Using government guarantees carefully as the private sector redefines bankability

Full Description

The COVID-19 pandemic has placed risk allocation of public-private-partnerships (PPPs) under a stress test: risks that seemed reasonable for the private sector to take mere months ago may no longer be acceptable today. As PPP projects suffer from supply chain disruptions and lower demand, the private sector will start to redefine bankability and seek to transfer more risks to the government. To that end, there is likely increased demand for government guarantees.

At the same time, governments around the world have passed significant fiscal packages to support immediate health, social protection, and economic needs—often through increased borrowing. Therefore, the ability for governments to take on additional risks and contingent liabilities such as guarantees may be limited, especially if existing guarantees become at risk of being called.

How to resolve this dilemma?

Assessing whether and how to use government guarantees is similar during times of crisis as during times of relative calm. In all cases, they should be used strategically to cover specific or target risks based on market sounding for carefully selected, economically viable projects, under an adequate governance and risk management framework.

A new World Bank publication Government Guarantees for Mobilizing Private Investment in Infrastructure, developed with support from the Public-Private Infrastructure Advisory Facility (PPIAF) and the Global Infrastructure Facility (GIF), sets out guidance for governments on best practices in their use of guarantees for PPPs. Key takeaways include:

- Government guarantees are important tools to help make many infrastructure projects bankable from the private sector's perspectives. They can increase investor confidence in PPPs; demonstrate government commitment and support; increase the amount and sources of financing available; and reduce the required returns and cost of capital.

- However, government guarantees must be structured and reviewed carefully upfront as they may fundamentally change the risk allocation of underlying projects. They also may also have serious fiscal impacts in terms of contingent liabilities. For example, overly broad guarantees that transfer risks to the government that should be borne by the private investor can create moral hazard and potentially lead to larger government payouts than necessary.

- There are different ways to structure government guarantees that may have completely different implications for the governments in terms of contingent liabilities. For example, there is a clear distinction between the two fundamental forms of guarantees: financial or credit (debt) guarantees and performance guarantees. Financial or credit guarantees are usually unconditional commitments to service debt obligations of the borrower in case of default. They are often used to help state-owned enterprises (SOEs) or subnational governments raise commercial financing at better terms. This kind of government guarantee essentially transfers all risks to the government and will have more direct fiscal impacts on the government's balance sheet as the guarantee provider.

- Government guarantees used in PPP projects, on the other hand, are typically performance-based and cover targeted risks. These may include political and regulatory risk, revenue and demand risk, and payment and early termination risk of the underlying contract with less creditworthy counterparties. The implications of a financial or performance guarantee for governments' contingent liabilities can be very different, yet often they are erroneously viewed as the same. From a public policy and risk management perspective, it's important to differentiate between the two, and avoid using financial guarantees for PPP projects unless there is a real compelling reason.

- In addition to guarantees, government support for PPP projects may also come in different forms—from comfort letters to letters of support. Here, the legal effectiveness and fiscal risks can be very different as well. What really matters is the actual wording and drafting, which determines the government's real exposure and whether it is legally binding.

- Managing fiscal risks from guarantees requires adequate governance structures and risk management frameworks from appraisal, approvals, accounting, disclosure, and monitoring throughout the project's life cycle, starting with preparation . Budgeting and accounting standards are evolving to allow for more accuracy and transparency of government guarantees, although measuring contingent liabilities still requires complex estimations of the probability of default and the size of the payout. Transparency and public disclosure of the key elements of PPP contracts, including guarantees, are also key to ensure appropriate fiscal risk management for governments.

Finally, government guarantees should only be considered after appropriate sector planning, rigorous analysis of the underlying projects, market sounding, advice from experienced advisors, and careful coordination among different government departments. Unfortunately, this is rarely the case in many developing countries. The government should also establish a system and process to plan, coordinate, and manage its risk exposure ahead of time. The line ministries in charge of project development and approvals should coordinate closely with the Ministry of Finance, which should measure and disclose the government's exposure and obligations on a regular basis. Finally, government guarantees

Although fiscal prudence is more important than ever in light of the emergency spending that the current global crisis entails, issuing guarantees may be one way for governments to encourage continued economic activity in infrastructure through private sector mobilization. Done carefully, this can have positive effects during the recovery phase of the pandemic and help ensure that the infrastructure financing gap can continue to be bridged.

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