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Risk Mitigation Mechanisms (including guarantees and political risk insurance):Building entrance reflection

Risk Mitigation Mechanisms

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This section looks at the different mechanisms products that are available in the market for project sponsors, lenders and governments to mitigate some of the project risks. Including guarantees and political risk insurance.

Hedging and Futures Contracts

Some financial risks can be shared through financial instruments known as **derivatives, futures contracts or hedging**. For example, exposure to foreign exchange risk can be mitigated by swapping currency requirements with another market participant. Equally other risks such as interest rate risk can be managed through the use of derivatives. These arrangements are usually managed under the common terms set out in the International Swaps and Derivatives Association (ISDA) master agreement.

Hedging arrangements will influence the cost of debt, and the breakage costs to be included in termination compensation. Hedge counterparties, or possibly a hedging bank, will be a party to the intercreditor agreement to formalize the sharing of security and arrangements on default. To the extent that hedge counterparties benefit from project security, in theory their hedges should also be limited recourse. Similarly, if hedge counterparties get paid out if they suffer a loss when they close out their hedge, then lenders will argue that they should share any windfall profits. These issues will be addressed in the intercreditor arrangements.

Derivatives are used in many functions in project finance transactions, including

- interest rate swaps – to manage movements in exchange rates to convert variable rate debt to fixed rate debt;
- currency swaps – to manage movements in currency exchange rates; and
- commodity derivatives – to fix the price of commodities over time.

The offtake purchaser may agree to bear interest rate risk, by indexing part of its tariff to cost of debt. However, such tariff adjustments to account for interest rate fluctuations are unlikely to be applied at the speed at which interest rate fluctuations can arise, creating a mismatch risk. Guarantees and other credit enhancement mechanisms can be used to mobilize fixed rate debt.

Use of Insurance

Although the project participants may each provide insurance for the project, it is generally more efficient for the **project company** to provide or ensure provision of **comprehensive insurance coverage** for the **entire project**. In this way the interfaces between different insurance packages, the coverage provided by different insurance providers and the overlapping of the tasks performed by the various project participants will not result in overlapping insurance or gaps in insurance coverage.

The lenders may require that insurance proceeds received by the project company, in certain circumstances or over certain amounts and at their discretion, must be paid to the lenders for repayment of debt. The grantor and the project company will want insurance proceeds always to be used for reinstatement of the works. This

is contrary to the interests of the lenders and will be a heavily negotiated issue. Restrictions imposed by insurers and at law will need to be considered in this context.

Required insurance may become too costly or unavailable. The project company will be required to have in place certain insurances, under the concession agreement and the financing agreement. The parties will need to agree how to manage risks that become "uninsurable", and the definition of this term. For certain risks, and in certain markets, the grantor may agree to be the insurer of last resort, effectively stepping in to insure risk in exchange for the payment of the premium last paid when the insurance was "insurable" or some other agreed rate. However, the grantor will want to be sure that the increased cost is not due to project company failure or actions.

Applicable law may require insurance to be obtained locally, in which case the project company will seek to reinsure those risks internationally in order to obtain the higher-quality insurance protection. Local law may limit the extent to which reinsurance can be used.

Lenders will likely seek cut through arrangements with **reinsurers**, to allow direct payment from reinsurers to the project company and or to the lenders.

Guarantee and Risk Insurance Products Provided by IFIs

Get a snap shot below or click here to view the complete section.

Quick View:

Guarantee and Risk Insurance Products Provided by International Financial Institutions

Visit the section on Risk Mitigation Mechanisms for general information on the topic.

Links to Guarantee and Risk Insurance Products

World Bank Group

- World Bank Group Guarantees Matrix
- World Bank Guarantees
- IFC Partial Credit Guarantee
- MIGA

Asian Development Bank

- Asian Development Bank Guarantees

Inter-American Development Bank

- Inter-American Development Bank Guarantees

African Development Bank

- African Development Bank Guarantees

A number of regional development banks and development finance institutions (DFIs) also offer guarantee and risk insurance products.

Further Reading

- World Bank Group Guarantee Products Guidance Note by the PPP Resource Center, a product of the World Bank PPP Group. Edited by Victoria Delmon and Susanne Foerster, 2016. This publication summarizes key features of the guarantee products offered by each World Bank Group institution and highlights main similarities and differences among them, looking in particular to how these guarantee products may be used in support of public-private partnership (PPP) transactions for infrastructure projects in emerging markets. It is also available in Spanish - Productos de Garantía del Grupo Banco Mundial Nota de Orientación and French - Produits de Garantie du Groupe de la Banque Mondiale
- Index Insurance Forum, an online knowledge platform for global index-insurance practitioners.
- Review of Risk Mitigation Instruments for Infrastructure Financing and Recent Trends and Developments by Tomoko Matsukawa and Odo Habeck, Trends and Policy Options No. 4, Public-Private Infrastructure Advisory Facility (PPIAF) 2007.

Related Content

- **Financing Mechanisms**
- **Government Support**
- **Risk Mitigation**
- **Private Sector Mobilization**
- **Financial Intermediaries**
- **Intercreditor Arrangements**
- **Project Finance – Key Concepts**
- **Key Issues in Developing Project Financed Transactions**
- **Risk Allocation**

- **Government Guarantees**

- **Further Readings on Infrastructure Finance and Risk Mitigation**

Additional Resources

- Managing PPP risks with a new guide on guarantees
- Using government guarantees carefully as the private sector redefines bankability
- Insurance Checklist
- Availability and Terms of Insurance
- Political Risk Insurance

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