Third Party Risk Mitigation and Credit Enhancement

Full Description

The PPP Agreement is at the center of a PPP, as shown in Typical PPP Project Structure. This agreement allocates projects risks, responsibilities, and rewards between the two signatories—the contracting agency and private parties—following the principles discussed in Structuring PPP Projects. The overarching goal is to align the profit incentives of the private parties with the government's objectives for the project.

However, a well-structured PPP agreement, based on sound risk allocation, may not necessarily result in a bankable project. As described in Considerations for Government, if the level of risk allocated to the private party is too high, lenders may increase their lending rates or reduce their willingness to lend to the project to the point where the project becomes unviable or not bankable. For example, projects with particularly high exposure to geotechnical or natural disaster risks—particularly in the context of climate change, as described in Climate Change and Natural Disasters—could be difficult to finance. Projects in countries with a high perceived risk of doing business with the government in general, such as in fragile or conflict-affected states, as described in Infrastructure in Fragile and Conflict-Affected States, often face similar challenges.

In these circumstances, governments can secure the bankability of the project by accepting more risk (through adjusting the agreement or providing additional guarantees), or providing government grants or loans to reduce the extent to which the private party needs to raise finance, as described in Finance Structures for PPP. However, these levers have limitations: they may reduce the risk transfer to the point where the alignment of incentives is simply too weak to be effective; they may present fiscal costs or risks that the government is not willing to bear; or they may simply not be effective, particularly in the case of significant political risk or risk of adverse government behavior, which is borne by the private party by definition.

An alternative option is to assign some part of the project risk to a third party through a credit enhancement or risk transfer instrument. These instruments include guarantees, insurance policies, or hedging mechanisms under which, for a fee, the provider will agree to compensate the concessionaire (or its lenders) in case of default and/or loss due to some specified circumstance. Some of these instruments are offered by commercial providers, such as insurance companies or swap providers, which specialize in pricing and managing risks. Others are offered by development finance institutions, such as MIGA, that have access to concessional capital, explicit mandates, different risk appetites, and/or are better placed than private sector lenders to assess and manage the specific risks involved in investing in emerging markets—see (WB 2016h) as an example.

Risk mitigation or credit enhancement instruments fall into three broad types: full, or comprehensive credit guarantees, which cover the totality of a project's senior debt against all risks; partial credit guarantees, which cover a certain proportion of a project's debt for all risks; and a range of partial risk instruments which provide full or partial cover of loss due to specific risks.

For a general discussion of risk mitigation instruments, the **OECD's report mapping instruments and incentives for infrastructure financing** (OECD 2015c) provides a comprehensive description of different instrument types, and the **African Development Bank (AfDB) on the Initiative for Risk Mitigation** (Pierris 2012, 68–72) present several examples. The **World Economic Forum** (WEF 2016) has undertaken a recent assessment of the availability and use of risk mitigation instruments for infrastructure in developing countries.

Example of Third-Party Risk Mitigation or Credit Enhancement Instruments

Instrument	Description	Example Provider(s)

Full or comprehensive credit guarantees	Cover the full value of a project's senior debt for all risks. Such cover is typically available for projects that are already relatively low-risk, with the objective of raising the rating of those projects to investment grade, enabling more risk-averse investors such as pension funds to participate in the project financing.	Historically such guarantees were provided by "monoline" insurers. Providers of such guarantees are relatively few, and include some development finance institutions (e.g. EIB), Export Credit Agencies, and MIGA's guarantees regarding 'non honoring of financial obligation'.
Partial credit guarantees (PCGs)	Tailored to the project, they cover loss in case of default up to a certain proportion of a project's senior debt. This cover may be on a first loss or *pari passu* basis. First loss guarantees absorb the first percentage of loss given default: that is, they reduce the risk of loss from a lender's perspective in a similar way to subordinated debt. Pari passu guarantees absorb a defined percentage of any loss—that is, reduce the size of loss, but not the risk.	Most development finance institutions can provide partial credit guarantees, for example the World Bank, or the EIB's Project Bond Initiative, which can offer both subordinated debt or partial credit guarantees. GuarantCo specializes in providing partial credit guarantees in local currency, to enable local financial institutions to participate in project financing (also reducing currency-related risks).
Political risk insurance	Protect the project sponsor and/or lender from loss due to political risks. These may include the risk of expropriation, political violence such as war or civil disturbance, or transfer or convertibility risk, and breach-of-contract risks.	Offered by several development finance institutions, including the Multilateral Guarantee Agency (MIGA). A report by the **Initiative for Risk Mitigation in Africa** (IRMA) (Pierris 2012), which is a program in partnership with the AfDB, it illustrates that the range of IRMA's PRI instruments that can be used for PPP projects.
Currency swaps or forward contracts	Swaps or forward contracts to hedge against fluctuations in currency or commodity prices. Currency swaps in particular are often available only for a limited range of widely-traded currencies.	Commercial banks and the Currency Exchange (TCX), a donor-funded initiative that provides currency swaps for a wide range of currencies.
Insurance or contingent credit lines against natural disasters	Protect from loss due to natural disaster, or alternatively, provide a contingent credit line to finance needed investments.	Provided by several development finance institutions or in some cases, private providers. Examples include index-based weather derivatives (see the Uruguay Weather Derivative), or the World Bank's Catastrophic Risk Deferred Drawdown Option (WB 2011a).

Accessing these risk mitigation or credit enhancement instruments is mostly the responsibility of the concessionaire during arranging financing for the project. Governments may also consider the option of credit enhancement when structuring a project, and engage with potential providers prior to bringing it to market—particularly for credit enhancements designed to back up the government's own commitment to the project. This can help attract bidders who may otherwise not participate, and ensure bids are based on comparable assumptions, resulting in a more competitive procurement for the project.

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