How is it financed?	Instruments	Typical borrower	Eligible countries
Investment projects	Direct lending or grants	Investment lending	Public sector	IBRD and IDA
	Private lending, with a Bank guarantee	Partial credit guarantee	Public sector	IBRD
		Partial risk guarantee	Private sector	IBRD and IDA
Policy and institutional reforms	Direct lending or grants	Development policy pending	Public sector	IBRD and IDA
	Private lending, with a Bank guarantee	Policy-based guarantee	Public sector	IBRD

11. **The Bank’s guarantee instrument essentially offers three options:** the project-based partial risk guarantee (PRG), the project-based partial credit guarantee (PCG) and the policy-based partial credit guarantee (PBG).

- **Partial risk guarantees** support private lending to normally private sector projects. They cover debt service defaults caused by the failure of the government or government owned entities to meet their contractual obligations to the project. Among such obligations, PRGs typically cover undertakings that are under the government’s control, not genuine commercial risks. The Bank uses PRGs to help governments attract private financing to projects in infrastructure and other sectors in which the viability of projects depends heavily on the government’s policy and regulatory actions or on the actions of state-owned suppliers and customers. PRGs are available in all IBRD and IDA countries. In IDA countries, PRGs can be issued by IDA and also by IBRD as “enclave guarantees”.
- **Partial credit guarantees** normally support sovereign or state-owned enterprise (SOE) borrowing from private creditors to finance public investment projects. They protect private financiers against default on a specified portion of the debt service irrespective of the cause of default. PCGs are currently available only for projects in IBRD-eligible countries.
- **Policy-based guarantees** help a country meet its development financing requirements and support its programs of policy and institutional reforms. Like

¹⁰ However, the Bank does not share its preferred creditor status with private lenders.

PCGs, PBGs protect private creditors against default on a specified portion of debt service irrespective of the cause of default. Like development policy loans (DPLs), they are associated with the implementation of a program of policy and institutional actions and may be provided to a member country or a political subdivision of a member country; but unlike DPLs, they have the additional objective to help countries improve their market access. PBGs are currently available only for IBRD-eligible countries.

12. **The Bank’s mandate for providing guarantees is rooted in its Articles of Agreement** (see Box 1). The Bank started using guarantees in 1983 for the purpose of attracting private co-financing for Bank-financed projects. The 1994 Board paper *Mainstreaming of Guarantees as an Operational Tool* introduced the policy provisions for the use of PRGs and PCGs for private and public sector projects in IBRD-eligible countries.¹¹ PRGs became available for projects in IDA-only countries in 1997, consisting of IBRD-funded guarantees for enclave projects¹² and IDA-funded guarantees for private sector projects.¹³ PBGs were introduced in 1999 for well-performing IBRD borrowers.¹⁴ In 2002, Management summarized the guarantee policy provisions approved by the Board since 1994 in an Operational Policy statement (OP 14.25) and also issued a statement on Bank Procedures (BP 14.25).¹⁵

Box 1: Legal Framework for the Provision of Bank Guarantees

Guarantees. The Bank’s mandate for guaranteeing private and sovereign borrowings for development purposes is rooted in its Articles of Agreement. Under Article III (section 4) of IBRD’s Articles of Agreement, the Bank may -- subject to specified conditions -- guarantee loans to any member or any political subdivision thereof and any business, industrial and agricultural enterprise in the territories of a member. Under Article IV (section 1), it may guarantee such loans made by private investors. Under Article V of IDA’s Articles of Agreement, IDA is authorized to provide guarantees that further the purposes of the Association if so provided for in the IDA replenishment resolution (section 2); and to provide guarantees of loans in special cases from the reflow of credits made out of the initial subscriptions to IDA (section 5(iv)).

Counter-guarantees. In line with Article III (section 4) of its Articles, IBRD provides guarantees subject to receiving a counter-guarantee from the relevant member country in whose territory the project is located. IDA’s Articles do not expressly require a counter-guarantee from the member. However, Article V (section 2(d)) states with respect to loans that IDA “may, in its discretion, require a suitable governmental or other guarantee or guarantees.” Accordingly, as a matter of policy, IDA requires member countries to enter into an indemnity with IDA as a pre-condition to the issuance of an IDA guarantee.

13. **The “loan-equivalency” principle forms the basis for financial policies relevant to guarantees.** The concept underlying this principle is that the loss suffered by the Bank from a member country’s failure to make timely payment on a Bank-guaranteed loan obligation is equivalent to that suffered from the country’s failure to make timely

¹¹ See *Mainstreaming of Guarantees as an Operational Tool* (R94-145), July 14, 1994.

¹² See *Use of IBRD Guarantees to Support Private Enclave Project in IDA-Only Countries*, (R97-85, IDA/R97-36), April 28, 1997.

¹³ See *A Proposal for IDA Guarantees in IDA-Only Countries* (IDA/R97-135), November 20, 1997.

¹⁴ See *World Bank Policy-Based Guarantees* (R99-53), April 20, 1999.

¹⁵ Annex A provides a more in-depth discussion of the evolution of the Bank’s guarantee policies.

payment on an equivalent loan-service obligation to the Bank. IBRD guarantee fees are uniform across IBRD-eligible countries and IDA guarantee fees across IDA-eligible countries. For IBRD countries, the front end fees of guarantees and loans are equivalent, and the guarantee fees are equivalent to the spread on the loans. For IDA countries, guarantee fees are equivalent to the service charge on IDA credits. In the case of PRGs, the Bank may also charge initiation and processing fees for private sector projects. Although guarantee fees for PRGs are not differentiated according to risk coverage, the governments may charge fees to the private sector to offset costs associated with issuing a counter-guarantee. Teams are required to advise governments on the value of their counter-guarantee. Fees are paid by the beneficiary of a guarantee.

14. **The use of Bank guarantees holds the potential for generating large additional benefits but also additional risks and costs for both the Bank and the borrower.** Guarantees are inevitably more complex than simple loans in that they involve multiple parties rather than two—in addition to the World Bank and the borrower, they also include the private lender and, for PRGs, project sponsors and investors. Bank guarantees can only be effective in achieving their objective if all parties perceive that the guarantees add net value to them.

- **World Bank.** For the Bank, the benefits of providing a guarantee rather than a loan lie in leveraging Bank resources while assuming, on account of the member's counter-guarantee, the same credit risk that it would bear if it provided a loan. Due to the contingent nature of guarantees, the Bank is exposed to credit risks only if there is a call under the guarantee. However, guarantees expose the Bank to risks not associated with loans given that they are irrevocable once issued, regardless of any deterioration in the country's performance or creditworthiness.¹⁶
- **Borrower.** Leveraging the limited Bank resources available to a country is a major benefit for the borrower, in addition for the Bank. For private sector projects, PRGs can result in significant leveraging by backstopping the government's commitments and obligations to the projects, thus addressing a major constraint to attracting private investments in high-risk countries with critical investment needs. Guarantee operations can lead to sustained market access and diversification of the sources of financing, and also strengthened policy environment and business climate through the Bank's engagement and associated policy dialogue. However, the total cost of the guaranteed borrowing may exceed the alternative of a Bank loan for the guaranteed amount combined with borrowing the remainder from the market without a guarantee.

¹⁶ The Bank may suspend its guarantees, often during a specified period, where, *inter alia*, a member country falls into arrears with the Bank, ceases to be a member of the Bank and in other specified situations of default, as provided in the particular transaction agreements. Generally, the remedies available which allow the Bank to suspend or terminate guarantees are limited to specific circumstances or events that vary depending on the particular transaction. Termination events typically include, *inter alia*, certain fraud and corruption occurrences, material breach by the project company of its obligations under the project agreement, untrue statements and assignment or transfer of the guarantee by a lender without the required consent of the Bank.

- **Lenders, investors and project partners.** For the private parties, a Bank guarantee means that project risks and the risk of default can be shared with a strong guarantor. They also can take comfort in the Bank's strong relationship with governments and direct involvement in the projects and sectors, which can mitigate the risks of default on the nonguaranteed portion of the financing. However, the value added by the Bank guarantee needs to exceed its opportunity costs; the lender may bear the risk or may purchase risk mitigation instruments from other private or public suppliers.

15. **Guarantees have accounted for a small share of the Bank's portfolio but have mobilized significant additional private financing.**¹⁷ To date, Executive Directors have approved 37 guarantee operations for the aggregate guarantee amount of \$4.5 billion. They consisted of 24 IBRD operations for a total guarantee amount of \$3.5 billion and 13 IDA operations for \$1.0 billion. Bank guarantees have been used in 31 countries across all Regions and in many sectors, but the largest shares have been in Africa and in the energy sector. A majority, 25 of these guarantees have been PRGs—12 backed by IBRD and 13 backed by IDA—with an aggregate guarantee amount of \$2.9 billion. Most recent guarantee operations have also been PRGs; all 15 guarantee operations from 2002 to 2009 were PRGs, after which a PCG was approved in 2010 and PBGs in 2011 and 2012. Eight project-based PCGs and 4 PBGs backed by IBRD have been approved to date, with a total guarantee amount of \$1.8 billion. Not all of these operations achieved financial closure and the issuance of a guarantee. PRGs with an aggregate guarantee commitment of \$1.3 billion achieve financial closure and helped mobilize private financing of \$9 billion, approximately seven times the amount guaranteed. PCGs and PBGs with a nominal guarantee amount of \$1.9 billion reached financial closure and mobilized commercial debt of \$5 billion. The PBG to Argentina in 1999 is the only Bank guarantee that has been called.

16. **Bank PRGs have helped secure adequate financing for large and complex public-private partnership (PPP) projects in high-risk countries**—countries with high political and regulatory risks and difficult business climates. For example, PRGs were crucial to addressing investor concerns about possible nationalization, delays in construction approvals and permits, and the ability of state-owned utilities to honor purchase contracts for IPP projects in Cote d'Ivoire, Uganda, Vietnam and Lao PDR. The Bank's long term policy engagement and relationship with governments were often a critical added-value of the PRGs, notably with respect to investor concerns about changes in laws and regulations. PRG-supported projects typically require a long preparation time, substantial development costs and greater uncertainty than public sector projects because of the complexity of the limited recourse projects and the participation by additional private stakeholders. Thus, Regions tend to limit this type of support to truly transformational PPP projects.

¹⁷ See Annex B for a complete list of Bank guarantee operations.

Box 2: Examples of Bank Guarantee Operations

Partial risk guarantee for a private power project in Uganda (FY07). The Bujagali hydropower project is one of the largest private sector investments in the power sector in Sub-Saharan Africa and is critical in addressing Uganda's severe power supply shortages. IDA issued a PRG to commercial lenders against debt service defaults resulting from the government's failure to meet its contractual obligations to the project, including for failure to pay for the power purchased, events of political force majeure, and restrictions on currency convertibility and transferability of funds. The significant financing needs for the project required a coordinated and joint commitment by the World Bank Group; the PRG mobilized \$115 million in commercial loans, IFC provided loans totaling \$130 million and MIGA insured equity investments up to \$115 million.

Partial risk guarantee for energy sector privatization in Albania (FY09). The PRG, for \$78 million equivalent, facilitated the privatization of Albania's Electricity Distribution Operator (OSSH) by addressing investors' concerns regarding regulatory risks. There had been mixed experience with privatization by investors in distribution utilities across different countries, primarily due to slow adjustment of tariffs towards cost recovery. The PRG guaranteed the government's obligation to compensate the privatized OSSH for lost revenues should the government fail to implement the regulatory framework agreed as part of the privatization, in particular the tariff formula and timely adjustment of tariffs. It used an innovative guarantee structure, whereby the government provided a Letter of Credit (L/C) through a commercial bank which the privatized OSSH can access should the government fail to meet its contractual regulatory obligations, and in turn the PRG guarantees the government's debt arising from the drawing of the L/C.

Partial credit guarantee for a public sector power generation and transmission project in Botswana (FY10). The PCG from IBRD helped the state-owned utility Botswana Power Corporation raise a \$825 million loan from a state-owned commercial bank in China, in order to finance its Moropule B Power Generation project. The PCG was in the amount of \$243 million and helped extend the maturity of the loan by covering the last five years of a 20-year amortizing commercial bank loan. The longer maturity reduces the revenue requirements for debt servicing, thus lowering retail tariffs which benefits consumers and the economy as a whole. The PCG was provided together with an IBRD loan for \$136 million.

Policy-based guarantee to Serbia (FY11). IBRD supported Serbia's public expenditure reform program with a PBG. The guarantee allowed Serbia to enter the international loan market for the first time by issuing an Euro 292.6 million 6-year loan. Without the guarantee Serbia would have been able to borrow only at shorter maturities (3-4 years). The PCG covered the bullet principal repayment of the loan.

17. **PCGs have been effective in improving market access for public utilities in IBRD countries, particularly in extending maturities.** In the Philippines and China, for example, the 15-year loan tenures obtained were almost double what the market was offering at the time. Some of these operations have been characterized by high financial leverage, notably the Botswana Moropule project and the China Ertan project with ratios of approximately 7:1.¹⁸ Six PCGs were provided between 1994 and 1997, but since then only one PCG operation has been prepared and declared effective (the Botswana project, in FY10).

18. **PBGs have helped countries reenter markets under severely constrained conditions.** Following the East Asian crisis, PBGs were introduced to help countries with good fundamentals and sound economic policies access markets after a crisis. There have

¹⁸ Financial leverage is the ratio of private financing (equity and debt) for the project over the guarantee exposure.

been a total of three PBG operations: Argentina (FY00), Colombia (FY01) and Serbia (FY11). The PBGs for Argentina and Colombia facilitated mobilization of significant private financing under difficult market conditions, but they utilized a rolling reinstatable guarantee structure which is no longer used by the Bank.¹⁹ The Argentina operation became the only guarantee operation ever called when the country defaulted on its external borrowing in 2001-02. Since the recent global financial crisis, IBRD sharply increased lending but saw relatively limited demand for PBGs.²⁰

19. **Innovation has often been a key feature of Bank guarantee operations.** The operational policy on guarantees provides flexibility in structuring guarantee operations to fit specific client needs and project circumstances, which substantially enhances the applicability of Bank guarantees beyond traditional loan. Accordingly, the Bank has developed innovative structures which have been reviewed by Management and approved by the Board on a case-by-case basis, including the use of the letter of credit structure and the “deemed loan” structure designed to provide risk mitigation to private investors and contractors by backstopping government payment obligations. Such guarantee structures have been used to facilitate privatization transactions and encourage private investments in gas development (see Box 2, Albania privatization PRG). The Bank is currently exploring an innovative use of guarantees to help develop carbon markets to finance low-carbon projects in developing countries, by facilitating upfront payments for carbon revenues from these low-carbon projects. As part of the second phase of this review, Management proposes also to explore the possibility of extending guarantees to hedging products (see Box 3).

Box 3: Guarantee of Hedging Products

Management proposes to explore options for expanding guarantees to hedging products. In providing Bank guarantees, the Bank’s objective is to mobilize private sector financing for development purposes, either for investment loans or borrowings associated with a reform program. This core objective may also be achievable by guaranteeing a member country’s obligations for a hedging transaction associated with an underlying investment project or program of reforms. The Bank already has a menu of IBRD hedging products, limited to interest rate swaps, currency swaps and commodity swaps, which it is able to offer to IBRD countries for hedging risks on IBRD as well as non-IBRD loans.¹ These products would provide the basis for further discussions on extending guarantees to hedging transactions. For any consideration of guarantees beyond the limited set of hedging products currently available from the Bank, it would be appropriate to first discuss expanding the menu of Bank hedging products before considering guarantees of such products. The possible expansion of guarantees to hedging products would require addressing several issues, including the legal (IBRD Articles) implications; the Bank’s comparative advantage; client eligibility; client demand and capacity to utilize such products; and the associated IBRD financial, credit, operational and reputational risks. It may also require a more consistent operational approach between hedging products (which are currently offered as a financial service) and the possible Bank guarantee of hedging products (which would be provided as a Bank operation).

1. “Expanding Opportunities for Clients’ Use of IBRD Hedging Products,” R2005-0113, May 17, 2005.

¹⁹ “Review of IBRD’s Use of the Rolling Reinstatable Guarantee Structure,” SecM2003-0046, February 3, 2003.

²⁰ Since the onset of the global financial crisis, there has been one new PBG operation (Serbia (FY11)) and another operation (Macedonia) is currently being prepared.

20. **Bank guarantees complement MIGA and IFC support in assisting member countries mobilize private capital for investments.** Each WBG institution has a mandate that is defined under its articles and each serves the needs of its clients according to these mandates. IBRD and IDA clients are first and foremost member governments. IBRD and IDA guarantees, which require a sovereign counter-guarantee, thus play a role that is distinctly different from MIGA’s political risk insurance (PRI) and IFC guarantees whose primary clients are the private sector. Bank guarantees also support private lending to private sector projects but only by backstopping government obligations for which the government is willing to provide indemnity. By contrast, IFC provides credit guarantees, which do not require a sovereign counter-guarantee, directly for borrowing by private sector clients, in addition to providing loans and equity investments to the private sector. MIGA offers political risk insurance (PRI) for cross-border direct investments for a wide range of private sector clients, including financial institutions and manufacturers.

21. **The need for WBG coordination is particularly relevant for energy and infrastructure projects with private participation, such as PPP projects.**²¹ The majority of private sector projects are not critically dependant on public support and government undertakings. For such projects, Bank guarantees provide limited added-value and instead IFC and MIGA remain the preferred sources of finance and insurance. By contrast, energy and infrastructure projects with private participation are typically regulated and have various interfaces with government entities, such as through off-take agreements. Bank PRGs would make the projects more attractive by backstopping such government obligations, while being complemented by MIGA PRIs and IFC’s equity and loans (rather than IFC guarantees). IFC and MIGA participation provides significant financial leverage for Bank PRGs. In turn, Bank participation in such projects is often crucial for facilitating IFC and MIGA engagement as PRGs cover government undertakings that are critical for project viability and are reinforced by the government’s counter-guarantee, which is not available for IFC and MIGA instruments. The Bank’s sector policy dialogue also tends to provide comfort to other financiers, including IFC and MIGA.

22. **WBG coordination is based on a general principle of “hierarchy of instruments,”** consisting of market first, MIGA and IFC instruments second and Bank guarantees (with the sovereign counter-guarantee) last. This principle is meant to ensure that private sector finance is not displaced and government and Bank Group exposure is limited to the minimum required for the private investment to take place on reasonable terms. To facilitate its operational application, it was further clarified that the deployment of Bank PRGs would be generally considered for transactions where one or several of the following conditions are met:²²

- Transactions in sectors in early stages of reform, where the risk of reversal is seen as significant, and where the involvement and influence of the Bank in the sector

²¹ See also Annex C for a more detailed discussion on WBG coordination.

²² See *Enhancing the Use of World Bank Guarantees as an Operational Tool. A Review of the World Bank Guarantee Program* (R2000-215; IDA/R2000-215), December 19, 2000.

dialogue and related policy conditionality are seen as central to the viability and private financeability of the project;

- Riskier and larger operations, where booking of the risk on the Bank's balance sheet, with remedies attached to bank operations, are seen as preferable from a risk management perspective; and
- Operations highly dependent on government support and/or undertakings, where the explicit counter-guarantee and the clout of the Bank are seen as critical to mobilizing private financing or enhancing leverage in the market.

III. THE CASE FOR MODERNIZATION OF WORLD BANK GUARANTEES

23. **Management sees potential for the guarantee instrument to make a greater contribution to development in member countries.** To that end, Management proposes to streamline, strengthen, and increase the applicability of the instrument in order to enhance its potential. A comprehensive review of operational policy has sought to identify unnecessary constraints which may hinder the Bank's ability to respond to changing financing needs of member countries or may bias the choice between lending and guarantee instruments. A greater share of guarantee operations in the Bank's portfolio could enhance the Bank's overall development effectiveness, adding to the value the Bank currently provides for member countries principally through investment and development policy lending.

The Broader Guarantees Renewal Agenda

24. **Management recognizes that complementary actions to the proposed policy reforms are critical for further growth of guarantees.** Management has taken or is exploring a number of complementary actions to address obstacles to the greater use of guarantees. This Approach Paper focuses solely on the operational policy, while the broader agenda will be developed as part of the upcoming WBG Infrastructure Strategy FY12-15.²³ Management expects that only implementation of the whole program will allow the full potential of Bank guarantees to be achieved. Possible complementary actions include the following, many of which have already been initiated:

- ***Incentives for client demand.*** Management has reinstated a discount for guarantees with respect to IBRD country exposure. Since December 2009, only 25 percent of new guarantee exposure (the disbursed and outstanding balances under the guaranteed financing) are counted against the IBRD country exposure limit, which creates an incentive for the greater use of guarantees. However, availability of this incentive is limited as the remaining 75 percent of new guarantee exposure must be charged to a limited, dedicated and centralized pool.

²³ The members of CODE have endorsed the concept note for the infrastructure strategy paper. See *World Bank Group Infrastructure Strategy Update—Issues and Concept Note*, CODE2011-0030/1, June 15, 2011.

The incentive does not affect IBRD's provisioning for guarantees which continues to be on a "loan-equivalence" basis. IDA continues to count 25 percent of the nominal amount of a committed guarantee against a country's IDA allocation, while provisioning for 50 percent.

- ***Alignment of processing procedures.*** Corporate review processes of guarantees have been fully aligned with those for equivalent IBRD loans and IDA credits.
- ***Public-Private Partnerships (PPPs).*** PPP projects have been the main beneficiaries of Bank PRGs, as well as for joint WBG support. But they are also costly, time-intensive and technically complex to develop, raising issues of funding, staff incentives and WBG collaboration. The WBG Infrastructure Strategy for FY12-15 is likely to include a joint action plan for PPP scale-up with actions to grow the pipeline of projects and align the necessary expertise and budget and trust fund resources. Management is also exploring possibilities for establishing and funding a PPP project preparation facility. The Bank already supports PPP development through TA lending and TA grants from the Public-Private Infrastructure Advisory Facility (PPIAF).
- ***Deployment of staff skills.*** Guarantee operations require specialized staff skills, for developing the best solutions to countries' financing requirements, structuring guarantees efficiently, and developing complex projects often supported by guarantees. The Bank has such skills and replenishes them through staff training and recruitment, but needs to improve their deployment to the relevant Regions and project teams. Management has encouraged country teams to seek assistance from FEU/SDN and BDM/TRE when engaging with clients to identify suitable projects. SDN will continue to maintain experts in PPPs, project finance and guarantees to provide advisory and transaction services and also experienced sector specialists for certain complex projects such as in hydropower. TRE will continue to provide expert services for helping teams develop financial solutions to countries' project and development financing requirements.
- ***Outreach.*** A potential advantage of the WBG as a guarantor rests on its ability to offer clients financial solutions from a broad menu of WBG financial instruments and advisory services. To fully use this potential, Management has been providing training in order to enhance staff capacity to offer clients financial solutions from the whole menu of WBG products. SDN and TRE are leading work to provide enhanced assistance to country teams in engaging with clients and expanding the pipeline of potential guarantee operations. BDM has integrated IBRD and MIGA guarantees into IBRD financial products training, including workshops for country directors and country managers, field-based staff, and clients. FEU organizes internal training sessions in partnership with IFC and MIGA and is planning to provide hands-on training for targeted countries. OPCS, with FEU, is preparing the launch of a regular Guarantee Academy (after Board approval of the new guarantee policy) to enhance staff understanding of the Bank operational policy on guarantees. OPCS continues to assist country teams to apply operational policy in a way which best responds to client needs.

- **WBG coordination and collaboration.**²⁴ The guarantees and other support instruments used by the Bank, IFC and MIGA are complementary and benefit from coordination. In order to strengthen this coordination, SDN has entered into a MOU with IFC advisory unit and MIGA, in particular to enhance the cross marketing of Bank PRGs, IFC services and MIGA insurance. This allows the Bank to take advantage of the strong relationship IFC and MIGA have with investors and financiers. The Bank continues to work closely with IFC and MIGA to jointly support PPPs in many countries. One example of joint support is the issuance of a joint WBG letter of expression of interest to bidders in which the Bank offers its potential PRG support together with IFC investments and MIGA political risk insurance. The upcoming WBG Infrastructure Strategy will explore additional actions to strengthen WBG collaboration, including for joint projects.
- **Pricing and capital allocation.** Management treats IBRD capital allocation and pricing for all guarantee options equivalent to that of loans, a practice that is also used by other MDBs. The IEG report concludes that the pricing of Bank guarantees has not been a constraint on demand for the instruments.²⁵

The Case for a New Operational Policy

25. **Management has decided to review the Bank’s operational policy on guarantees in the light of major shifts in the markets for emerging market debt, foreign direct investment and risk mitigation instruments.** The potential policy reforms discussed in this paper would aim at strengthening the Bank’s ability to respond to such developments. Since the Bank adopted its guarantee policy in the 1990s, emerging market (EM) capital markets have significantly grown in size, sophistication and participation. Foreign Direct Investment (FDI) has also experienced substantial growth in emerging markets, and the demand and supply of Risk Mitigation Instruments (RMIs) have expanded in line with the growth in FDI and the associated debt financing. However, access to private financing remains uneven between middle-income and low-income countries and FDI is highly concentrated in a few large middle income countries. Hence, there remain opportunities for the Bank to help countries attract foreign financing and investments (see Box 4).

26. **Although alternative options have clearly expanded, the World Bank retains several clear comparative advantages as a supplier of RMIs.** As a guarantor, the Bank can add higher value because of (a) its information advantage derived from strong relationships with governments and direct engagement and oversight of projects and programs; and (b) its willingness and superior capacity to spread risks as a highly capitalized development institution with a large and geographically highly diversified portfolio. These advantages also enable the Bank to help governments limit systemic risk during a crisis through better coordination among market participants. For private sector projects, PRGs can also facilitate the efficient allocation of risks among the private and public stakeholders, thus strengthening their incentives to ensure the success of the

²⁴ Annex C describes in more detail WBG coordination.

²⁵ Independent Evaluation Group, op. cit..

projects. For example, private parties bearing construction risk have an incentive to manage the construction well; a government assuming regulatory risk has an incentive to enhance the performance of its regulatory agencies.²⁶

Box 4: Expansion of Emerging Markets

Emerging Market (EM) capital markets have grown exponentially. Since the Bank adopted its guarantee policy in the 1990s, EM capital markets have significantly grown in size, sophistication and participation. Capital flows to developing countries have rebounded somewhat since the onset of the financial crisis, but the current outlook is uncertain, with market volatility ongoing and global economic risks growing. The increase in market access has been quite uneven between middle-income and low-income countries. Most IBRD-only countries (45 countries) have issued debt over the last decade, but only four blend countries (India, Pakistan, Vietnam and Sri Lanka) and three IDA-only countries (Ghana, Nigeria and Senegal) have done so in the same period.

Foreign Direct Investment (FDI) has also experienced substantial growth in emerging markets but it is highly concentrated in a few large middle income countries. After growing from US\$20 billion in 1990 to around US\$150 billion in 1997, FDI commitments fell sharply to around US\$70 billion in 2002 following the Asian and Brazil crises and regained the 1997 levels of investment only in 2009. FDI recipients are dominated by a relatively few countries, particularly higher-income and resource-rich countries. Hence, there are opportunities for the Bank to help the remaining countries attract foreign investments in critical sectors, particularly by strengthening government commitments to appropriate policies and assisting in identifying and developing commercially viable projects.

In response to growing demand, the supply of political risk mitigation instruments (RMIs) has grown significantly over the past three decades. While risk perceptions have declined in middle-income countries with tested regulatory frameworks, political risks remain a major constraint to investments in emerging markets. A political risk survey commissioned by MIGA in 2010 shows that political risks continue to rank at the top of investors' concerns. As a result, demand for RMIs continues to rise as FDI and the associated debt financing grow. In response, public providers such as bilateral and multilateral agencies have significantly increased the supply of RMIs and private providers have also expanded their product portfolios. EM investors can now purchase a variety of RMIs, including credit derivatives, insurance and credit guarantees.

27. **Market developments suggests that the potential beneficiaries of Bank partial credit guarantees may increasingly be found lower along the income spectrum**, particularly among higher-income IDA-only countries. For many of these countries, HIPC and MDRI debt relief has significantly improved prospects for market access. However, IDA countries have historically been more vulnerable to debt crises than higher-income countries and the significant international debt relief was required precisely because of poor debt management in the past. Thus it is important to take a cautious approach to supporting renewed market access by these countries. In the large majority of IBRD countries that already have access, there may still be demand for Bank guarantees during crisis situations. Bank guarantees can potentially also be effective for sub-sovereign borrowers with no credit history, such as SOEs and political subdivisions that seek to establish themselves in the market, or for new sovereign entities as demonstrated by the recent PBG to Serbia.

²⁶ Annex E provides a more detailed discussion of the market for risk mitigation instruments and the rationale for Bank guarantees.

28. **A determination now needs to be made as to which provisions need to be modified in view of the evolving markets and the emerging needs of clients.** The various provisions in the Bank's guarantee policy were established to ensure leverage in the mobilization of private financing and increase development impact, and also to manage risks associated with the guarantees. Some may no longer serve their purpose and unnecessarily hinder the Bank's capacity to address client needs, while others may need to be revised to increase the benefits of guarantees to the country and strengthen the management of risks to the Bank. In addition, the Bank has gained much experience with guarantee operations and its thinking on investment and policy-based lending have evolved over time, which would need to be reflected in the proposed reforms of the guarantee operational policy.

29. **Management's considerations are reinforced by the views of external partners.** These include discussions among the G-20 about the greater use of WBG guarantees to support countries through the crisis; and recommendations by IEG²⁷ that the Bank review policy restrictions that may constrain the use of PRGs and that it consider partial credit guarantees for higher-income, well-performing IDA countries that are on the verge of accessing markets directly and in which IDA assistance is constrained by IDA allocations.

30. **While Management believes that there is potential for further growth of guarantees, guarantees are expected to remain a relatively small share of the Bank's portfolio.** Rather than the number of operations, the contribution of Bank guarantees will be better measured by the significant impact of individual projects. Regions tend to focus on a limited number of transformative projects given the additional time and resources required for their development. Demand will also depend on whether member countries consider the net benefits of guaranteed borrowing to be greater than those of borrowing directly from the Bank. Despite such inherent constraints, Management believes that Bank guarantees have yet to be used to their full potential.

31. **The Approach Paper discusses 17 operational policy issues and proposes approaches to addressing each of them.** For several issues the paper also discusses the advantages and disadvantages of alternative approaches. Among the main policy issues areas are (a) appropriate risk coverage of PRGs; (b) supervision requirements for project-based guarantees, particularly for Bank safeguard policies; (c) extension of PCGs and PBGs to IDA-only countries; (d) requirements for guarantee facilities and guarantee series; and (e) the fuller alignment of PBGs with development policy lending. The Paper also discusses possible reforms of Bank procedures for guarantee operations.

IV. OPERATIONAL POLICY: ISSUES AND PROPOSALS

32. **This section identifies and discusses the key operational policy issues concerning Bank guarantees and proposes approaches to possible policy revisions.** Subsection A focuses on issues regarding PRGs; subsection B on issues regarding PCGs; subsection C on issues common to project-based guarantees (PRGs and PCGs);

²⁷ See *The World Bank Group Guarantee Instruments 1990-2007: An Independent Evaluation*, op.cit. Annex D summarizes IEG findings on Bank guarantees.

subsection D on issues regarding PBGs; and subsection E on the issue of financial leverage which is common to all guarantees. For each issue identified, we set out (a) a summary of the current policy; (b) a discussion and assessment of the issues arising; and (c) a proposed approach to possible policy revisions.

A. Issues Regarding Partial Risk Guarantees

33. **This subsection looks at a number of policy issues concerning the use of PRGs to support private sector projects.** These include (a) appropriate risk coverage of government contractual obligations to the project; (b) the priority of IBRD enclave guarantees over IDA PRGs in IDA-only countries; (c) the eligibility of local currency earning projects for enclave guarantees; and (d) the coverage of government obligations to provide a partial credit guarantee to private projects.²⁸

Issue A1: Appropriate Risk Coverage

Current Policy

34. **A PRG covers debt service defaults when they are caused by a government's failure to meet its obligations under project contracts.** It covers government contractual obligations only to the extent necessary to obtain the private financing for the project, and only insofar as they are covered by the government counter-guarantee²⁹. The nature and scope of the government's undertakings that a PRG may back vary depending on specific project, sector, and country circumstances. A PRG generally does not cover risks of a purely business or commercial nature. It typically covers undertakings that are critical to project viability and are under the government's control, but may also cover undertakings of support against risks that cannot be insured at a reasonable cost such as force majeure risks.

Issues and Assessment

35. **The current policy is flexible as regards risks that can be covered by a PRG and it recognizes the case-specific nature of many risks.** For private projects with government involvement or obligations, the standard principle is to allocate risks to the parties best able to control, manage or bear them. This would mean, for instance, that commercial risks would be assigned to the private sector and political and regulatory risks to the government. However, in practice the distinction between commercial and political or regulatory risks is not always clear, so flexibility is useful. There may be a case for the PRG to cover certain commercial risks if those risks are influenced by government actions and are thus not of a purely commercial nature. For example, a government may require the project to be of a certain size or in a certain location, or use a

²⁸ This paper does not discuss a suggestion in the IEG evaluation of WBG guarantees that the Bank should consider not requiring a counter-guarantee for IDA PRGs in all cases. Such a change would raise major issues across instruments and cannot be considered in isolation from the requirement for a sovereign guarantee for IDA credits to sub-sovereign borrowers.

²⁹ The Bank may guarantee a government entity's contractual obligations, so long as a government indemnity agreement is obtained.

specific technology. If such requirements constrain the private management of commercial risks, the PRG could help the government structure its commitments by identifying the impact of the government's specific requirements. In some cases, the Bank has also covered government undertakings for support against non-insurable force majeure risks such as earthquakes. This can be appropriate when government decisions (for example, on project location and construction standards) affect the project's exposure to the risk or the government is better placed to bear it than the private project company. However, any government undertaking covered by a PRG must be critical to project viability and not be associated with costs that put into question the value of the project to the country.

36. **Risk coverage needs to be flexible but the allocation of risks among the different public and private stakeholders needs to be appropriate.** The major shortcoming of the current policy is that the definition of risk coverage does not focus on the appropriateness of the coverage. Essentially, any risks may be covered as long as they are specified as government contractual obligations. This places the focus on whether the risk is specified as a government obligation, rather than whether it is a risk that the government is best able to manage or bear. This vagueness leaves staff and clients lacking a substantive principle under which to design PRG operations and it raises the possibility that teams may accept an inefficient risk allocation, given that risks can be allocated on the basis of commercial and negotiating strengths. An inefficient allocation of risks creates the danger of moral hazard, that is, those best placed to manage a risk do not have the incentive to do so.

Proposed Approach

37. **Management proposes to introduce a principle for PRG risk coverage based on the efficient allocation of risks among the government and private project sponsors and lenders.** The flexibility in PRG coverage provided in the current policy needs to be complemented by a principle for its use. The principle would be consistent with the standard approach to efficient risk allocation in project finance, which places each risk on the party controlling that risk or best able to manage or bear it, and would take into account the impact of each party's decisions that influence another party's control or management of a risk. Project financing would not be viable if a risk ultimately cannot be borne by any of the parties.

38. **PRGs normally cover risks that are under the government's direct control or significantly impacted by government decisions or actions.** For some risks that neither the government nor the private sector controls or influences, there may still be a case for PRG coverage if the government is better positioned to take them than the private sector. In such cases, however, the onus would be on the team to clearly articulate the rationale for such extended risk coverage and show that the private sector is not better placed, the government undertaking is critical for project viability, and the project remains valuable to the country despite the costs associated with the undertaking.

39. **The new principle for PRG risk coverage would maintain flexibility while establishing a clear principle for determining appropriate risk coverage so as to**

avoid excessive risk-bearing by government and/or the Bank. The principle would recognize that covering risks the private sector controls or is better placed to manage would be inefficient because it weakens incentives for the private sponsors to manage the project well and for private lenders to carefully monitor the project. The principle would recognize parties' rights to make decisions and costs of bearing risks can affect the efficient allocation of risks.

40. **This new principle would supplement the existing policy on PRGs.** Bank PRGs would continue to cover debt service defaults that are caused by the government's failure to meet its contractual obligations to a project. The contractual undertakings a PRG may back would continue to vary depending on project, sector and country circumstances. The aim of the new principle is neither to expand nor reduce the categories of risk that may be covered. Rather, it is meant to help teams determine whether the backing of specific undertakings would be appropriate. A wide range of risks are already covered under the established PRG policy, including force majeure risks (see Box 6).

Box 5: Application of the New Principle on Risk Coverage to Force Majeure Risks

Natural hazards such as earthquakes, hurricanes, floods, and droughts and political force majeure such as violent conflict and civil disturbances are under the control of neither the government nor the private parties. If private sponsors consider the project's exposure to such risks significant and cannot obtain insurance at affordable terms, they may condition their investment on a government undertaking to provide compensation in the event of damages. In considering PRG coverage, the team will need to establish whether the government can bear the risk at a lower cost than the private project company. PRG coverage is typically requested for limited recourse projects where risks cannot be shifted onto the balance sheets of project sponsors. The team will need to consider whether the project remains valuable to the country taking into account the undertaking to compensate. Notably, if the risk event is not limited to a small area of the country but causes a country-wide emergency, the opportunity costs of diverting to private parties resources needed for dealing with the emergency could be prohibitive for a country with limited access to financial markets. An unconditional obligation to compensate the private project company then may be inefficient and not suitable for PRG coverage. Under the new principle for PRG risk coverage, the government undertaking would need to be appropriately structured to be covered by a PRG.

Issue A2: Priority between IBRD Enclave Guarantees and IDA PRGs

Current Policy

41. **Current guarantees policy states that IDA PRG may be used only if the project is ineligible for an IBRD enclave guarantee** and if support from IFC and MIGA is unavailable. This hierarchy principle essentially gives priority to IBRD enclave guarantees over IDA PRGs.

Issues and Assessment

42. **The current policy reflects the high opportunity costs of using donor resources to support private sector projects in IDA-only countries.** It is arguably redundant given that IDA countries would inevitably prefer to access additional IBRD

funds through an IBRD enclave guarantee rather than using their scarce concessional IDA resources.

43. **However, the Bank's opportunity costs of an IBRD enclave guarantee are also non-negligible.** Like all IBRD exposures, IBRD enclave operations are subject to loan loss provisioning and allocation of risk capital. This affects IBRD's net income and reduces the overall availability of capital to other borrowing countries. In addition, allocation of IBRD capital for guarantees to non-creditworthy countries tends to be higher than for IBRD countries, compounding the cost of such operations to IBRD.

Proposed Approach

44. **One option is not to change the policy,** on the grounds that IDA's opportunity costs are normally higher than those of IBRD; and that IBRD can decline an enclave guarantee in a country considered too risky.

45. **Another option would be to remove the policy provision** in question and make the choice between an enclave guarantee and an IDA PRG a matter for country and World Bank judgment, on a case-by-case basis and as part of the CAS dialogue. This option would recognize that the balance of IBRD and IDA opportunity costs may differ between cases. In Management's view the advantage of allowing for an informed choice to be made argues for removing the policy provision.

Issue A3: Enclave Guarantees and Foreign Exchange Earnings

Current Policy

46. **The current policy requires projects to generate foreign exchange outside the country in order to be eligible for an enclave guarantee.**³⁰ Such projects also would need to include credit enhancement arrangements with appropriate risk mitigation measures to minimize IBRD exposure and the risk of a call on the guarantee.

Issues and Assessment

47. **So far there has been only one enclave guarantee operation: the FY 2004 Southern Africa Regional Gas Pipeline Project for Mozambique.** Recognizing the limited opportunities for export-oriented private infrastructure projects in IDA-only countries, the 1997 Board paper indicated that Management would explore other credit enhancement mechanisms to extend enclave guarantees to projects that do not earn foreign exchange. Energy and infrastructure projects, which are critical for a country's development, often generate only domestic revenues.

48. **In December 2009, Management signaled its support for extending the enclave eligibility criteria to projects that generate domestic revenue.** Such projects

³⁰ *Use of IBRD Guarantees to Support Private Enclave Projects in IDA-Only Countries*, IDA/R97-36, April 28, 1997.

would need to be located in relatively highly rated IDA-only countries;³¹ have clear economic and financial benefits; have strong financial flows in local currency through an off-take to a strongly creditworthy party; and in addition, a pre-existing alternative defined source of foreign exchange would need to be “ring-fenced” into a dedicated debt service payment escrow account.³²

Proposed Approach

49. **In accordance with the direction indicated in December 2009, Management proposes to modify the relevant operational policy provision to state that an enclave guarantee project normally is expected to generate foreign exchange outside the country.** This would express a clear preference for foreign exchange earning projects on the grounds that their capacity for credit enhancement better mitigates both IBRD’s credit risk and non-creditworthy countries’ risk of having to shoulder an incremental burden of external indebtedness. It would also implicitly allow for projects that generate domestic revenues and meet the requirements articulated in the recent guidance from Management (see previous paragraph).³³ Note that no new eligibility criteria are being proposed.

Issue A4: PRG Operations with PCG-like Features

Current Policy

50. **The current guarantee policy establishes PRGs and PCGs as distinct guarantee options governed by separate sets of policy provisions.** It does not allow for PRG operations that include coverage for government credit-related commitments, which in effect would transform a component of a PRG into a PCG.

Issues and Assessment

51. **Private lenders for private sector projects have recently demanded credit-type guarantee cover as part of PRG operations.** Some governments have included such cover in their contractual obligations to private sector projects, for example, to mobilize local currency loans and develop the capacity of local financial institutions to support limited-recourse infrastructure projects earning local currency. The Bank so far has not backed such a commitment in a PRG operation, though it is preparing a PRG in support of private power project in Cameroon that would include credit coverage essential for mobilizing domestic debt financing at a late stage of the project. Given the demand, some bilateral agencies and private insurers are pioneering hybrid structures that combine credit and political risk insurance.

³¹ Highly-rated IDA-only countries are considered to be those with low risk of debt distress and above-average CPIA ratings.

³² Enhancing World Bank Guarantees and Enclave Operations, Kiosk Announcement from Senior Management, December 15, 2009.

³³ The operational policy for investment lending is currently being revised and could result in the incorporation of specific provisions on enclave loans. In such a case, those provisions would need to be made consistent with the new policy provisions on enclave guarantees.

52. **A hybrid PRG-PCG guarantee structure would need to be both consistent with the efficient allocation of risks and fully compliant with both PRG and PCG policy provisions.** It should not be used as a mechanism to circumvent important policy requirements for either PRGs or PCGs.

53. **An alternative possible approach is to apply only PRG policy provisions, on an exceptional basis, for hybrid PRG-PCG guarantee structures in cases where the PRG transaction would be predominant.** This would consist of a PRG transaction with some relatively minor credit risk coverage in cases where the nature of the PRG transaction would not change. The challenge of operationalizing this approach is the difficulty of objectively determining whether a hybrid operation is predominantly a PRG transaction. Even if this can be satisfactorily addressed, there would need to be credible arguments for why policy provisions deemed appropriate for PCGs would not be applicable when it is provided together with a PRG transaction.

Proposed Approach

54. **Management proposes to allow a single Bank guarantee operation to provide both PRG and PCG risk coverage for a private party.** This can be achieved by allowing the operation's legal agreements to outline both types of risk coverage. Such an operation would be subject to the policy provisions governing the use of both PRGs and PCGs. Thus the country would need to be eligible for a PCG as well as a PRG. If the reforms of PRGs proposed in this Approach Paper are accepted, it would also mean that the guarantee would need to be consistent with the new risk-based principle for PRG coverage. The key issue is how a credit guarantee by the government for borrowing by a private project could be economically efficient, given that such a guarantee would result in the government taking on commercial risks that it does not influence or manage. The resulting development benefits would need to be clearly articulated and compared against the potential costs.

B Issues Regarding Partial Credit Guarantees (PCGs)

55. **This subsection looks at issues concerning the use of Partial Credit Guarantees (PCGs).** The major issue is the possible extension of PCGs to IDA-only and notional blend countries. In addition, we discuss the current ineligibility for a PCG of countries undergoing debt restructuring.

Issue B1: Eligibility for PCGs for IDA-only countries³⁴

Current Policy

56. **PCGs have so far been made available only to IBRD-eligible countries.** The 1997 IDA Guarantee Board paper introduced PRGs to IDA-only countries, while continuing to exclude PCGs. However, the 2009 Board paper on mainstreaming IDA

³⁴ In the discussions on PCG eligibility, IDA-only countries refer also to nominal blend countries.

PRGs indicated that Management would explore extending PCGs as well as PBGs to IDA-only countries.³⁵

Issues and Assessment

57. **PCGs have been little used in recent years.** There were seven PCG operations between 1994 and 2001. However, in recent years PRGs have been the dominant choice for project-based guarantees and there has only been one PCG operation in the past decade, the Botswana Morupule B power generation and transmission project (2010).³⁶ This in part reflects the shift in demand for guarantees over this period from IBRD to IDA countries, as IBRD-eligible countries found it increasingly easy to mobilize private financing. There might have been greater demand for PCGs if IDA-only countries had been eligible.

58. **In 1997 when the IDA Guarantee Board paper was prepared, it was decided to limit PCGs, as well as PBGs, to only IBRD countries.** The main reason was that IDA-only countries lacked the necessary creditworthiness to access international capital, even with the Bank's credit guarantees. Reflecting this lack of creditworthiness, there were virtually no international capital markets for these borrowers.

59. **Since the late 1990s, the emerging markets have significantly expanded and market access for developing countries has substantially improved, including for IDA countries.** Although generally higher income countries continue to have greater access to the financial markets, IDA countries are increasingly accessing the markets and hence there are greater opportunities for the Bank's partial credit guarantees to have an impact. Improved access has resulted from both gains in credit quality of developing countries as well as the proliferation of dedicated investors in emerging market assets, many of whom are willing to take on higher risks in return for high expected returns. As a result, market access has improved even for countries with relatively lower credit quality. Informal consultations in the financial markets indicate that there could be strong demand for credit guarantees especially for IDA countries in "frontier" markets. Some have benefited from sound macroeconomic policies, good growth prospects and lower debt levels resulting from HIPC and MDRI debt reliefs.

60. **Improved market access can be critical in helping IDA-only countries meet their significant development financing needs, particularly for infrastructure.** The investment needed for infrastructure is estimated at 7 to 9 percent of GDP per year for developing countries, while available concessional funds and domestic public resources are estimated to provide only half this amount. The undersupply of infrastructure services significantly reduces national economic growth and business productivity, limiting countries' ability to reduce poverty and achieve the Millennium Development Goals. The poor state of infrastructure in Sub-Saharan Africa is estimated to reduce national economic growth by 2 percentage points every year and business productivity by as much

³⁵ "Review of the IDA Guarantees Pilot Program," IDA/R2009-0137, May 20, 2009.

³⁶ The Brazil-Bolivia Gas Pipeline Project (2001) was prepared but never signed.

as 40 percent.³⁷ Many IDA-only countries have little choice but to seek private financing to address the financing gap.

61. **Although unmet infrastructure needs are significant today, the same needs were used to justify the unsustainable debt burden accumulated over the 1970s and 1980s.** In countries where the infrastructure projects were ill chosen and the investments poorly executed and maintained, the development impact was limited and unsustainable. In addition, developing economies have historically been more vulnerable to debt crises than higher income countries, and many IDA-only countries required HIPC and MDRI debt relief precisely because of their unsustainable debt accumulation and poor debt management capacity. Although it is critical to address the development investment needs, it is equally critical to ensure that the financing facilitated by PCGs is provided in an environment that maximizes the likelihood of its effective use and minimizes any possible negative impact of the resulting debt on the country's outlook. With respect to extending PCGs to IDA-only countries, regard must be paid to the fact that the Bank would be supporting the contracting of commercial debt in a category of countries which, by definition, the World Bank does not itself consider creditworthy for non-concessional IBRD loans or, in the case of IDA grant recipients, even able to sustain concessional IDA credits.

62. **Consistency with the Bank's Non-Concessional Borrowing Policy (NCBP) will also be an important consideration in extending PCGs to IDA-only countries,** given that in both cases the key concern is ensuring debt sustainability in IDA countries. The NCBP outlines how IDA would respond to instances of non-concessional borrowing by IDA grant-eligible and post-MDRI countries, by either reducing the volume or hardening the terms of assistance. Its primary objective is to address the risk that non-concessional loans may lead to a rapid re-accumulation of debt and thus undermine borrowers' debt sustainability prospects. Of the 80 IDA-eligible countries (including 16 blend countries), 46 countries are subject to the NCBP.

63. **A key building block of the NCBP is the establishment of overall limits on non-concessional external debt,** based on the country's macroeconomic and public financial management capacity and extent of its debt vulnerabilities. The level of debt distress would be determined by the debt sustainability analysis under the Bank's Debt Sustainability Framework (DSF). For countries with lower capacity and high risk of debt distress ("red light" assessment under IDA's resource allocation framework), there would be limited or no room for non-concessional borrowing. For countries with higher capacity or low to moderate risk of debt distress ("green light" and "yellow light" countries), the policy allows for a nonzero limit within which IDA need not respond. While the NCBP sets debt limits, it is not a blanket ban on non-concessional borrowing and the policy acknowledges that under certain circumstances non-concessional loans can appropriately form part of a financing mix that helps promote economic growth and poverty reduction.

³⁷ "Africa's Infrastructure: A Time for Transformation", a co-publication of the Agence Française de Développement and the World Bank.

The policy thus contains a set of country-specific and loan-specific criteria for assessing potential exceptions to the policy.³⁸

Proposed Approach

64. **It is proposed to extend PCGs to IDA-only countries.** Below three options are discussed in terms of the eligibility requirements, with varying degrees of risk tolerance and consistency with the NCBP. Countries which are subject to the NCBP would need to satisfy both the NCBP as well as any eligibility requirements for PCGs. Hence, for these countries any Bank guaranteed borrowing which results in a breach of NCBP country debt limits would be subject to NCBP loan-by-loan exemption procedures regardless of whether PCG eligibility requirements have been met.

65. **Option one is to make IDA countries eligible for PCGs but only if they have low risks of debt distress and adequate debt management capacity.** These requirements would help ensure fiscal sustainability and prudent debt management for countries accessing commercial debt with a World Bank guarantee. In the long run, the general expectation is that higher income, well performing IDA countries on the verge of market access would be better able to satisfy the new eligibility requirements. As currently already required, investment projects benefiting from a PCG would also continue to be assessed in terms of their development impact and economic and financial returns.

66. **It will be important to ensure that the assessments of debt distress and debt management capacity are robust and credible.** The required debt sustainability analysis would utilize the Bank's DSF and would reflect the medium term overall borrowing plan of the country. For IDA countries, a low risk of debt distress translates into a "green light" assessment under IDA's resource allocation framework. The definition and assessment criteria for adequate debt management capacity will need to be further developed and staff may require guidance on relevant procedures and methodology. Debt management capacity can be narrowly defined in terms of the management of public debt and guarantees; or alternatively the definition can be broadened to encompass macroeconomic and public financial management capacity, which would be more consistent with the definition of capacity used for NCBP.³⁹ All IDA countries subject to the NCBP are currently assessed to have low capacity, and therefore potentially only a very limited number of IDA countries could be initially eligible for the PCGs under option one or any other option which requires adequate debt management capacity, if capacity were to be broadly defined.

67. **Option one is generally consistent with but more restrictive than the NCBP.** It is generally consistent in that the eligibility requirements are based on the country's

³⁸ For further details, refer to "IDA's Non-Concessional Borrowing Policy: Progress Update," April 26, 2010, IDA/SecM2010-0240.

³⁹ A more narrow definition has the advantage of limiting additional new requirements by focusing on the capacity constraint considered most relevant to debt management. The broader definition has the advantage of greater consistency with the NCBP but it would add country-level requirements normally associated with only development policy lending and not project-based lending or guarantees.

level of debt vulnerability and government capacity. It is more restrictive than NCBP in two ways: (a) only “green light” countries would be eligible for PCGs whereas under the NCBP “yellow light” in addition to “green light” countries are able to borrow on non-concessional terms, up to an overall debt limit; and (b) option one does not include the loan specific exemption process available under NCBP for all countries, including “red light” countries.⁴⁰

68. The major disadvantage of option one is that it may result in only a limited expansion in opportunities to help countries meet their critical development needs, due to the fact that there may be only a small number of IDA countries which satisfy the requirements for low risk of debt distress and adequate capacity for debt management. Thus, option one may fall short in furthering the potential of guarantees to facilitate member countries’ borrowing for development purposes. In addition, option one would apply country-level requirements to the eligibility for PCGs, without any consideration of the underlying investment project. Even for countries with some concerns regarding its public debt, the underlying investment project may still be sensible if it is expected to have significant economic and financial returns.

69. Option two is to expand eligibility for PCGs to IDA countries with low to moderate risks of debt distress, without an explicit requirement for adequate debt management capacity. Option two would significantly expand country eligibility compared to option one, by including “yellow light” in addition to “green light” IDA countries and by not specifically requiring adequate capacity for debt management. This option would also be more consistent with the NCBP, which allows for greater flexibility for countries with moderate as well as low risks of debt distress. It is also the option most likely to promote expansive use of PCGs in IDA countries. Against this, the Bank would be promoting commercial borrowing by countries which cannot sustain borrowing on IDA’s substantially subsidized credit terms, given its moderate risks of debt distress. In addition, these countries may not have the capacity to adequately plan and manage their borrowing. Hence, under option two there is a greater risk that PCGs can result in promoting unsustainable or poorly managed public debt accumulation.

70. Option three is to require low risks of debt distress and adequate debt management capacity, as in option one, and in addition allow for an exemption for projects with significant financial returns. In IDA countries with moderate risk of debt distress or low debt management capacity, option three would provide access to PCGs for projects with significant financial returns, in the form of strong revenue generation. The exemption would be provided on an exceptional basis and would not be available for countries with high risk of debt distress. The basic rationale for the exemption is that

⁴⁰ There are several arguments for more restrictive requirements for PCGs compared to the NCBP. PCGs actively promote and encourage non-concessional borrowing using the Bank’s resources and reputation, whereas the NCBP outlines IDA’s response to countries’ independent borrowing decisions. PCGs support not just a onetime market access but rather initiate sustained access to capital markets, which could potentially result in rapid re-accumulation of sovereign debt in the absence of adequate debt management capacity. Finally, the markets will perceive the guarantee as a Bank endorsement of the borrowing, thus exposing the Bank to possible reputational risks.

discrete projects with revenues sufficient to service its debt would minimize the risks to government's fiscal and debt sustainability and help mobilize financing for critical projects with significant development potential. Under current Bank policies and procedures, staff is already required to assess the economic and financial viability for all guarantee-supported projects. In order to qualify for the exemption, it would in addition be required that: (a) the financial returns be significant and robust to shocks; (b) the associated borrowing not seriously threaten the borrower's fiscal and debt sustainability if the project is unable to service its debt; and (c) there is an adequate arrangements to ring-fence project revenues in order to ensure that at all times there is sufficient funds for debt service. Alternatively, a broader set of criteria for the exception could be considered, possibly drawing from those used to evaluate exceptions under the NCBP.⁴¹ In cases of exemptions, the PAD would describe the shortcomings in the eligibility criteria and the measures taken by the government to address them.

71. Management believes option three represents the most appropriate balance between the potential benefits and risks of extending PCGs to IDA-only countries. It retains the potential to substantively expand the use of the instruments in IDA-only countries, while also establishing clear eligibility criteria to ensure prudent borrowing. The incorporation of both country and project considerations in the eligibility criteria is also broadly consistent with the approach under the Bank's NCBP.

Issue B2: Eligibility of Countries Undergoing Debt Restructuring

Current Policy

72. For PCGs, the Bank does not guarantee sovereign international borrowings in countries undergoing external debt restructuring until the country completes a debt restructuring agreement with commercial lenders and has in place a macroeconomic framework acceptable to IBRD. The restriction does not apply for PBGs.

Issues and Assessment

73. The rationale for this restriction was the concern that Bank guarantees not become associated with debt restructuring exercises and thereby undermine debt reduction operations supported by the Bank. However, the Bank's policy is that the portion of debt underwritten by a Bank partial credit guarantee (PCG or PBG) is not subject to rescheduling or restructuring, and the Bank's legal agreements include the necessary provisions to this effect. Hence, this policy restriction was not introduced for PBGs.

⁴¹ The criteria under NCBP for assessing exceptions to the policy the impact of borrowing on the macroeconomic framework and the risk of debt distress; strength of policies and institutions; development content of loan; and estimated economic, financial and social returns.

Proposed Approach

74. **It is proposed to remove the restriction.** It appears obsolete given that the portion of debt underwritten by a Bank partial credit guarantee (PCG or PBG) is not subject to rescheduling or restructuring. However, as a matter of normal business judgment, the Bank typically would not consider it prudent to extend guarantees when there is an ongoing major debt restructuring. In addition, an IDA country undergoing a major debt restructuring would not be expected to satisfy the proposed eligibility requirement of low (or moderate) debt distress and, if applicable, the requirement for adequate capacity for debt management.

C. Issues Common to Project-Based Guarantees (PRGs and PCGs)

75. **This subsection looks at policy issues that are common to both types of project-based guarantees, PRGs and PCGs:** policies regarding guarantee facilities and guarantee series; application of the Bank's safeguard policies to project-based guarantees; and the requirements regarding the sector policy framework.

Issue C1: Guarantee Facilities

Current Policy

76. **The Bank's current guarantee policy has no explicit provisions governing guarantee facilities.** Rather, the Board has discussed each proposed facility on a case-by-case basis. Each one involved setting out a framework for some broad parameters for Bank PRG support in certain sectors (mostly infrastructure) of the relevant member countries. However, it is notable that these were each quite different in their terms. Under some of these facilities, arrangements may provide that the local guarantee agency or other suitable agency would identify and pre-appraise candidate projects for proposal to the Bank and subsequent Bank appraisal. The Board may also delegate final approval of PRGs to Management. In the absence of any specific provisions in the policies, in principle guarantee facilities could be for PCGs and well as PRGs.

Issues and Assessment

77. **Experience with PRG facilities has been disappointing; all have been cancelled without issuing a single guarantee.**⁴² Inaccurate estimates of demand and lack of readiness for implementation have undermined these facilities. One major problem was these facilities were submitted to the Board without adequately developed subproject pipelines and without adequate attention to the capacity of the government

⁴² The Ukraine Pre-Export Facility, approved by the Board in 1997, was cancelled in 1999 without becoming effective after the Ukrainian Parliament failed to ratify the project. The 2001 Russia Coal and Forestry Guarantee Facility was closed in 2005 without issuing any guarantees due to limited demand. A PRG Facility for West African Economic and Monetary Union (WAEMU) Capital Market Development, to be implemented through the Banque Ouest Africaine de Developpement (BOAD), issued no guarantees and was cancelled. The Peru Guarantee Facility of 2005 also issued no guarantees and has been cancelled.

counterparts that acted as the Bank's guarantee intermediaries or facilitating partners. The Bank's added-value could also be questioned if the wholesaling of PRGs removes opportunities for close Bank policy dialogue and assistance in appraisal of complex PPPs.

78. **Nevertheless, if appropriately designed, guarantee facilities may have the potential to build national capacity and reduce transaction costs**, through the streamlining of guarantee preparation and appraisals. This might be particularly effective for supporting small-to-medium scale projects. Indonesia has requested PRG support to complement its own national guarantee scheme, and there are likely to be future demands. A key objective of the Indonesia operation, currently being prepared, is to modernize and strengthen the government's capacity and institutions for guarantee issuance. Critical success factors for such facilities include helping governments establish appropriate policies, institutions and capacities for guarantees management; identifying and preparing specific bankable projects for the initial pipeline; and defining guarantee parameters and coverage to address the actual demands of financiers.

Proposed Approach

79. **One option is to incorporate provisions on guarantee facilities in the Bank's operational policies.** There would be new requirements that each guarantee facility operation be presented for Board approval with an assessment of the capacity of the implementing agency, as applicable; a well-prepared subproject pipeline; and at least one first Bank guarantee subproject operation that the Board would approve alongside the guarantee facility framework.

80. **Another option is to continue the current approach of not treating guarantee facilities as a policy matter and instead issuing Management guidance**, on the various requirements proposed under the first option. This second option would be justified if the new requirements can be viewed as Bank procedure matters and as long as each individual Bank PRG associated with the facility adheres to Bank policies and procedures, with the possibility for some limited delegation to a domestic guarantee or other agency should such agency feature in the particular guarantee facility project structure. It is also worth noting that there may not necessarily be delegation to any local agency, and instead there may be complementary parallel actions by the Bank and the relevant national agency. It might be that there is no national agency and just a Bank guarantee facility. In this regard, flexibility of the approach would be an important consideration for the proposed policy reforms.

81. **The first approach directly addresses the key weaknesses manifest in previous PRG facilities.** While the second option appears to be more flexible, necessary flexibility can also be associated with the first option, e.g., by allowing for variation in the structure of the implementing agency. This suggests that incorporating provisions on guarantee facilities in the operational policy would be the more effective approach. In both options, though, it will be important to clarify Bank procedures for subprojects.

Issue C2: Guarantee Series

Current Policy

82. **Similar to guarantee facilities, the Bank’s current guarantee policy has no explicit provisions for guarantee series**, which are essentially guarantee operations that issue multiple guarantees or a series of guarantees with a common structure for similar risk coverage for transactions of similar nature in the same sector. Although each guarantee in a series is thus quite similar, current Bank procedures (BP 14.25) require regular Board presentations for all guarantee operations.

Issues and Assessment

83. **Management has sought and received Board approval for streamlined Board presentation of second and subsequent guarantees in a series.** For the Nigeria Electricity and Gas Improvement Project (2009) which proposed a series of PRGs for similar gas contracts, the Board approved streamlined Board presentation of future guarantees.

Proposed Approach

84. **Management proposes formally to incorporate provisions on guarantee series in the Bank’s operational policies.** Management proposes formally to establish the streamlined Board approval processing for the series of recurring PRGs and PCGs, whereby the project is initially presented to the Board for approval (a) for specific guarantee transactions already appraised; and (b) for a streamlined approach for pre-identified future guarantee operations with similar guarantee coverage in the same or related sector within a predefined guarantee envelope amount.

Issue C3: Application of Safeguard Policies to Guarantees

Current Policy

85. **The Bank’s guarantee policy lacks clarity regarding the specific end point for the Bank’s responsibility for supervising environmental and social safeguard policies.** The policy requires that any investment project benefiting from a Bank guarantee must comply with all Bank social and environmental safeguard policies,⁴³ and Bank procedures require that overall supervision of guarantee operations must continue until the expiration of the guarantee. The guarantee policy is not clear as to which, if any, safeguard requirements ought to be supervised beyond the completion of the underlying project. In the absence of clarity, the Bank may have to continue to supervise environmental and social requirements until the expiration of the guarantee. This creates

⁴³ The environmental and social safeguard policies are set out in the following: OP/BP 4.01, Environmental Assessment; OP/BP 4.04, Natural Habitats; OP 4.36, Forests; OP 4.09, Pest Management; OP/BP 4.10, Indigenous Peoples; OP/BP 4.11, Physical Cultural Resources; OP/BP 4.12, Involuntary Resettlement; OP/BP 4.37, Safety of Dams; OP/BP 7.50, Projects on International Waterways; and OP/BP 7.60, Projects in Disputed Areas.

a significant discrepancy with lending operations, for which the Bank's responsibilities for supervising compliance with safeguard requirements are expected to largely end after loan disbursement and project completion, in accordance with OP13.05, *Project Supervision*.⁴⁴

Issues and Assessment

86. **Recently, the Board approved measures to address similar issues associated with carbon finance operations, through which formal supervision would end at completion of the low-carbon projects.** The operational guidelines that have been in place for the supervision of carbon finance operations until recently have mirrored those for lending operations, not taking into account the fact that the nature of supervision changes over the life of these operations. In March 2011, Management informed the Board⁴⁵ that henceforth for most carbon finance operations, supervision would be carried out in two phases: a first phase, from effectiveness of the Emission Reduction Purchase Agreement (ERPA) to project completion, during which the Bank is responsible for supervision of the underlying project, including compliance with the Bank's environmental and social safeguards, in accordance with supervision procedures applicable to investment lending⁴⁶; and a second phase, from project completion to termination of the ERPA, during which the Bank monitors compliance with the obligations of the party to the ERPA but Bank's OP/BP 13.05, *Project Supervision*, do not apply.

87. **An added complication is that some project-based guarantee operations are not associated with any readily identifiable physical investment.** In guarantee operations which have supported privatization transactions and backstopped government off-take payment obligations, the relevant infrastructure facilities were already in place prior to the Bank's guarantee. In such operations, there is no clear completion date associated with an underlying project, to serve as the basis for determining the end of Bank supervision responsibilities prior to guarantee expiration.

Proposed Approach

88. **Management proposes to clarify Bank policies and procedures relating to guarantee operations to make clear that Bank supervision of the environmental and social safeguard policies would apply only up to the physical completion of the underlying project.** Supervision responsibilities for environmental and social safeguard policies would end upon physical project completion, unless the period for such supervision is extended in accordance with a specific safeguard policy or due to

⁴⁴ BP 13.05 states that Bank supervision of a project normally ends with the ICR, which is prepared upon project completion. In special cases, the country director and sector manager may decide to continue supervision beyond project completion for defined periods, for example continuing supervision of environmental and social safeguards where there are concerns relating to the implementation of resettlement action plans.

⁴⁵ Application of Bank Policies to Carbon Finance Activities, March 8, 2011 (R2011-0056).

⁴⁶ This phase may be extended in the event material issues remain outstanding during the project's operational stage and until they have been resolved satisfactorily.

remaining issues being outstanding without satisfactory resolution. From project completion up to guarantee expiration, staff would continue to monitor any remaining applicable legal covenants and the risks relevant for a possible debt default and call on the Bank guarantee. For operations without a readily identifiable underlying physical investment, the determination of the end point of safeguard supervision responsibilities remains to be clarified over coming months, as part of the Guarantee Modernization exercise.

Issue C4: Requirements regarding satisfactory sector policies

Current Policy

89. **Current guarantee policy requires a satisfactory sector policy framework for IDA PRGs but makes no such requirement for any other project-based guarantees, including PRGs backed by IBRD, PCGs and enclave guarantees in IDA-only and notional blend countries.**

Issues and Assessment

90. **While satisfactory sector policies are important for the achievement of a project's development objectives, there is no clear rationale for requirements to differ between IDA PRGs and IBRD project-based guarantees.** In both IBRD and IDA countries private lenders and investors often seek the Bank's PRG because of concerns about weak sector policies. Thus, requiring that a satisfactory sector policy framework be in place tends to reduce the interest of lenders and investors in an IDA PRG and limit IDA's ability to catalyze private financing for valuable projects which may still be able to succeed within a less than satisfactory overall sector policy environment. Also, given that IDA applies a less demanding requirement to investment lending, the current provision in the guarantee policy tends to create a bias against the use of PRGs in IDA-only countries.

91. **The current policy governing the use of investment lending does not explicitly require a satisfactory sector policy framework.** Instead, the Bank's policy currently requires that investment lending operations "be anchored in country/sector policy analysis." As a matter of Bank practice, staff review and assess whether the country's sector policy is supportive of the achievement of the project development objectives.

Proposed Approach

92. **Management proposes that Bank policy and practice regarding satisfactory sector policies be the same for project-based guarantees and investment lending.** The operational policy on investment lending is being revised in parallel with operational policy on guarantees and a final proposal will be articulated as that work is advanced.

Issue C5: Additional Financing

Current Policy

93. **Current guarantee policy does not include provisions for additional financing.** Additional financing (OP 13.20) applies only to investment lending.

Issues and Assessment

94. **Additional financing may be particularly useful for guarantee series,** in cases where additional guarantee operations are identified which share the common structure of the original series. These new operations would have similar risk coverage for transactions of similar nature in the same sector as the original series. If the option of additional financing were made available for guarantee series, new guarantee operations could be presented to the Board on a streamlined basis. The Africa region has requested that an additional financing operation be considered to scale up activities supported by the PRG series for the Nigeria Electricity and Gas Improvement Project (FY09).

Proposed Approach

95. **Management will explore introducing additional financing operations for Bank guarantees, as part of the Guarantee Modernization exercise.** Although the internal discussions so far have focused on guarantee series, the applicability of additional financing would need to be considered in the context of all guarantee operations. In addition, the operational policy on investment lending is being revised in parallel with operational policy on guarantees, and the need for a consistent approach between the two instruments on additional financing will be an additional factor to consider.

D. Issues Regarding Policy-Based Guarantees

96. **This subsection looks at key policy issues concerning Policy-Based Guarantees:** PBG coverage of domestic financing; the requirement for improved market access; the alignment of PBGs and DPLs; and the extension of PBGs to IDA-only countries.

Issue D1: PBG Coverage of Domestic Financing

Current Policy

97. **PBGs are limited to foreign private financing for external financing needs.** By contrast, PCGs can be used to mobilize both domestic and foreign financing, and DPLs can be provided to help borrowers meet their development financing requirements of either domestic or external origins.

Issues and Assessment

98. **At the time of the 1999 Board paper on PBGs, policy-based financing through adjustment lending was viewed as “balance of payments support” and was thus limited to external financing.** PBGs, as an alternative form of policy-based lending, adopted this same approach. Since then, the Bank’s thinking on policy-based financing has evolved and DPLs can be used to address development financing requirements that have domestic or external origins. In addition, although developing countries’ demand for sovereign domestic financing has increased significantly in recent years, local institutional investors are often limited in their investment choices to short-term debt instruments. A PBG backing longer maturity domestic sovereign debt could broaden choices and contribute to the very important development of domestic capital markets.

Proposed Approach

99. **Management proposes to allow PBGs to be used for both domestic as well as external financing.** This policy change would align PBGs with DPLs and with other Bank guarantee options and would lift an important restriction on the use of PBGs.

*Issue D2: Requirement for a Strong Track Record**Current Policy*

100. **PBGs currently require a strong track record of performance.** In order to be eligible for PBGs, countries must satisfy all DPL eligibility criteria and in addition have a strong track record of performance, sustainable external financing plans with coherent borrowing strategies, and programs for gaining access to international financial markets on their own in the medium term. This section discusses the requirement for a strong track record, while the remaining two additional requirements are addressed later in the paper, in the section on extension of PBGs to IDA-only countries.

Issues and Assessment

101. **A strong track record of performance was meant to strengthen the market signaling value of the Bank’s endorsement of the country’s performance and creditworthiness.** It reflected the notion that the Bank was more informed than the markets about countries’ policy performance and prospects. The requirement was also meant to protect the Bank from reputational risks resulting from the possible misjudgment of country performance or market conditions. This more stringent requirement was in line with expectations that PBGs would be selectively used for countries that met the highest performance standards.

102. **There is little evidence that the requirement for a strong track record has enhanced the market signaling value of PBGs.** Since the PBG option was introduced in 1999, the Bank has provided only three operations: Argentina in 1999 for US\$250 million; Colombia in 2002 for US\$505.6 million; and Serbia in 2010 for US\$400 million.

Despite this limited use, there has been little evidence that PBGs provide a significant signaling value, in terms of the impact on market access, financial leverage or terms. If PBGs had a strong signaling value, increased demand during the recent global financial crisis would have been expected, but in actuality there was little demand. One important reason may be that, for most IBRD countries, the Bank has more limited informational advantage compared to the markets. With the significant expansion of EM capital markets, IBRD countries are now closely tracked by dedicated investors and international credit agencies. Finally, a strong track record would not necessarily be a robust predictor of future performance, particularly if the country's political system has significantly changed or can be expected to change. In such cases, a more forward looking assessment would be relevant.

Proposed Approach

103. **Management proposes to remove the requirement for a strong track record of performance**, given the lack of supportive evidence of its effectiveness in enhancing PBG's impact. Given that PBGs are still subject to DPL operational policies, it remains a requirement that the country's reform program and the commitment to the program be assessed against the country's track record. The strong track record for PBGs was defined relatively broadly, encompassing structural, social and macroeconomic policy performance. Although track record as defined could indicate commitment to the policy reforms supported by the PBG, it would not necessarily be the best predictor of sovereign credit performance. In this sense, low risks of debt distress and adequate debt management capacity, proposed in discussions below on extending PBGs to IDA-only countries, would be more relevant requirements.

Issue D3: Requirement for Improved Market Access

Current Policy

104. **Current policies require that PBGs be used to improve market access.** The 1999 Board paper emphasized that PBGs would be used to facilitate access to markets and OP 14.25 states that PBGs are provided to help borrowers improve their access to private financing.

Issues and Assessment

105. **The introduction of PBGs in the late 1990s was motivated by the East Asian crisis when countries abruptly lost access to international finance.** In addition, at the time, most developing countries had limited opportunities to borrow from the international financial markets.

106. **The requirement for market access appears less relevant today for IBRD countries.** Since the introduction of the PBGs in the late 1990s, the EM capital markets have significantly expanded and many more IBRD countries can access international finance on their own. Hence, demand for PBGs among such countries has significantly declined, and there was little demand for PBGs during the recent global financial crisis,

even though it was the type of situation originally envisioned for the instrument. The PBGs for Argentina (FY00) and Colombia (FY01) helped these countries mobilize substantial private financing when markets were constrained, but this was achieved using the rolling reinstatable guarantee structure which the market might have viewed as providing full guarantee coverage. The Bank no longer uses this guarantee structure.⁴⁷

107. Currently PBGs are of limited use to countries with some level of market access. Unless the current narrow definition of improved market access is satisfied, countries could not use PBGs to gain such benefits as reduced financial terms, diversification of sources of financing (by accessing new market segments) or increased leverage of Bank resources available to the country. Combined with the significantly improved market access for developing countries, this has meant much reduced opportunities to deploy PBGs. The 1999 PBG Board paper defined improved market access as greater volume of private financing and lengthened maturity. However, the Board paper also required PBGs to be “financially efficient,” which was defined as financial leverage and improved financial terms. An appraisal framework for PBGs was outlined that incorporated assessments of both market access and financial efficiency, without prioritizing one over the other. This approach reflects the fact that, inherently, there are trade-offs among increased volumes of financing, lengthened maturities, higher leverage and reduced terms, and PBGs can contribute to the mobilization of private financing through any combination of these factors.

Proposed Approach

108. Management proposes to continue requiring “improved market access” for PBGs but to broaden the definition of improved market access. In addition to the current definition of greater volume of private financing and lengthened maturity, the definition of market access would also include significant financial leverage, improved financial terms,⁴⁸ and access to new sources of financing. In the current policies, a PBG is required to both improve market access, through either greater volume of private financing or lengthened maturity, and also improve financial leverage or terms. With the proposed policy reform, PBGs would be required to have an impact on market access through any combination of the specified factors. Hence, a PBG could be provided to countries that already have some level of market access, if it could have a significant impact through financial leverage or terms. As before, PBGs can continue to be used to help countries access severely constrained markets.

⁴⁷ “Review of IBRD’s Use of the Rolling Reinstatable Guarantee Structure,” SecM2003-0046, February 3, 2003.

⁴⁸ Improved financial terms refers to the implied spread on the unguaranteed portion of the borrowing (which thereby adjusts for the effects of the protection that the Bank guarantee provides) being equal to or lower than a comparable reference spread on nonguaranteed borrowing. Even with the broadened definition of improved market access, at a minimum the implied spread on the unguaranteed portion of the borrowing is expected to be equal to a comparable reference spread.

Issue D4: Alignment of PBGs with DPLs

Current Policy

109. **The operational policies for PBGs and DPLs are distinct and separate.** The policies for PBGs are set out in OP 14.25, while those for DPLs are set out in OP 8.60. OP 14.25 cross-references OP 8.60 to indicate that PBGs need to satisfy all requirements for DPLs.

Issues and Assessment

110. **PBGs and DPLs share many characteristics, as both are policy-based general financing instruments** that help borrowers address development financing requirements and support institutional and policy reforms. In fact, the 1999 PBG Board paper described PBGs as a hybrid of DPLs and PCGs. Unlike DPLs where the financing is provided directly by the Bank, under a PBG operation the private sector provides the financing.

111. **All PBGs have been used to support the continuation of the reforms of preceding policy-based lending operations, but the process has been cumbersome because a formal linkage between the instruments was not possible.** In the most recent case, the Serbia PBG operation necessitated the early termination of the existing programmatic DPL series even though it continued to support essentially the same underlying policy and institutional reforms.

Proposed Approach

112. **Management proposes to structure PBGs as DPLs with streamlined additional requirements.** It would be possible to formally link PBGs and DPLs in a programmatic series supporting the same medium term reform program. PBGs would continue to satisfy all the eligibility conditions for DPLs under OP 8.60. The borrower would choose a PBG over a DPL by assessing the benefits of improved access and comparing the incremental costs of the former compared to the latter. PBGs could either be retained in OP 14.25 or it could be newly incorporated in OP 8.60 as an option under DPLs. For the latter approach, in principle it would be possible to restructure a DPL to a PBG (although this would likely constitute a major restructuring requiring Board approval). For either approach, the goal would be to cover all the relevant provisions to produce a self-contained OP with minimal cross-references to other operational policies.

*Issue D5: PBG Eligibility for IDA-Only Countries*⁴⁹

Current Policy

113. **PBGs, like PCGs, are restricted to IBRD-eligible countries.** Hence, IDA-only countries are currently ineligible for PBGs. Currently, only PRGs are available to IDA-only and notional blend countries.

Issues and Assessment

114. **As for PCGs, the main rationale for excluding IDA-only countries from PBGs was their lack of creditworthiness for accessing international finance.** Hence, the same arguments for extending PCGs to IDA-only countries also apply to PBGs.⁵⁰ In summary, the significant expansion of the EM capital markets and the improved performance of developing countries have expanded market access for these countries. As a result, demand for PBGs in middle-income countries has significantly declined while new opportunities have emerged for low-income countries, including IDA-only countries. Market access has improved even for countries with relatively lower credit quality, because of the emergence of international investors with a greater risk tolerance. However, it is expected that PBGs would be most effective for higher income, well performing IDA countries on the verge of market access.

115. **Ensuring prudent borrowing and appropriate debt management is particularly critical for IDA-only countries,** given their lower capacity and relative lack of experience with commercial sovereign borrowing. Again, the arguments for PCGs generally also apply for PBGs. IDA countries have historically been more vulnerable to debt crises than higher income countries and many of these countries required HIPC and MDRI debt reliefs because of poor debt management. Developing countries could also be more exposed to fluctuations in global capital flows given the more modest size of their economies. Although surging inflows could bring important investment and growth benefits, this would only occur if the countries have appropriate institutions and adequate capacity to absorb the resources.

Proposed Approach

116. **Options one and two for extending eligibility of PCGs to IDA-only countries (Issue B1) are also applicable for PBGs.** Option one is to provide PBGs to IDA-only countries that have low risk of debt distress (“green light” assessment under IDA’s resource allocation framework) and adequate debt management capacity. The major shortcoming of option one is that only a small number of IDA countries may satisfy the eligibility criteria and therefore there may be limited opportunities to help countries meet their critical development needs. Option two widens eligibility to include IDA countries with moderate risk of debt distress (“yellow light” assessment) and in addition would not explicitly require adequate capacity for debt management. The second option expands the

⁴⁹ In the discussions on PBG eligibility, IDA-only countries refer also to nominal blend countries.

⁵⁰ See Issue B1 on eligibility for PCGs for IDA-only countries.

range of countries eligible for PBGs and it would be more consistent with the NCBP which provides for greater flexibility for countries with moderate as well as low risks of debt distress. However, there is a greater risk that the Bank would be promoting commercial borrowing in countries which lack the capacity to plan and manage their debt. Under option two, the Bank would be promoting commercial sovereign borrowing by countries which cannot sustain borrowing even on IDA's substantially subsidized credit terms.

117. Option three would be to delay the extension of PBGs to IDA-only countries until lessons can be learned from using PCGs in these countries. This would allow for greater institutional risk management given that the potential risks associated with PCGs are arguably more manageable than PBGs. PCGs provide targeted support for specific investment projects for which the economic and financial returns can be readily identified. In particular, the sufficiency of the returns for debt service can be assessed. Such an assessment would be more challenging for PBGs which support general sovereign borrowing. Such differentiation is reflected in the NCBP framework which includes project-specific criteria for assessing exemptions from the policies. However, the sequencing of the roll-out of partial credit guarantees would mean that potentially very few IDA-only countries would benefit from the instruments, even more so than under option one. There may also be very few PCGs in the initial years to allow for adequate stocktaking, given that PCGs would normally support large and complex energy and infrastructure projects which typically require a long gestation period.

118. On balance, Management considers option one to be the preferable choice. Option two has potentially significant risks that the Bank would facilitate unsustainable borrowing. Option three would result in missed opportunities to help countries with their development financing needs and would seem overly cautious given that it would not extend PBGs to even those IDA-only countries which have low risks of debt distress and adequate debt management capacity. The additional advantage of option one is that it would apply the same eligibility criteria as under the preferred choice of option three for the proposed extension of PCGs to IDA-only countries.

E. Issues Common to All Guarantees

119. An overarching issue for all guarantee options is whether significant financial leverage should be a requirement for guarantee operations, given that the major objective of guarantees is the mobilization of private financing. The extent to which the Bank's guarantee mobilizes private financing is typically measured by financial leverage, which is the ratio of total private financing (both equity and debt)⁵¹ to

⁵¹ Typically non-Bank guaranteed official debt, for instance IFC lending, is also included in total private financing when calculating leverage for PRG-supported projects.

the present value of the guarantee exposure.⁵² A financial leverage ratio close to (but higher than) one would represent very limited leverage.

Current Policy

120. **Current policy does not include a specific requirement on financial leverage and instead requires that the Bank provide guarantees to the minimum extent necessary to mobilize private financing**, taking into account the nature and complexity of each operation. Hence, there is a general requirement that the appropriate level of guarantee coverage be determined on a case-by-case basis, in recognition of the fact that more complex transactions in less creditworthy countries would require a higher level of credit enhancement. The current policy also requires that partial credit guarantees cover only a portion of the debt and that the risk borne by the private sector be appropriate.

Issues and Assessment

121. **PRGs typically have significant financial leverage**, as the guaranteed debt tends to be relatively small compared to the private equity financing and the additional unguaranteed private debt financing. PCGs and PBGs achieve leverage by (a) covering only a portion of a guaranteed loan or bond issue⁵³ and (b) catalyzing additional non-guaranteed private financing.

122. **Financial leverage has varied widely among the Bank's partial credit guarantee operations.** Historically, financial leverage has ranged from a relatively low 1.56 in Jordan (bullet principal for a 10 year debt instrument) to a high leverage of 7.14 in China (partial principal repayment in the last 3 years on a 15-year amortizing loan). The recent Botswana PCG achieved a financial leverage ratio of almost 7 both by covering only a small portion of debt service for the guaranteed loan (the last 5 years of a 20-year amortizing loan) and by catalyzing substantial additional non-Bank-guaranteed financing. In contrast, the recent Serbia PBG covered a large portion of debt service for the guaranteed loan (bullet principal of a 6-year loan). As a result, the PBG operation achieved a financial leverage of only 1.19. Instead of financial leverage, the major contribution of the guarantee was facilitating market access during times of regional uncertainty and diversifying the country's sources of financing by accessing the international loan market for the first time.

123. **When Bank guarantees were "mainstreamed" in 1994, the requirement for a minimum leverage ratio was considered and explicitly ruled out.** The conclusion was that a minimum ratio would be inappropriate as the judgment about what is significant leverage needs to take into account specific project and country circumstances as well as prevailing market conditions. Instead, it was decided to adopt a more general and flexible

⁵² Alternatively, financial leverage can be measured as the ratio of total *unguaranteed* private financing to the present value of Bank's guarantee exposure, where total unguaranteed private financing equals total private financing net of the present value of Bank's guarantee exposure.

⁵³ Bank PCGs and PBGs guarantee only a specified part of the interest or principal payments for the guaranteed debt. For non-guaranteed payments the Bank does not share its preferred creditor status with the private lenders.

approach based on the aforementioned requirement that the Bank provides guarantees only to the extent necessary.

124. **A priority for financial leverage may not in all cases maximize the benefits of improved market access for the country**, given that there can be trade-offs between increasing financial leverage and other factors of improved market access including lengthened maturities, improved terms of non-guaranteed borrowing, and diversified sources of private financing. This would argue for retaining some flexibility in the approach to financial leverage. The possibility of trade-offs underlies the proposed reform of the PBG requirement for improved market access, which essentially allows for relatively low leverage if market access can be improved based on other factors (see Issue D3).

Proposed Approach

125. **Management proposes that the policy state that financial leverage is a major consideration in providing Bank guarantees.** The analysis of each guarantee operation would include a discussion of the level of financial leverage, taking into account project and country circumstances and prevailing market conditions, and this would be a key part of the Management review of the operation. If there are trade-offs between financial leverage and other financial benefits of the guarantee (including a lengthening of maturities, improvements in the terms of non-guaranteed borrowing, and access to new sources of private financing),⁵⁴ they would be analyzed and taken into account in the discussion and review of the appropriate level of financial leverage. A relatively low level of financial leverage could be potentially acceptable if the guarantee exhibits other financial benefits which are significant and it can be credibly argued that increasing such benefits is more critical for addressing the needs of the country.

V. BANK PROCEDURES FOR GUARANTEES

126. **As part of the Guarantee Modernization exercise, the Bank Procedures (BP 14.25) for Guarantees will be reviewed and revised as necessary.** The main objectives will be to clarify and strengthen supervision and evaluation requirements and align procedures with ILs and DPLs as necessary. A more streamlined and consolidated BP will be prepared which would incorporate the procedural reforms outlined below and reflect the policy reforms proposed in this Approach Paper.

127. **Project-based guarantee operations generally require more time and resources to prepare than ILs, but this largely reflects the nature of the underlying projects as opposed to major differences in processing requirements.**⁵⁵ Most project-based guarantees support large and complex energy and infrastructure projects with

⁵⁴ For example, increasing leverage could be achievable only at the cost of higher financial terms or shorter maturities.

⁵⁵ The comparison is between Bank guarantees and ILs/DPL. For private sector projects, a comparison could also be made between the processing requirements of Bank guarantees and IFC. However, this is an issue that is more broadly applicable to WBG support for private sector projects and hence outside the purview of this Approach Paper.

considerable due diligence requirements. Additional costs and complication result from the need to deal with the financial markets and, in the case of PRGs, the private sponsors and investors. IBRD PRGs have averaged 18.8 months to prepare, at an average cost of US\$800,000, while IDA PRGs averaged 20 months and US\$800,000, excluding the Lao PDR Nam Theun 2 Power Project which cost more than US\$5 million.

128. **The internal processing requirements for guarantees are broadly comparable to their IL and DPL counterparts.** The internal processing of guarantees has several aspects which provide greater flexibility compared to the other instruments. Bank policies on procurement (OP 11.0) and financial management (10.02) do not directly apply to guarantee operations. Guarantees can be presented to the Board before negotiations have been completed. As proposed in this Approach Paper, the supervision requirements for project-based guarantees beyond the completion of the underlying project, particularly with regards to Safeguards, will be aligned with ILs. All guarantee operations require regular Board presentations, whereas ILs and DPLs have the option of streamlined Board processing. The possible introduction of streamlined Board procedures for guarantees will be reviewed, as part of the Guarantee Modernization exercise.

129. **Management plans to apply the risk-based approach of recent IL reform initiatives to project-based guarantees,** which would enhance alignment with IL processing procedures. Accordingly, project-based guarantee operations would need to include an Operational Risk Assessment Framework (ORAF) and the level of risks would determine the extent of processing based on a two-track system. A Nigeria PRG operation currently being prepared is already following the new IL ORAF approach on risk assessment.

130. **Management may need to consider explicitly incorporating Bank procedures for restructuring of guarantee operations,** including the possibility of restructuring which involves conversions between lending and guarantee operations. As with existing procedures for lending operations, restructuring procedures for guarantees is expected to incorporate an approach which differentiates according to the significance of the restructuring.

131. **The new appraisal requirements would need to reflect any revised eligibility requirements for the various guarantee instruments.** Depending on whether the proposed policy reforms are approved, the appraisals of guarantee operations may be required to include specific assessments of financial leverage, debt distress, capacity for debt management, improvements in market access as more broadly defined, and the appropriateness of risk allocation under a PRG. The templates for Project Appraisal Documents and Program Documents may need to be developed specifically for guarantee operations.

132. **There is a substantial need to strengthen supervision and evaluation of guarantee operations.** Current Bank procedures require continued supervision of guarantee operations and preparation of Implementation Status Reports (ISRs) until guarantee expiration. All guarantee operations also need to be formally evaluated, through the preparation of Implementation Completion Reports (ICRs). Current Bank

procedures require that regional staff and FEU together supervise and evaluate Bank guarantee operations. There is a need to clarify and further strengthen the basic requirements for supervision and evaluation. There is a need to formally incorporate guarantee operations in the monitoring of Bank-wide operational portfolio. Currently, the Bank's standard portfolio definition does not include guarantee operations and hence they are excluded from the Bank-wide systematic monitoring of ISR and ICR compliance. Operational portals and ISRs and ICRs specifically designed for guarantee operations would also facilitate supervision and evaluation and the systematic monitoring of these operations.

133. For guarantee operations, the Bank needs to consider its approaches to “integrity due diligence” of the different parties potentially involved in guarantee operations. IFC and MIGA have in place procedures designed to identify reputational risks associated with potential participants in their projects, whether they be borrowers, project sponsors, guarantee holders or other parties. The main purpose is to prevent the involvement of parties that pose a high risk of corruption or require remediation before proceeding with a project. Both institutions have in place a process to screen the names of proposed participants in a project against international watch lists of corruption, money laundering and financing of terrorism. Management will consider such procedures for guarantee operations, taking into consideration the resources and skills required to carry out these specific types of due diligence.

134. Alongside the revisions of the guarantees operational policy, Bank Management also intends to develop tax transparency policies and procedures for World Bank guaranteed operations. These policies are expected to be consistent with the intent of the policies that are adopted by the Board for MIGA, IFC and Treasury operations.

135. The appropriate timing of formal market engagement may need to be further clarified. Market sounding and dialogue with the lenders and project sponsors necessarily occur early on in the preparation of guarantee operations. The Bank's willingness to consider providing a guarantee, which may be required at an early stage in the project cycle, is conveyed to potential lenders and project sponsors with the caveat that it is subject to project due diligence, compliance with applicable Bank policies and approval by the Management and the Board of Executive Directors. While the bond underwriters or lead bank arrangers may be selected by the borrower early on to prepare specific guarantee operations, the Bank reminds the borrower and their underwriters the existence of the caveat and advises that they launch bond issue to general public or general syndication upon Board approval.⁵⁶ However, there remain concerns that formally engaging the markets before Management review and Board approval, for

⁵⁶ In the case of previous loan guarantee transactions, the underwriting banks were selected by the government much ahead of the Board date with a usual caveat. In the case of previous capital market operations, underwriters have been selected by the government with a usual caveat prior to the Board approval and it was clear that no underwriter launch a road show and bond issue until Bank's formal Board approval. Similarly, no arranger bank launches general syndication until after Bank's Board approval.

example by launching a bidding process for the underlying debt, could result in constraining the Bank's decision-making and potentially expose the Bank to reputational risks if it chooses not to proceed with the guarantee.⁵⁷ Such concerns would need to be balanced by the need to have substantially negotiated project documents and guarantee terms in place before Board consideration.

VI. OUTLOOK AND CONSULTATIONS

136. **This paper has proposed an approach to the modernization of the World Bank's operational policy on IBRD and IDA guarantees.** It has identified a range of operational policy issues that Management believes need review and has indicated possible options for modifying or changing policy provisions to address these issues. The proposed modernization of the policy is part of the ongoing broader program for enhancing the use of guarantees that aims at realizing the potential of the instrument to serve member countries' development needs.

137. **Management believes that a modernized operational policy is necessary to enhance client demand for guarantees and increase the number of operations.** Internal consultations with the Bank's Regions, particularly the Africa region, indicate that IDA-only countries would respond to the offer of PCGs and PBGs. Client demand for PBGs also may increase with the proposed possibility for guaranteeing domestic private financing, given the interest of local pension funds and commercial banks in assets with a longer maturity than is currently available in many countries. However, demand for guarantees relative to Bank loans will remain constrained by factors that lie in the nature of the instrument: guarantee operations involve a third party; guarantees are suitable primarily for large and complex PPP projects that are costly and time-intensive to develop; and the costs of guaranteed borrowing may exceed those of borrowing from official sources. On balance, Management expects the share of guarantees in the Bank's portfolio to increase but to remain relatively small.

138. **Management seeks comments and inputs of external stakeholders.** This version of the paper reflects the guidance of CODE members. Before presenting to the Board a final policy paper for its approval, Management is inviting the views and suggestions of external parties that have an interest in the Bank's use of guarantees. Stakeholders may want to focus on the following questions:

- What are your views on how the guarantee instrument can best help developing countries meet their development financing needs?
- Do you agree that the proposed policy reforms will enable better and more effective use of the Bank guarantee instrument, in a wider range of circumstances?

⁵⁷ Note that the government may also cancel the bidding of any transactions, which is well understood by the market.

- Do you agree with the proposal to introduce partial credit guarantees (PCGs and PBGs) to IDA countries but only if they meet eligibility criteria which would ensure that the resulting debt is prudently managed and sustainable?
- Do you agree with the proposals further to align the policy requirements of Project-based guarantees for investment including by aligning supervision responsibilities for Bank safeguard policies?
- Do you agree with the proposals further to align the policy requirements of Policy-based guarantees with those for DPLs?
- Do you agree with the proposal to explore the possibility of extending guarantees to support low-carbon projects to combat climate change and also for hedging products?
- What other suggestions or comments do you have?

ANNEX A: EVOLUTION OF THE BANK GUARANTEE POLICY

1. While the Articles of Agreement envisaged the guarantee of loans to become IBRD's primary instrument for supporting reconstruction and development, members proved to prefer direct lending for various reasons including more favorable terms and absence of credit distinctions. Interest in Bank guarantees emerged in the 1980s when it became apparent that needs for infrastructure investment exceeded many countries' capacity for public funding or borrowing from official sources. The Bank initially used guarantees only to attract private cofinancing for Bank-financed projects, first in the B-Loan program (1983-1988) and then in the Expanded Cofinancing (ECO) program (1989-1994).¹ In 1994, the Bank mainstreamed the guarantee instrument in a policy document that since has governed the use of PRGs and PCGs for private and public sector projects in IBRD-eligible countries.² By widening the applicability and increasing the flexibility of guarantees the Bank responded to estimates of growing infrastructure financing needs, the emergence of large public-private partnerships (PPPs), and also the need of emerging economies to attract private capital for long-term developmental investments rather than short-term and portfolio investments. PRGs became available to IDA-eligible countries in 1997, including IBRD guarantees for enclave projects³ and IDA guarantees for private sector projects not eligible for an enclave guarantee.⁴ PBGs were introduced in 1999 to help IBRD borrowers with strong reform programs gain or regain access international financial markets which had temporarily closed to a number of emerging economies during the Asian financial crisis.⁵ In 2002, Management summarized the guarantee policy documents approved by the Board since 1994 in an Operational Policy statement (OP 14.25) also issued a statement on Bank Procedures (BP 14.25). OP/BP 14.25 was re-issued in 2005 to clarify procurement and supervision requirements and update guarantee charges.

2. **B-Loan program.** The B-Loan program (1983-88) offered commercial bank lenders that were cofinancing Bank-financed projects a choice between guarantees, direct Bank participation in loans, and Bank acceptance of a contingent obligation to finance principal remaining unpaid at final maturity. The B-Loan guarantees were partial credit guarantees limited to late maturity principal repayments of commercial loans. Five B-Loan guarantees were completed including four that were part of concerted debt restructuring packages for heavily indebted Latin American countries. The B-Loan program was suspended in 1988 due to concerns about risks to the Bank resulting from payment sharing arrangements in the direct participation loans.

3. **ECO program.** Partial credit guarantees were continued under the ECO program (1989-94) as an instrument for attracting private cofinancing for public and joint public/private projects in the Bank's lending program. Sources of private capital were expanded by allowing ECO guarantees to be used for bonds as well as commercial loans,

¹ See: *Enhancing the Use of World Bank Guarantees as an Operational Tool. A Review of the World Bank Guarantee Program* (R2000-215; IDA/R2000-215), December 19, 2000.

² See: *Mainstreaming of Guarantees as an Operational Tool* (R94-145), July 14, 1994.

³ See: *Use of IBRD Guarantees to Support Private Enclave Project in IDA-Only Countries*, (R97-85; IDA/R97-36), April 28, 1997.

⁴ See: *A Proposal for IDA Guarantees in IDA-Only Countries* (IDA/R97-135), November 20, 1997.

⁵ See: *World Bank Policy-Based Guarantees* (R99-53), April 20, 1999.

though the limitation to late maturity principal repayments was maintained. In 1991, the guarantee concept was broadened to allow support for private sector projects. The ECO program excluded projects in countries that had undergone debt restructuring in the previous five years. Six guarantees were initiated under the program, including one (in Hungary) that reached financial close before the mainstreaming of guarantees, one (in India) that did not reach financial close due to weak investor confidence at the time, and four that reached financial close after mainstreaming (including power projects in Philippines, China, and Pakistan and a telecom project in Jordan). With the exception of Pakistan, all were PCGs supporting bond issues and syndicated loans for the cofinancing of public sector projects, with four guaranteeing bullet principal and one (China) late principal payments. The guarantee for the Hub Power project in Pakistan was developed for mobilizing private cofinancing for a private sector project. Allowing for the segregation of political and commercial risks, this was the first PRG provided by the Bank.

4. **Mainstreaming of guarantees.** In 1994, the Bank formally established guarantees as a normal instrument of Bank support for projects in IBRD-eligible countries—one that can be used on a stand-alone basis or in conjunction with the investment lending instrument and for all specific projects the Bank may also support through a loan.⁶ The Board-approved paper *Mainstreaming of Guarantees as an Operational Tool* (in the following referred to as *Mainstreaming* paper) introduced two flexible options of the instrument--PRGs for private sector projects and PCGs for public sector projects⁷--that allow for different structures and levels of coverage suitable for mobilizing private financing for a project. (The key features of the options are described below.) *Mainstreaming* also articulated the common policy provisions that govern the use of all guarantees.

5. **PRGs for IDA Countries.** Until 1997, the efforts of IDA-only countries to attract private foreign financing for development projects received WBG support only through IFC, MIGA, and a few IBRD enclave loans with foreign exchange-related credit enhancements. While IDA's mandate is to assume credit risk for the most vulnerable countries, IDA did not directly fund private sector projects, mainly due to competing demands for limited concessional resources from other sectors that cannot attract private resources and the associated high opportunity costs. Facing increasing demand for risk mitigation, and recognizing a gap in the spectrum of instruments, IBRD made PRGs available for enclave projects and IDA for private sector projects that are not eligible for an enclave guarantee and for which sufficient support from IFC and MIGA is not available. Both PRGs are normally non-accelerable, i.e., they limit IBRD's or IDA's payment obligations to the annual principal and interest obligations originally scheduled under the guaranteed loan.

⁶ *Mainstreaming of Guarantees as an Operational Tool*. Op. cit.

⁷ The policy paper did not explicitly exclude the use of PCGs for private sector projects or of PRGs for public sector projects. But it did state that the rationale for supporting a private sector project through a guarantee rather than a loan rested in the Bank's (and the government's) partial risk exposure. Like a Bank loan, a Bank PCG would involve exposure to comprehensive risk. In public sector projects, the government typically carries all risks and the purpose of a guarantee can only be to improve the terms and volume of private financing for the projects.

- **Enclave Guarantee.** Since 1997 IBRD may provide PRGs for projects in IDA-only countries that allow for foreign exchange-related credit enhancement by generating foreign exchange outside the country.⁸ The government is expected to use its revenue from enclave projects for productive development purposes. IBRD minimizes its exposure by (i) determining that the country will have adequate foreign exchange to meet its obligations under the indemnity if the guarantee is called; (ii) normally guaranteeing no more than 25 percent of project financing; (iii) achieving enhancement through appropriate arrangements such as offshore revenue escrow accounts and debt service reserves acceptable to IBRD; and (iv) limiting annual commitments to an aggregate guaranteed amount of US\$300 million. In 2009, Management concluded that foreign exchange-related credit enhancement can also be achieved by projects that do not themselves generate foreign exchange but have strong financial flows through an off-take by a strongly creditworthy party, with enhancement achieved through the dedication of a pre-existing alternative defined source of foreign exchange that is ring-fenced into a dedicated debt service escrow account.
- **IDA Guarantee.** In October 1997, Executive Directors approved a US\$300 million pilot program under which IDA could offer PRGs for private sector projects in IDA-only countries that are not eligible for an enclave guarantee and for which sufficient support is not available from IFC or MIGA.⁹ The size of the pilot program was increased to US\$500 million in 2000.¹⁰ In 2004, eligibility was expanded to include also projects in notional blend countries, and the incentives for using the guarantee were enhanced by a reduction in the IDA commitment authority amount required to back new guarantees from 100 percent to 25 percent.¹¹ IDA PRGs were mainstreamed in 2009, ending the pilot status of the program, and a program ceiling of initially US\$1.5 billion was adopted for risk management purposes.

6. **Policy-Based Guarantees.** A number of emerging economies temporarily lost access to international financial during the East Asian financial crisis and the subsequent global financial crunch in the late 1990s. In 1999, the Bank introduced policy-based guarantees (PBGs) to help IBRD-eligible countries with sound economic policies gain, re-gain or improve access to private foreign financing.¹² Such guarantees must be financially efficient. Under the pilot PBG program outstanding Bank exposure was limited to US\$2 billion. PBGs support strong reform programs which the Bank could also support through development policy lending. However, to limit potential reputational risk to the Bank, the criteria for country eligibility are more demanding than for development policy lending, as discussed below.

⁸ *Use of IBRD Guarantees to Support Private Enclave Project in IDA-Only Countries.* Op.cit.

⁹ *A Proposal for IDA Guarantees in IDA-Only Countries.* Op.cit.

¹⁰ *Enhancing the Use of World Bank Guarantees as an Operational Tool. A Review of the World Bank Guarantee Program.* Op.cit.

¹¹ See: *IDA Guarantees Amendments to Pilot Program (IDA/R2004-0057)*, March 17, 2004.

¹² *World Bank Policy-Based Guarantees.* Op.cit.

ANNEX B: GUARANTEES APPROVED BY THE BOARD TO DATE
(US\$ MILLIONS GUARANTEE COMMITMENT AMOUNT)

Board FY	Region	Country	Name	Type	\$ IBRD	\$ IDA
1994	EAP	China	Yangzhou Thermal Power	C – Partial Credit	57	0
	MNA	Jordan	Jordan Telecom PCG	C – Partial Credit	50	0
1995	EAP	Philippines	Leyte Luzon Geothermal Power	C – Partial Credit	100	0
	SAR	Pakistan	Hub Power Guarantee	R - Partial Risk	240	0
1996	EAP	China	Zhejiang Power Development	C – Partial Credit	64	0
	SAR	Pakistan	Uch Power Guarantee	R - Partial Risk	67	0
1997	EAP	China	Ertan Hydroelectric II	C – Partial Credit	50	0
	MNA	Lebanon	Power Sector Restructuring	C - Partial Credit	100	0
	ECA	Ukraine	Pre-Export Guarantee Facility	F – PRG Facility	120	0
1998	ECA	ECA Region	Commercial Space Launch (UA & RU)	R - Partial Risk	200	0
	MNA	Morocco	Jorf Lasfar PRG	R - Partial Risk	180	0
1999	EAP	Thailand	EGAT-INV PROG SUP PJ	R - Partial Risk	300	0
	AFR	Cote d'Ivoire	Azito Partial Risk Guarantee	R - Partial Risk	0	30
2000	LCR	Argentina	Policy-Based Guarantee	P - Policy Based	250	0
	SAR	Bangladesh	Haripur Power Project	R - Partial Risk	0	60.9
2001	ECA	Russia	Coal/Forest Guarantee Facility	F – PRG Facility	200	0
	LCR	Brazil	Brazil-Bolivia Gas Pipeline	C - Partial Credit	180	0
	LCR	Colombia	Policy-Based Guarantee	P - Policy Based	159	0
2002	AFR	Uganda	Bujugali Hydropower PRG	R - Partial Risk	0	[115] ¹
2003	EAP	Vietnam	Phu My 2.2 BOT Guarantee	R - Partial Risk	0	75
2004	AFR	Mozambique	Southern Africa Regional Gas	R - Partial Risk	30	0
	AFR	AFR Region	WAEMU: Capital Markets Development	F – PRG Facility	0	70
2005	AFR	AFR Region	West Africa Gas Pipeline	R - Partial Risk	0	50
	ECA	Romania	BANAT & DOBROGEA ELECT PRIV GUAR (CRL)	R - Partial Risk	76.7	0
	EAP	Lao PDR	Nam Theun 2 Power Project	R - Partial Risk	0	42
	LCR	Peru	Peru Guarantee Facility	F – PRG Facility	200	0
	AFR	Senegal	Elec Sec Efficiency Enhance Guarantee	R - Partial Risk	0	7.2
2006	AFR	Sierra Leone	Bumbuna Hydro Guarantee	R - Partial Risk	0	38
	AFR	AFR Region	Trade Transp Facilit Rail	R - Partial Risk	0	55
2007	MNA	Jordan	Amman East Power Plant	R - Partial Risk	45	0
	AFR	Uganda	Bujugali Hydropower PRG	R - Partial Risk	0	115
2009	ECA	Albania	Power Distribution Privatization PRG	R - Partial Risk	78	0
	AFR	Nigeria	Electricity and Gas Improvement PRG	R - Partial Risk	0	400
2010	AFR	Botswana	Morupule B Generation Project	C - Partial Credit	242.7	0
2011	ECA	Serbia	Policy-Based Guarantee	P - Policy Based	400	0
2012	AFR	Cameroon	Kribi Gas Power Project	R - Partial Risk		82
	ECA	Macedonia	Policy-Based Guarantee	P - Policy Based	134.9	
Total					3,524	1,025

Note: Not all of the IBRD/IDA guarantee operations listed above have reached financial close.

1. The Uganda Bujugali Hydropower PRG approved in 2002 has been superseded by the same operation in 2007, for a different project sponsor. The total guarantee commitment amount reflects only the 2007 PRG, in order to avoid double counting.

ANNEX C: WORLD BANK GROUP COORDINATION

1. The World Bank Group (WBG) offers a multitude of loan, guarantee, and insurance instruments to help a diverse range of public and private sector clients mobilize private financing. Each WBG institution uses its instruments in accordance with its distinct mandate to serve the needs of its different clients. Coordination between the institutions is needed in cases where the Bank, IFC, and MIGA could potentially support the same private sector project. Collaboration serves to make the best use of complementarities between the institutions' different instruments, specifically in the joint support of large private infrastructure projects, and to exploit synergies in the identification of potential projects and in the marketing of guarantee and political risk insurance instruments. In recent years, a need for wider coordination has arisen with the availability of IFC loan and guarantee support for sub-sovereign public sector borrowers and of MIGA insurance support for sovereign and sub-sovereign borrowings. The following reports on each of these points in turn.

2. **Use of WBG instruments.** Each WBG institution has a mandate that is defined under its charter; and according to these mandates, each member of the group serves the needs of its clients. IBRD and IDA clients are, first and foremost, member governments. IBRD and IDA guarantees, which require a sovereign counter-guarantee, thus play a role that is distinctly different from MIGA political risk insurance (PRI) and IFC guarantees whose primary clients are the private sector. This difference is evident in the usage pattern of guarantees. Bank guarantees are used in support of sovereign and sovereign-guaranteed borrowing to meet a country's development financing needs or finance its priority public sector projects and in support of private lending to private sector projects for which the sovereign government is willing to provide indemnity. IFC guarantees which do not require a sovereign counter-guarantee are used chiefly as unfunded loans to support the borrowing of a wide range of private sector borrowers including corporate clients and securitized transactions, as well as in support of trade finance in increasing amounts in recent years. MIGA offers political risk insurance for cross-border investments, for a wide range of private sector clients such as financial institutions and manufacturers.

3. **Coordination.** The WBG coordination strategy—presented first in a 2000 Board paper¹-- focuses on private sector projects, in particular infrastructure projects, where in practice the chief instrument of Bank support is a Partial Risk Guarantee (PRG), MIGA offers its political risk insurance, and IFC's support has been predominantly in the form of equity and loans (rather than its guarantees). To ensure the most appropriate instrument is selected for a particular project and country context, the deployment of Bank PRGs would generally be considered for transactions with *one or several* of the following characteristics:

- Transactions in sectors in early stages of reform, where the risk of reversal is seen as significant, and where the involvement and influence of the Bank in the sector

¹ See *Enhancing the Use of World Bank Guarantees as an Operational Tool — A Review of the World Bank Guarantee Program*, op. cit.

dialogue, and related policy conditionality are seen as central to the viability and private financeability of the project;

- Riskier and larger operations, where booking of the risk on the Bank's balance sheet, with remedies attached to bank operations, are seen as preferable from a risk management perspective; and
- Operations highly dependent on government support and/or undertakings, where the explicit counter-guarantee and the clout of the Bank are seen as critical to mobilize private financing or enhance leverage in the market.

4. To implement these principles, Bank practice (BP 14.25) requires that IFC and MIGA are consulted at the time of the Bank's concept review and corporate review of all guarantee transactions for private sector projects. As a matter of MIGA internal policy, furthermore, MIGA staff is required to consult with Bank country and sector staff during due diligence on prospective PRI contracts.

5. The majority of private sector projects do not have the above characteristics and IFC and MIGA continue to be the only WBG sources of finance and insurance for such private projects. The need for coordination arises mainly with regard to infrastructure projects with private participation such as Public-Private Partnership projects, BOT projects, and concession projects. After experiencing a sharp slowdown in 1999–2004, annual investment commitments in infrastructure projects with private participation more than doubled between 2004 and 2009, reaching its highest level in 2008. In that period, more than 110 developing countries implemented new infrastructure projects with private participation. Commitments revived after the global financial crisis: by the first quarter of 2010, some 61 developing countries had around 440 PPP infrastructure projects, involving US\$174 billion in commitments, that were seeking financing, had been awarded or had yet to start looking for finance, or were in the final tender stage.

6. **Collaboration.** The WBG institutions often join in supporting projects and also collaborate in the identification of projects and the marketing of instruments. MIGA and IFC often join the Bank in supporting large and complex infrastructure projects (see Annex B). The Bank is in the lead in such projects, helping in their development and providing comprehensive due diligence. The Bank's PRG participation, its ongoing engagement with the country and the sector, and the backing of the PRG by a sovereign counter-guarantee facilitate the participation of MIGA and IFC from the viewpoint of their risk management. This can be particularly effective and efficient where limited Bank resources can be leveraged by MIGA and IFC participation, and where the Bank's guarantee for private lenders can be complemented by MIGA's political risk insurance for equity investors and IFC's equity or loan investments. The Bank works closely with IFC in cases where IFC serves as a transaction adviser to the government in the preparation of private infrastructure projects and the selection of private investors through bidding. To formalize such collaboration FEU on behalf of the Bank entered into a Memorandum of Understanding (MOU) with IFC Advisory unit in 2009. The privatization of the power distributor operator in Albania is an example of an IFC-advised transaction for which an IDA PRG was provided to cover regulatory risks. The

Bank and MIGA collaborate in the marketing of guarantee and PRI instruments. FEU on behalf of the Bank entered into a formal Joint Business Development Agreement with MIGA in 2010 to strengthen cross-marketing abilities, and held workshops to enhance mutual knowledge of instruments for effective marketing.

7. ***Public sector projects.*** In recent years, IFC and MIGA have expanded their focus beyond private sector projects. Since 2007, IFC offers its loans and credit guarantees to sub-sovereign public sector borrowers (subnational governments and state-owned enterprises) without a sovereign guarantee or counter-guarantee. MIGA introduced in 2009 a new insurance coverage called *Non-honoring of Sovereign Financial Obligation* (NHSFO) to cover the irrevocable payment obligations of the government for commercial debt², and has since offered such covering in support of public sector projects in Ghana and Turkey. The deployment of Bank guarantees continue to follow the coordination principles described above. The expansion in the focus of IFC and MIGA, however, suggests a need for wider coordination including all instruments of financial support as well as support for both private and public sector projects.

² “Proposed Change to MIGA’s Policies and Operational regulations” dated April 14 2009 (MIGA/R2009-0014)

Table 2: Private Sector Projects Supported Jointly by the Bank, IFC and MIGA

Country/ Project	IBRD/IDA and IFC/ MIGA Support
Albania – May 2009 OSSH Electricity Distribution Privatization	IBRD PRG EUR 60 million IFC Advisory
Uganda – April 2007 Bujagali Hydropower	IDA PRG US\$115 million IFC US\$100 million A loan; US\$30 million C loan MIGA US\$115 million PRI
Uganda – December 2006 Umeme Power Project	IDA Credit US\$5.5 million used as PRG IFC US\$25 million A loan MIGA US\$45 million PRI
Kenya & Uganda – January 2006 ³ Kenya Uganda Joint Railway Concession	IDA PRG US\$45 million (Kenya) IDA PRG US\$10 million (Uganda) IFC US\$32 million A and C loans IFC Advisory
Lao PDR – March 2005 Nam Theun 2 Hydropower	IDA PRG US\$42 million; US\$20 million IDA Grant MIGA US\$91 million PRI
West Africa – November 2004 West Africa Gas Pipeline	IDA PRG US\$50 million MIGA US\$75 million PRI
Romania - December 2004 Power Dist. Privatization	IBRD PRG – EUR 60 million IFC Equity EUR 170 million
Mozambique - November 2003 S. African Regional Gas Project (SASOL)	IBRD “enclave” PRGs – US\$20 m & US\$10 million MIGA – US\$72 million PRI IFC Equity US\$18.5 million (approx)
Philippines (FY2002) Manila North Tollway Corporation	MIGA US\$85 million PRI; US\$22 million Equity IFC US\$45 million A loan
Cote d’Ivoire – June 1998 Azito Power Project	IDA PRG US\$30.3 million IFC US\$32 million A loan; US\$30 million B loan
Pakistan – May 1996 Uch Power Project	IBRD PRG US\$75 million IFC US\$40 million A Loan; US\$75 million B Loan

³ Not yet effective

ANNEX D: SUMMARY OF IEG FINDINGS ON BANK GUARANTEES

The Independent Evaluation Group's *The World Bank Group Guarantee Instruments 1990-2007 – An Independent Evaluation* includes a comprehensive review of the use of Bank guarantees. The following is a summary of findings.

Effectiveness. The IEG review found that Bank guarantees have been effective in achieving their objectives. PCGs have helped public agencies tap commercial markets on better lending terms and with greater maturities than they would have received without the guarantee. They also have helped introduce or re-introduce borrowers to commercial markets. With one exception, all borrowers subsequently accessed markets without credit enhancements. PRGs backed by IBRD have helped projects in high-risk sectors with untested regulatory frameworks reach financial closure. PRGs backed by IDA have helped introduce complex PPPs in high-risk countries using limited IDA resources. In several large PPPs, IDA's engagement has been critical to secure adequate financing. In addition, PRGs backed by IBRD and IDA have advanced sector policy reforms, and have raised the developmental value of private sector projects by ensuring compliance with the Bank's safeguard policies and continued engagement during project implementation. However, national and regional PRG facilities that were supported by a Bank loan or guarantee suffered from very low utilization. Such facilities have been undermined by inaccurate estimates of demand and often a lack of readiness for implementation. In addition, IEG noted that the coverage of natural force majeure risk in some PRGs has yet to be tested by events.

Potential demand. The IEG review found that liquid capital markets have undermined the value of PCGs and PBGs for investors in many IBRD-eligible countries. However, PCGs/PBGs continue to have potential as an instrument with which the Bank can help countries regain access to capital markets during an economic downturn, help them channel the flow of commercial funds into underserved sectors, and help them mobilize local capital markets for public investment needs. IEG also stated that PCGs would seem to be an effective tool for assisting higher-income, well performing IDA countries that are on the verge of accessing markets directly to help more favorable market credit terms. In addition, the review found that a declining risk perception of doing business in middle-income countries appeared to limit the scope for PRGs in such countries, but that demand for PRGs for projects in higher-risk IDA countries would continue to be strong.

Constraints. In addition to external constraints limiting demand for PCGs and PRGs, the IEG review found that the long preparation times and high costs of PRG operations are largely due to the complexity of the projects and the Bank's value addition, i.e., reflect the nature of the projects. Bank internal constraints are partly of an organizational nature including lack of financial expertise, training, and marketing. A bias for using loans rather than partial credit guarantees to support public sector projects reflects a lack of consensus in the Bank over the relative merits of the instruments. With respect to PRGs, furthermore, the review questioned the continued appropriateness of several policy provisions including the coverage of natural force majeure risks without risk pricing, the application of the last resort principle for PRGs relative to MIGA political risk insurance in all cases, the need for requesting a sovereign counter-guarantee for all IDA PRGs. The review also stated that the Bank's public sector approach in appraising project or requiring private sponsors to mitigate impacts that go beyond the project might be excessive and that a better balance was needed between the PRG as an instrument that enhances the flow of investment and the PRG as an instrument to further broader development objectives.

THE ROLE OF THE BANK IN THE MARKET FOR RISK MITIGATION INSTRUMENTS

1. The Bank as a guarantor participates in the markets for credit and political risk mitigation instruments (RMI) through the supply of its partial credit guarantees (PCGs and PBGs) and PRGs, respectively. These markets have experienced massive changes over the last decade, which have affected the demand for the Bank's guarantees (subsection A). The potential role of the Bank as a guarantor—and the benefits of its guarantees to members that issue counter-guarantees—depends on the value added of Bank guarantees for investors, which is the rationale for the Bank supply of guarantees rather than loans (subsection B).

A. Risk Mitigation Instruments in Developing Countries

1. Credit Risk

2. The markets for emerging markets (EM) capital market issuance have grown manifold in size, sophistication, and participation since the early 1990s when very few developing countries had access to funding in the global capital market and virtually all debt issues were denominated in USD. (See Annex F.) EM debt issuance (including sovereign, corporate, and local bond issues) reached over US\$250 billion in 2010, with issues in about 20 currencies. Surpassing commercial banks, a class of investors in EM assets has emerged that is prepared to take greater credit risk for high returns. Most countries can theoretically raise funds in this market, i.e., market access has become a question of whether the terms demanded by investors are acceptable to the borrower. However, participation in these markets is very uneven. While the great majority of IBRD-only countries has issued sovereign debt either regularly (23 countries) or sporadically (22 countries) over the last decade, only three blend countries (India, Pakistan, and Vietnam) and four IDA-only countries (Ghana, Nigeria, Senegal, and Sri Lanka) and have issued debt sporadically and none regularly.

3. **Supply of RMIs.** EM investors can purchase a variety of RMIs to mitigate credit risk including credit derivatives, insurance, and credit guarantees, though most are available only for debt issues of IBRD-only countries. Some developing countries also offer credit guarantees, though chiefly for the debt of SMEs.

- **Credit derivatives.** Credit default swaps (CDSs) are available for most IBRD countries, but rarely for IDA countries.¹ While CDSs are predominantly used by underwriters/traders for the risk management of their trading positions and by asset managers, hedge funds, and high net worth investors for speculative reasons without necessarily owning the underlying bonds, EM bond investors also buy and hold them to mitigate credit risk.

¹ According to information from The Depository Trust and Clearing Corporation, 26 IBRD-eligible countries (including one Blend country) have had CDS transactions close in the last two quarters (Q4, 2010 and Q1, 2011). Many other countries have CDS quoted, but rarely traded as they have relatively few bonds outstanding, e.g., Serbia and FYR Macedonia.

- **Insurance.** Private mono-line insurers provide full credit (so-called “wrap”) coverage. However, their product supply tends to be highly selective with respect to developing country borrowers and is typically limited to investment-grade transactions². Many mono-line insurers have suffered from the recent financial crisis in the U.S. and other developed countries, resulting in some insurers’ exit from the markets and the reduction of financial capacity in general.
- **Credit guarantees.** Some bilateral agencies such as JBIC have actively offered partial credit guarantees recently to sovereign and sub-national borrowing in lieu of direct lending³, especially to help major middle-income countries’ access to the Japanese capital markets. Other bilateral agencies such as USAID (Development Credit Authority) offer partial credit guarantees for small-scale borrowers and municipalities in local currency. Regional development banks operate public sector and private sector windows within one institution and generally offer a range of products similar to those of the WBG⁴.
- **National credit guarantees.** Developing country themselves have established or contemplate to establish a variety of guarantee schemes chiefly to facilitate access to finance for difficult sectors such as SMEs and sub-nationals and typically offer credit guarantees. The Bank has provided lending support for several of such government-sponsored guarantee and insurance schemes, including IDA-IFC joint risk-sharing facilities for SMEs. Demand for local currency guarantees appears strong especially from sub-sovereign entities seeking to mobilize local currency loans for infrastructure projects with local currency revenues including small-scale projects such as clean energy projects.

4. **Demand for PCGs/PBGs.** These developments suggest changes in the potential demand for the Bank’s partial credit guarantees (PCGs and PBGs). In the large majority of IBRD countries that already have access, potential demand would be limited to crisis situations where investors may turn risk-averse and to cases where sub-sovereign borrowers with no credit history such as SOEs and political sub-divisions seek to establish themselves in the market. Demand could also exist in countries that want to diversify their sources of private financing, e.g., by issuing sovereign debt in local currency or in market segments where they have not been present before, and in countries requesting support for their national guarantee schemes. The main potential demand, however, would be in well-performing countries that seek to enter the market for the first

² Private monocline insurers generally focus on the developed world and lower-risk segment of developing countries because of their internal risk management and maintaining top rating.

³ JBIC provides partial credit guarantees with guarantee coverage of 94-95%. Its recent program for MIC was initially a crisis response program but also serves to help developing countries to diversify sovereign’s funding resources to the Japanese yen markets and risk-averse investor base. It has helped the issuance of US\$[] billion equivalent debt in the past few years by Mexico, Colombia, Indonesia and the Philippines and is said to prepare to assist more.

⁴ For detailed discussion of guarantee and insurance products available from multilateral, bilateral and private entities, please see World Bank/PPIAF Discussion Paper on “*Review of Risk Mitigation Instruments for Infrastructure Financing and Recent Trends and Developments*” (2007)

time, notably IDA countries and IBRD countries with non-investment grade credit ratings.

2. *Political Risk*

5. Private project investments in developing countries continue to be associated with non-commercial risks that could be caused by political and economic instability, structural inefficiencies, and weak structural arrangements. While risk perceptions have declined in middle-income countries with tested regulatory frameworks, the overall demand for political risk mitigation instruments continues to rise along with the growth of foreign direct investment (FDI). A political risk survey commissioned by MIGA in 2010 shows that overall political risks continue to rank at the top of investors' concerns, along with macroeconomic instability and access to financing. Survey respondents specifically mentioned that adverse regulatory changes, political violence, and breach of contract by the government or non-payment of sovereign obligations are the main sources of concern; and three quarters of respondents indicated that over the past three years they have experienced losses caused by political risks in one or more of their investment destinations.

6. ***Supply of RMIs.*** In response to demand, the supply of political risk mitigation instruments has grown strongly over the past three decades, and in recent years has undergone significant transformation with respect to product offerings.

- ***Suppliers.*** The market is dominated by public providers, especially bilateral or multi-national agencies, and served also by private providers with expanding product portfolios. The bilateral agencies are mainly export credit agencies, export-import banks, and investment insurance agencies ("ECAs"). The multilateral providers include the WBG, regional development banks and insurance agencies affiliated with them. Private providers include about twenty Lloyd's syndicates and about eight insurance companies, which offer traditional equity political risk insurance (PRI) as well as non-payment insurance or contract frustration and default by the government.
- ***Products.*** Traditional PRI products (covering currency inconvertibility, expropriation, and war and civil disturbance) have become relatively less important and new instruments have been pioneered by private insurers and ECAs. Among them are comprehensive coverage (combined offering of credit risk insurance and PRI), sovereign non-honoring or sovereign default coverage, and stand-alone property coverage for specific political risks such as terrorism.⁵

7. ***Demand for PRGs.*** The developments in the market for political RMIs suggest that the potential demand for PRGs continues to grow along with FDI except in middle-income countries with more mature institutions. However, other suppliers of RMIs

⁵ PRI has been used before as a surrogate for credit guarantees. For example, NEXI of Japan and OPIC of the U.S. assisted Asian countries' access to the capital markets in the aftermath of the East Asian financial crisis with their political and comprehensive risk insurance.

appear to respond to investor demand for a more comprehensive coverage of risks than provided by Bank PRGs.

B. Bank Supply of Guarantees

8. Bank guarantees offer borrowers a range of benefits additional to those of Bank loans such as limiting the government's risks to those it can control, obtaining financing that would otherwise not be available or affordable, and improving access to capital markets. However, the Bank can generate such benefits only if private lenders and investors see value in the Bank's partial credit and partial risk guarantees and prefer them to their alternatives (bearing risks on their balance sheets or obtaining RMI from other suppliers). The specific rationale for the Bank supply of guarantees therefore rests in the value added Bank guarantees provide to lenders and investors. The specific rationale complements the general rationale for providing Bank financial support (through loans and guarantees), which essentially rests on financial market imperfections due to information asymmetries that result in credit rationing and on externalities and public goods.⁶⁾

9. *Partial credit guarantees.* The Bank's PCGs and PBGs add value to private creditors for three basic reasons: information advantages, risk spreading and systemic or correlated risk.

- *Information advantages.* A Bank PCG adds value to the private creditor by providing comfort that the public sector project to be financed will be well managed and financially viable enabling the project agency to service the debt over the long-term. Such comfort derives from the Bank's information advantage on the project and sector level gained through its involvement in the development of the project and in the sector through previous projects, analytical work, and policy dialogue. This microeconomic knowledge is not readily available to private investors. While the Bank could share its knowledge, but the information would be less credible to private creditors without a guarantee which engages the Bank financially in the project. A Bank PCG therefore can bail in investors that would otherwise not have considered providing project financing on the terms and maturities needed. In the case of a PBG, however, the Bank has less of an information advantage as knowledge about the country's macroeconomic policies and other factors relevant to its creditworthiness tends to be widely available.
- *Risk spreading.* As a means of spreading and diversifying risk credit guarantees have value to risk averse private creditors. Being a well-capitalized guarantor with a large and geographically highly diversified portfolio the Bank can spread risk better than a government, a national development bank, or a private insurer.

⁶ Due to its deep involvement in a country's projects, reform programs, sectors, and policy dialogue the Bank can reduce problems of moral hazard and adverse selection resulting from asymmetric information. By conditioning support on specific actions and on the observation of its safeguard, disclosure, and fiduciary policies the Bank can address social and environmental externalities and further the supply of public goods such as good governance.

Creditors with a concentrated portfolio tend to be more risk averse—demanding higher risk premia and offering smaller amounts or shorter maturities—as they are more exposed to the risk of government default (the tail risk of an extreme loss event). Examples include local pension funds obligated to invest only domestically but also emerging market investors close to their country exposure limit. By spreading the risk of default Bank partial credit guarantees help to reduce risk premia, extend maturities, and allow additional lending within private lenders’ country exposure limits. Risk spreading is particularly valuable to creditors considering lending to first-time borrowers, i.e., borrowers without a credit history on which lenders can assess loss distribution.

- **Systemic risk.** During an economic downturn risks tend to become correlated and a coordination failure then may push the country into a low-level equilibrium. While the government may conduct appropriate macroeconomic policies and have a pipeline of promising projects, a private lender may have little choice but to turn risk averse if no other private lenders are willing to provide funding to the country thus depressing economic activity further, reducing expected returns to all projects in the country and lowering the country’s creditworthiness. As a risk neutral institution the Bank can resolve the coordination failure by offering to guarantee private lending, in effect helping the country re-gain its previous access to financial markets. Unlike the IMF, which provides systemic liquidity in such situations, the Bank’s counter-cyclical use of PCGs or PBGs can support the government’s specific counter-cyclical agenda, assuming credit risk for specific public sector projects and reform programs which it has helped the government prepare and about which it has knowledge.

10. **Partial risk guarantees.** The Bank can attract private financing for private sector projects for the reasons discussed above, specifically Bank knowledge about the project and sector and the Bank’s ability to spread risk better than the government or private insurers.⁷ But PRGs, unlike loans, can create additional value to lenders as well as the other parties to a project by allocating the risks to the parties best able to assess, manage, or bear them. This increases the economic value of the project to the benefit of all parties. For example: private parties bearing construction risk have an incentive to manage the construction well; a government assuming regulatory risk has an incentive to enhance the performance of its regulatory agencies; the private or public party assuming earthquake risk has an incentive to reduce the project’s exposure through choice of location and construction standards; and a private lender exposed to the risk that the private borrower may default for reasons not covered by the PRG is likely to enhance the quality of project screening and monitoring.

⁷ PRGs are less suitable than partial credit guarantees to help address systemic risk. The underlying large and complex private sector projects require long preparation times and so does the development of the appropriate guarantee structure—they cannot be accelerated to fit into the time frame of a countercyclical agenda. In contrast, the development of a PCG is less project-specific and time consuming than that of a PRG. The Bank often is involved in several of a country’s public sector projects of which one may be ready for starting implementation in the right time frame.