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Government Guarantees

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As noted in Government Support in Financing PPPs, efficient financing of PPP projects can involve the use of government support, to ensure that the government bears risks which it can manage better than private investors and to supplement projects which are economically but not financially viable. Where infrastructure projects have large public externalities, some level of direct financial support from the government may be appropriate.

The government will want to manage the provision of government support, and in particular any contingent liabilities created through such support mechanisms, for example through government guarantees of grantor payment obligations or debt repayment. Governments seek a balance between i) the risks they incur when supporting infrastructure investment and ii) fiscal prudence.[1] Striking this balance right will help the government make careful decisions about when to provide public-money support and manage the government liabilities that arise from such public-money support, while still being aggressive in encouraging infrastructure investment.

Valuing Liabilities

Governments need to assess the type of support provided to a project. Direct liabilities can be easily assessed and budgeted as and when the relevant liabilities fall due. For example, the government may undertake to make regular payments to providers of road, hospital, school or prison facilities. As long as the facilities are properly constructed and made "available" to the grantor, the actual use of the facilities has only limited relevance for the availability payment.

The government may also provide guarantees, such as the revenue and exchange rate guarantees provided for toll road projects in Chile, Columbia, Korea and Spain,[2] which compensate facility operators when revenues fall below a given point or when the exchange rate between local currency and the currency of debt exceeds a given ceiling. Such contingent liabilities are more difficult to assess accurately, since the events which give rise to them are uncertain. The insurance industry uses actuarial tables to quantify contingent liabilities, and set its premium at an amount intended to cover its risk, set aside reserves and earn a profit. But, unlike insurance products, government support for PPP is customized, and the body of data about the associated risks is extremely limited.

Other methods exist, such as option-pricing techniques, to value guarantees.[3] A simple way to approach this valuation exercise is to assume maximum exposure, i.e. a 100% likelihood of claims. This is an extremely conservative and most likely inefficient approach. A more aggressive approach assesses the likelihood of claims on the guarantee, the quantum of those claims and their periodicity. The sum of these represents the likely cost to the government of the guarantee. Clearly this approach requires a number of educated guesses, given data constraints.

Hence, valuing contingent liabilities is considered more of an art than a science despite a number of sophisticated methodologies and software designed to assist in the process.

Managing Liabilities

Once the likely cost of the guarantee to the government has been assessed, two practical issues need to be considered:

1) How will the government protect itself?

The government needs to protect itself from the practical and financial implications of calls on its guarantees. This involves first identifying the institution that will manage calls on guarantees with sufficient resources to ensure that calls are correctly made and processed. The government may want to be counter indemnified by the grantor or the relevant ministry; this has the added benefit of reducing the moral risk of guaranteeing breaches by another party (a guarantee of a party's obligation, without any come back by the guarantor against the breaching party, may reduce the incentive for that party to comply with that obligation). A counter indemnity will incentivize the grantor to perform its obligations properly and should reduce the likelihood of calls on the guarantee.

2) Who will pay for the cost of the guarantee?

The government will need to allocate the costs of providing guarantees, in particular the transaction costs associated with allocating government support, the cost of reserves set-aside for the guaranty, and any profit or additional funding to be used to increase available support. These costs can be borne by the government or by the project through the charging of guarantee fees, including upfront charges and periodic fees. Charging fees can also help ensure that guarantees are only sought when needed. Guarantee fees set too low encourage indiscriminate applications, and set too high discourage project implementation.

Governments actively managing fiscal risk exposure face challenges associated with gathering of information, creating opportunities for dialogue, analysis of available information, setting government policy and creating and enforcing appropriate incentives for those involved.[4] Given the complexity of these tasks, it is becoming more popular for governments, and in particular ministries of finance, to create specialist teams to manage fiscal risk arising from contingent liabilities, in particular those associated with PPP. This is often achieved through debt management departments, which are already responsible for risk analysis and management. The institution(s) created to help manage these liabilities can fulfill a number of functions, such as:

- obtaining information on government liabilities, in particular contingent liabilities;
- establishing criteria to guide government decisions (how much risk it will bear, what proportion of each risk it will cover, to which projects it will provide support, etc.);
- developing and housing specialist know-how in relation to the management of fiscal risk and its reporting;
- establishing rules governing the steps to be taken before public-money support can be offered;
- reviewing PPP project proposals to determine whether the proposed contract represents an appropriate investment of government resources and allocation of risk between the government and private investors and how much government support that project should receive;
- estimating the fiscal costs and fiscal risks of proposed public-money support;
- determining the type and level of government support to be extended to any given PPP project;
- monitoring government liabilities and disclosing them in the relevant forums, to give early warnings of required payments and any need to cut back on the issuance of new commitments;
- budgeting, accounting for and disclosing the fiscal risks associated with public-money support and setting the amount of reserve (if any) that the government must set aside with respect to the contingent liabilities borne, supporting the overall government fiscal management regime;
- improving collection through the counter-indemnities obtained from the party whose breach or failure resulted in the liability, to reduce moral hazard; and
- managing the government's total exposure to contingent liabilities, in principle rationing guarantees to their highest value uses while ensuring that the government is exposed only to manageable levels of risk.

Guarantee Fund

A mechanism currently being considered by a number of governments involves the creation of a fund of liquid assets that can be rapidly mobilized in the event that a contingent liability is realized. The fund would have its own balance sheet, be removed from the annual budget cycle, and benefit from independent governance.

The fund could be used to:

- ring fence budget allocations intended for government support of PPP projects;
- reduce the likelihood of diversion of such funds for inefficient use;
- limit liabilities for government support provided to PPP projects to the value of its capitalization of the fund;
- reassure the public that government liabilities in the face of PPP projects are less likely to have catastrophic consequences, improving the credit enhancement function of government support; and
- help the government in their risk management of contingent liabilities (increasing efficiency and targeting of guarantees and ring-fencing government contingent liabilities). Shifting contingent liabilities to a separate entity with its own capital and limited liability will help to ensure there are no hidden risks in the government accounts, and that the government's exposure is limited by its equity in the fund.

Such a fund must be sufficiently independent to permit proper management of the support provided, and closely regulated to ensure the project selection corresponds to government priorities and sectoral/cross-sectoral strategies. It must also have the staff with the skills and expertise needed to assess proposed projects, identify the right balance of government support and manage the implementation of that support, in particular in the run-up to financial close. This requires access to a significant amount of information and resources needed to perform appropriate due diligence.

The clear challenge of such a guarantee fund is its cost. Where assets or cash are set aside in such a fund, they are not available for other purposes and must be managed in a very conservative manner in order to retain the value of the fund. The government incurs this cost even if the assets or funds are not in fact needed to compensate fund liabilities. Where the PPP programme in question is large or high value, the amount of assets that would need to be set aside in the fund may be prohibitive. Governments can also obtain contingent, stand-by facilities (for example from trusted lenders with good credit ratings to provide confidence to the market and those potential purchasers of such guarantees) to offset some of the need to set aside assets. These contingent facilities would be structured in such a way as to provide confidence to recipients of guarantees that sufficient money will be available without delay to address any liabilities the fund may incur, in particular for calls on guarantees, off-setting some of the capital requirements of the fund.

Setting up and managing a guarantee fund would raise issues similar to a financing intermediary, as discussed in Government Support in Financing PPPs, in relation to:

- decision making processes;
- governance;
- management;
- credit enhancement; and
- ensuring the inviolability of its operating policies.

Further Reading and Resources

- Project Development Funds - this Primer by the World Bank Group seeks to identify lessons learned and success factors that influence the design and operationalization of Project Development Funds

(PDFs).

- Government Guarantees for Mobilizing Private Investment in Infrastructure by Jason Zhengrong Lu, Jenny Jing Chao and James Robert Sheppard, World Bank 2019
- An Operational Framework for Managing Fiscal Commitments from Public-Private Partnerships - The Case of Ghana by Riham Shendy, Helen Martin, and Peter Mousley, World Bank 2013
- Towards Better Infrastructure, Conditions, Constraints, and Opportunities in Financing Public-Private Partnerships - Evidence from Cameroon, Côte d'Ivoire, Ghana, Kenya, Nigeria, and Senegal, by Riham Shendy Zachary Kaplan Peter Mousley, World Bank and Public-Private Infrastructure Advisory Facility (PPIAF), 2011.
- Managing Contingent Liabilities in Public- Private Partnerships - Practice in Australia, Chile, and South Africa by Timothy Irwin Tanya Mokdad, World Bank and Public-Private Infrastructure Advisory Facility (PPIAF) 2010.
- *Public Accounting* in Module 2 of Toolkit for Public-Private Partnerships in Roads and Highways World Bank and Public-Private Infrastructure Advisory Facility (PPIAF), 2009 (English and Russian)
- Government Guarantees: Allocating and Valuing Risk in Privately Financed Infrastructure Projects by Timothy C. Irwin, World Bank 2007
- Public-Private Partnerships in the New EU Member States - Managing Fiscal Risk Nina Budina, Hana Polackova Brixi and Timothy Irwin, World Bank Working Paper No. 114, World Bank 2007
- Government Guarantees and Fiscal Risk, International Monetary Fund (IMF), April 2005

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[1]For further discussion of this issue, see Irwin, Government Guarantees: Allocating and Valuing Risk in Privately Financed Infrastructure Projects by Timothy C. Irwin, World Bank 2007

[2]Public-Private Partnerships in the New EU Member States - Managing Fiscal Risk Nina Budina, Hana Polackova Brixi and Timothy Irwin, World Bank Working Paper No. 114, World Bank 2007

[3]Government Guarantees and Fiscal Risk, International Monetary Fund (IMF) 2005

[4]Brixi, Budina and Irwin, (World Bank 2007) supra note 2

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Additional Resources

- Managing PPP risks with a new guide on guarantees

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