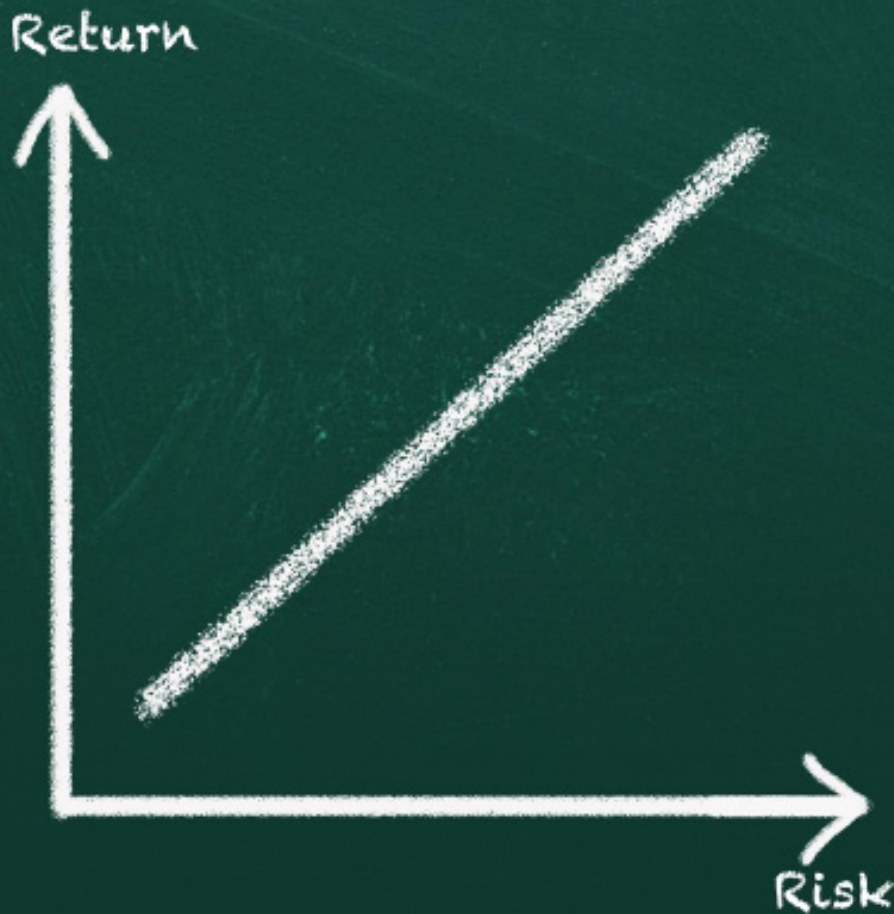


OCTOBER 2019



Innovations in Guarantees for Development

PROJECT DIRECTORS

Daniel F. Runde

Paddy Carter

AUTHORS

Romina Bandura

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A Report of the CSIS PROJECT ON PROSPERITY AND DEVELOPMENT

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Second, the authors would like to thank senior CSIS affiliates, Conor Savoy, John Wasielewski, and John Simon, for providing advice and critical feedback throughout the research process. Third, the authors would like to thank the various outside experts who reviewed this report and offered generous inputs: Neil Gregory, Jason Fleming, Jamie Cashman, Pablo Pereira dos Santos, Andrew Davison, Chris Humphrey, Joost Zuidberg, David Stevens, Josh Grundleger, Roy Torkelson, Harsha Kodali, Chris Clubb, Justice Johnston, John Moran, and Mildred Callear.

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Foreword

Mobilizing private investors has always been core to CDC's strategy. With our advisory services and our capital, we support new private equity fund managers in frontier markets so that they can fundraise successfully, and we invest equity directly in growing businesses to take them to the point where they can attract more risk-averse private capital—to give but two examples. But we know that we can do more, which is why this year we created a new Capital Partnerships team to identify more opportunities for risk-sharing partnerships and co-investment with both financial and strategic investors.

Supporting this research by CSIS is part of our effort to mobilize private investment in Africa and South Asia. We gave CSIS a difficult brief: to identify opportunities for innovation in the use of guarantees, ideas that could then be seized by development agencies and institutions.

It has been fascinating to watch the progression of their research through consultations and roundtables with industry participants. Early in the process, it became apparent that the role we had imagined CSIS might focus on—how to use guarantees to enable developing countries to access the huge pools of capital held by pension funds and insurers in the OECD—was not regarded as the priority. Although some projects did need this approach, the general view was that it was less important to direct hard currency debt towards developing countries than to develop financial markets at the local level.

The innovative ideas that CSIS have identified in this report range from actions that could be taken by development agencies tomorrow without too much difficulty, such as scaling-up local specialized guarantee providers or establishing new ones, to more blue-sky thinking, such as using guarantees as a tool to coordinate clusters of investments in low-income fragile states.

The emphasis on fostering local financial markets chimes well with the broader trend towards prioritizing market creation that we observe across development finance institutions. Although using guarantees to unlock individual investments can have an important impact, the larger goal must be to increase the capacity of the financial sectors in Africa and Asia, in order to understand, price, and take risks.

PADDY CARTER

Director of Research and Policy, CDC Group

Executive Summary

Bilateral and multilateral development agencies use guarantees in order to reduce investors' exposure to risks and to attract private capital to developing countries. A guarantee is a legally binding agreement under which the guarantor agrees to pay part or all of the amount due on a loan, or other financial instrument, in the event of non-payment.

Guarantees are not a silver-bullet solution to mobilizing private capital into the developing world. Purchasing a guarantee involves sacrificing some return in exchange for reducing exposure to risk; since investors deliberately take risks to earn returns, this is a trade to which they are often indifferent. But across the developing world, there are places where having access to the right guarantee product will enable investments that would otherwise have been blocked—where the returns are there, but the risks involved simply exceed market tolerances, or where regulations limit investors' ability to bear risk. These opportunities are waiting to be seized by bilateral development agencies and development finance institutions (DFIs), who have the flexibility to innovate.

Multilateral development banks (MDBs) are the dominant providers of guarantees in certain market segments, where their ability to influence government behavior and to reduce (rather than merely reallocate) risks on the ground gives them a natural advantage. That said, their accounting practices, governance structures, and business models can also constrain them. In other market segments, specialized guarantee providers or DFIs can create tailored guarantees, pricing them in a way that creates a commercially appealing proposition whilst still earning market rates of return on their capital.

This report sets out to present the virtues and shortcomings of scaling the use of guarantees, with a special focus on opportunities for innovation by actors that operate outside the established MDB business model. Since guarantees are not a form of financial flow (unless circumstances require calling the guarantee, with the guarantor assuming the debt of the borrower), they differ from other development finance instruments in terms of structuring, costs, and objectives. With their distinct features, guarantees provide a number of advantages vis-à-vis other forms of development assistance. Some of the things that guarantees can do include:

- Providing access to large pools of capital held by regulated investors. Although a guarantee does not necessarily lead to a credit rating uplift, guarantees can reduce the cost of capital by transferring certain types of risks, therefore enabling different

kinds of asset managers—such as pension funds, insurers and sovereign wealth funds—to invest.

- Facilitating project implementation. Guarantees, particularly those issued by MDBs, can provide the assurance that investors need to back long-term infrastructure investments and thus increase the chances of the project materializing.
- Sharing risks with financial institutions that have reached their exposure limits in certain markets, yet still see opportunities to do more business.
- Helping develop local financial markets. DFIs can have a long-term impact through getting new private investors comfortable with unfamiliar markets, and guarantees can be a more effective tool for that purpose than direct lending or equity investments.
- Strengthening domestic municipal bond markets. At a time of rapid urbanization where financing constraints create bottlenecks in public services and other urban infrastructure necessary for inclusive growth, guarantees can back municipal bonds and diversify the pool of assets for investors.

With that said, guarantees do have some shortcomings:

- They cannot fix the underlying problems created by weak legal and political environments or make a bad project bankable. In the absence of strong legal and political environments, no amount of financial engineering can change the commercial appeal of projects in small, unpredictable markets that are easily manipulated by political interference. Guarantees cannot fix business challenges either, such as an incompetent management team, inadequate human capital, or low demand.
- In certain situations, guarantees can create a moral hazard. For example, when a bank has a loan portfolio guaranteed, it may exert less effort in screening and monitoring borrowers.
- Although guarantees are flexible and highly customizable as a development finance tool, they are more difficult to structure compared to other development finance instruments like equity and loans.

Despite their potential, guarantees issued by multilateral development banks and development finance institutions only represent a small percentage of their portfolios, even given the fact that they have been rarely called or claimed. Only 13 of the 30 members of the Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD) have been structuring guarantees for international development. In fact, guarantees are used most often in middle-income emerging economies, while low-income and lower-middle-income economies remain underserved. Moreover, some sectors, such as infrastructure development, education, and health, continue to be underserved, with 70 percent of all private capital mobilized by guarantees going to two sectors: financial services and energy.

International development institutions are being asked to attract higher amounts of private financing in low-income countries and fragile states. Yet these countries face institutional and macroeconomic challenges making them unappealing to cross-border private investors. Furthermore, they may be unable to tap into their existing pools of domestic savings, and they only have a small pipeline of bankable projects.

This confluence of factors presents a challenge to bilateral aid agencies and DFIs: how to devise guarantees and other innovative approaches to crowd investment into low-income and fragile states. Bilateral development agencies and DFIs have the flexibility to act in these markets in ways their MDB counterparts might not. First, since most bilateral aid agencies (and some DFIs) are backed by their host country's treasuries and are not constrained by needing to maintain a credit rating, they can be more flexible and take on more risk. MDBs raise most of their money from financial markets; since their business model and stakeholder expectations require them to maintain AAA credit ratings, they are notably conservative when it comes to taking risk. Additionally, their internal accounting rules require them to provision guarantees in the same way as they would direct loans, even though guarantees are rarely called. This creates internal disincentives for MDBs to issue guarantees when they could instead offer a more straightforward loan.

Bilaterals have comparatively more freedom to structure and price guarantees. Moreover, they can create or support specialized providers that are able to make market rates of return on capital, thus obtaining a credit rating they can confer via their guarantees. This allows them to take advantage of business model efficiencies and tailored regulatory treatment to price their products more competitively. Second, bilaterals and specialized entities are smaller and less complex than MDBs, which may allow them to be more flexible and to respond more quickly to evolving challenges. Being supranational entities, MDBs are owned by multiple countries with diverse and sometimes conflicting interests, so pushing them to be more innovative is hard.

Recognizing the unique strengths of bilaterals, this report makes the following five recommendations for the innovative use of guarantees:

- i. Create or support specialized financial intermediaries that provide insurance and guarantees (similar to monolines);
- ii. Explore the use of guarantees to support the introduction of asset-backed securitization, in order to allow capital to be recycled more quickly;
- iii. Deploy guarantees as a tool to coordinate investment clusters in fragile countries;
- iv. Support national project development funds that can help develop bankable projects; and
- v. Increase collaboration between guarantee providers to share risks and scale guarantees in challenging contexts.

By supporting specialized financial intermediaries (like private monoline insurers) and using guarantees to back securitization and other structured finance products in developing countries, bilateral agencies can help develop local capital markets and scale up investments. Because MDBs price loans and guarantees similarly, a guarantee package can end up being more expensive than a simple loan. Thus, outside of cases where MDBs' influence on market behavior is required, the current pricing model at MDBs does not incentivize greater use of guarantees. However, specialized guarantee providers are able to leverage their capital more efficiently (because guarantees are unfunded) and obtain better credit ratings at higher levels of leverage; financial regulators know that loans will quickly be restructured, meaning that they will usually only have to cover a few payments when guarantees are called. This allows them to offer lower prices without sacrificing their

return on capital. Therefore, if donors want to scale up the use of guarantees, they need to scale up specialized guarantee providers—at least outside of those segments where the political influence of MDBs gives them an advantage.

Many current investments and guarantee deals are structured in “easier” places, i.e., upper-middle-income countries, or are skewed towards certain sectors, such as energy and financial services. In fragile contexts, the private sector remains underdeveloped; bilaterals could use guarantees to help coordinate investments to develop investment clusters in frontier markets. MDBs and DFIs are best placed to champion pioneering firms, whose success could generate spillovers with huge social benefits and whose presence in the market could generate an interdependent cluster of other firms. The use of guarantees and equity can help jumpstart these investments.

Bilaterals and MDBs can also support countries looking to mobilize private funding for infrastructure projects by helping governments set up their own national project development funds. These funds would create a pipeline of bankable projects and provide investors guarantees against early-stage risks. In this regard, the role of bilaterals would not be to provide guarantees, but rather to support these national development funds through advisory services, holding governments accountable to their commitments.

Finally, in order to increase the scale and development impact of guarantees, MDBs and bilaterals could collaborate in challenging contexts by sharing risks in projects that target underserved geographies or sectors, as well as in combining guarantees with policy reforms. By drawing upon their unique strengths, bilaterals and MDBs have ample space to work together to be more effective in structuring guarantees and in providing technical assistance across challenging contexts.

Introduction

Today, the most pressing challenges to global development lie in Africa and South Asia. Countries in these regions face significant infrastructure gaps and social needs requiring annual investments worth \$2.5 trillion, without which the United Nations' sustainable development goals (SDGs) cannot be realized.¹ However, these countries also account for some of the highest rates of population growth, urbanization, and economic vibrancy in the world, with many underexploited possibilities for private sector development.²

Numerous investment opportunities in these regions have the potential to be viable and to yield significant social benefits, but they are unable to be fully developed for various reasons. One of these limitations is a lack of financing due to risks being too high for investors. Countries with economic volatility face high political and commercial risks, which impedes their ability to attract private capital, both domestic and foreign;³ a 2013 survey showed that investors ranked macroeconomic instability and political risks (including breach of contract, regulatory changes, and transfer and convertibility restrictions) as the top two challenges when considering investments in developing countries.⁴ Subsequently, these risks severely curtail countries' ability to finance their development initiatives.⁵

Bilateral and multilateral development agencies use various financing tools to help overcome these impediments and attract private capital to developing countries. Guarantees are one of these tools. At present, guarantees issued by multilateral development banks (MDBs) and development finance institutions (DFIs) mainly target middle-income countries; they also

represent a very small percentage of their portfolios, even though they are rarely called on or claimed. In 2018, guarantees constituted 8 percent of the European Bank for Reconstruction and Development (EBRD)'s commitments, almost 4 percent of the International Finance Corporation (IFC)'s commitments, and 2.9 percent of the International Bank for Reconstruction and Development (IBRD)'s commitments.⁶ The use of guarantees has been slowly growing, however, in part because of the strong call from shareholders and the international community at large to further mobilize private resources. Guarantees come in various forms—covering project finance, corporate and sovereign bonds, and commercial banks' lending portfolios. Data from the Organization for Economic Cooperation and Development (OECD) reveals that out of six development finance instruments surveyed during 2012–2017, guarantees mobilized the most private capital (over \$62 billion, out of \$152 billion mobilized in total).⁷

There are certain gaps in guarantees' usage that bilateral aid agencies and DFIs can help to fill. Guarantees are overall underutilized as a development finance instrument and could be scaled up significantly, particularly in low- and lower middle-income economies. Sectors such as healthcare and education are also poorly targeted (see Figure 6), with guarantees overly supporting short-term transactions such as trade finance. Moreover, most of the private capital mobilized by guarantees has originated from OECD countries; local capital remains relatively untapped. Finally, bilateral and multilateral agencies are not collaborating enough, which would allow them to structure deals too complex to confront on their own.

There is a political push for international development institutions (i.e. bilateral aid agencies, DFIs, and MDBs) to increasingly operate in “tougher” places and take on more risks (see Box 1 for definitions). These institutions are being asked to structure deals that can attract higher amounts of private financing in low-income countries and fragile states, aiming to narrow down the \$2.5 trillion investment gap. These countries face three distinct challenges. First, they lack the right institutional capacity and macroeconomic fundamentals to foster an enabling environment for the private sector to grow. Second, they lack access to finance, preventing them from tapping into the full depth of local pools of capital to finance their development goals. Third, they have few bankable projects, which means investment cannot scale quickly enough to meet the countries’ development needs.⁸

The confluence of these gaps and needs in low-income and fragile states represents a challenging opportunity for bilateral aid agencies and DFIs. While there has been significant research on the use of guarantees by MDBs, the contribution of this report is to offer some ideas about what non-MDB actors—that is, bilateral aid agencies and DFIs, together referred as “bilaterals”—can do to scale up the use of guarantees to help attract private capital in low-income and lower-middle-income countries. Bilateral agencies have more institutional and operational flexibility than their MDB counterparts and can take more innovative approaches in structuring guarantees.

This report intends to inform policymakers and professionals in bilaterals (both DFIs and aid agencies) and to offer some ideas about how they can increase the use of guarantees or support innovative products or institutions in more challenging places. Section 1 describes the landscape of guarantees, identifying gaps and highlighting their advantages and limitations versus other development finance tools. Section 2 presents five recommendations to fill these gaps, which include improving existing instruments, coming up with innovations, and redesigning efforts.

First, by supporting specialized financial intermediaries (like private monoline insurers) and second, by using guarantees to back securitization and other structured

finance products in developing countries, bilateral agencies could help develop local capital markets and scale up investments. Second, bilaterals could use guarantees to help coordinate investments in frontier markets. Many of the investments and guarantee deals are structured in “easier” places (i.e., upper-middle-income countries) or are skewed towards certain sectors (such as energy and financial services). Bilaterals could structure guarantees to develop investment clusters in fragile countries, jumpstart investment, and help governments break the vicious cycle of fragility. Fourth, bilaterals could partner with MDBs and governments to support national project development funds and help create a pipeline of bankable projects. Finally, in order to increase the scale and development impact of guarantees, MDBs and bilaterals could collaborate in challenging contexts by supporting existing specialized guarantee institutions (where DFIs can invest), sharing risks in projects that target underserved geographies or sectors, and combining guarantees with policy reforms.

This report builds on key policy papers written on the topic: Matsukawa and Habeck (2007) describe the landscape of guarantees in MDBs and bilateral agencies; Humphrey and Prizzon (2014) provide an in-depth overview of guarantees and their challenges in MDBs, as well as recommendations on how to scale their use; and Humphrey (2018) and Pereira dos Santos (2018) focus on the use of guarantees in infrastructure projects, especially by MDBs. Two complementary papers by the Milken Institute (Betru and Lee (2017) and Lee, Betru, and Horrocks (2018)) present a set of policy and regulatory challenges affecting the use of guarantees, including operational disincentives in development institutions, restrictive Basel financial regulations, and incompatible banking business models.⁹

For this report, CSIS conducted significant desk research and held two private roundtable discussions, one each in Washington, D.C. (February 2019) and London (April 2019). These brought together 40 professionals in the field to gather ideas on how to scale the use of guarantees through new approaches, designs, and products. The authors also interviewed an additional 25 experts during February and June 2019 for a deep dive on some of the concepts presented in this report.

BOX 1: DEFINITIONS

For the sake of clarity, this report relies on the following descriptions to identify the key players in the guarantee space:

- **Development Finance Institutions (DFIs):** Per the OECD, development finance institutions are “specialized development banks or subsidiaries that are set up to support private sector development in developing countries.”¹⁰ National governments usually have a majority share in DFIs, which makes it easier for the institutions to secure capital from the national exchequer and to enjoy the creditworthiness needed to raise large amounts of money in international capital markets.¹¹ DFIs can be either multilateral or bilateral organizations.
- **Bilateral Aid Agencies:** As the term “bilateral” indicates, these refer to government agencies and public-sector organizations that provide foreign aid directly to officials in developing countries in support of their development projects. Often established as a cabinet or sub-cabinet agency, bilateral aid agencies get their funding through annual congressional or parliamentary appropriations. Set up in 1961, the United States Agency for International Development (USAID) is the largest bilateral aid agency in the world, committing over \$20 billion in 2018.¹²
- **Bilaterals:** We use the word “bilaterals” broadly, to refer to both bilateral DFIs and bilateral aid agencies.
- **Multilateral Development Banks (MDBs):** Multilateral development banks are international institutions that are established through the cooperation and support of multiple sovereign states. Many of these banks originated in the aftermath of World War II, to help rebuild war-ravaged nations, stabilize the global financial system, and foster economic and social progress. These institutions primarily engage with sovereign governments by providing subsidized loans, grants, and other tools of development finance, as well as technical assistance.¹³

1 | Understanding Guarantees

According to the OECD, a financial guarantee is a legally binding agreement under which the guarantor agrees to pay part or all of an amount due on a loan, equity, or other instrument in the event of non-payment by the obligor (or loss of value, in the case of investment).¹⁴ For simplicity, in this report we use the term “guarantees” interchangeably with risk insurance, but there are differences (see Box 2).¹⁵ Guarantees vary on numerous dimensions, including the type of instruments covered (debt or equity), amount of coverage (full or partial), type of risk covered (commercial, political, trade), and payment (principal and/or interest) (see Figure 1).

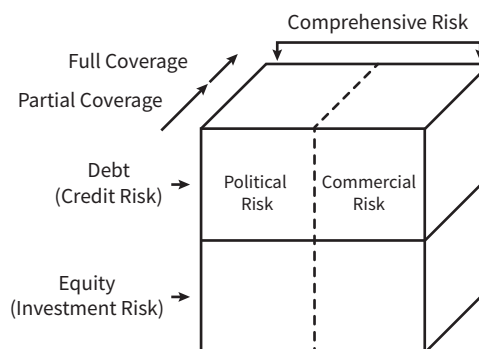
BOX 2: GUARANTEES VS. INSURANCE

Guarantees and insurance are different. First, insurance only covers losses that occur due to specified events or incidents. Guarantees cover a failure to fulfil obligations for a variety of reasons. Second, unlike insurance, which has a two-party relationship, guarantees involve three parties: lender, borrower, and guarantor. Third—and most importantly—while insurance coverage requires an extensive claim filing and review process, guarantees have a relatively quick and straightforward mechanism when invoked to cover a loss.¹⁶

Guarantees are by no means new. Throughout the industrial revolution in the nineteenth century, governments in Britain, France, Germany, the United States, and other countries used guarantees to help finance infrastructure projects such as bridges,

highways, ports, and railroads.¹⁷ When the World Bank was established in 1944, its intended mandate was to provide guarantees to help crowd in private capital. However, for several reasons, guarantees were not used by the Bank until the 1980s; it has relied on direct lending as its main operational tool until today.¹⁸

Figure 1: What Kinds of Risks do Guarantees Cover?



Source: Matsukawa and Habeck, *Review of Risk Mitigation Instruments*, p. 2

The Current Landscape of Guarantees: Where are the Gaps?

Several institutions issue guarantees to reduce investors’ exposure to risks in developing countries: multilateral development banks, bilateral donors and DFIs, specialized guarantee providers supported by development agencies, private insurance companies, and sovereign governments (see Box 3). Guarantees are used in project finance and public-private partnerships (PPPs), corporate bonds, and other debt products. They are also important tools in trade finance and are often used to support the targeted operations of financial

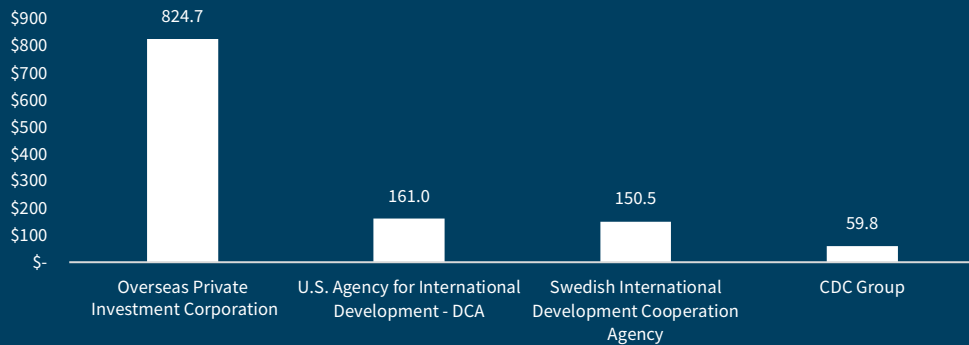
institutions, for example by de-risking a bank loan portfolio for small and medium enterprises (SMEs). The public sector can also receive guarantees, for instance through the World Bank's policy-based guarantees initiative or the United States' sovereign guarantees program.¹⁹ Subnational governments and state-owned enterprises can also benefit from guarantees.

To keep the scope of this report manageable, we have chosen to focus on guarantees for individual projects and firms, where we see greater potential for innovation by bilaterals. That is not to say that there are no opportunities to use guarantees to bring trade finance and bank lending into markets that are currently underserved. For example, CDC Group used a risk-participation instrument to enable Standard Chartered to maintain support to businesses during the 2014 Ebola outbreak in Sierra Leone, and in 2018 the CDC established a risk-sharing arrangement with Standard Chartered in Zimbabwe, a country in which firms find it very hard to obtain loans for working capital and other similar purposes. The European Commission and the Dutch DFI FMO, through a risk-sharing facility called Nasira, are using guarantees to support lending to borrowers that banks normally perceive as too risky, both in sub-Saharan Africa and in the European neighborhood.²⁰ That is one of 28 guarantee schemes announced under the EU External Investment Plan, 11 of which apply to intermediated lending to micro, small, and medium enterprises (MSMEs) or agriculture.²¹ Although bilateral agencies and DFIs should also be looking for opportunities to support the mobilization of finance to help high-quality financial institutions enter (or scale up) activities in low- and lower-middle-income countries that they would otherwise avoid, the capabilities to do so are largely already in place.

BOX 3: WHO ISSUES GUARANTEES?

Bilateral development institutions (aid agencies and DFIs) are institutions set up by donor governments to provide foreign aid and other types of financing (i.e., loans, guarantees, and equity) to help countries pave a path to achieve their development goals. Many of these institutions issue guarantees to help investors in emerging-market economies reduce their risk exposure, while opening up new avenues for domestic and foreign capital to reach these markets. Among bilateral aid agencies, the most active players in the guarantee space include the United States Agency for International Development (USAID)'s Development Credit Authority (DCA, which will merge operations into the new U.S. International Development Finance Corporation (DFC) at the end of 2019) and the Swedish International Development Cooperation Agency (Sida). Among bilateral DFIs, the U.S. government's Overseas Private Investment Corporation (OPIC) is the largest player in this space (Figure 2).

Figure 2: Guarantees Issued by Selected Bilaterals (\$ million, 2017)²²



Source: CSIS calculations based on information from institutions' websites

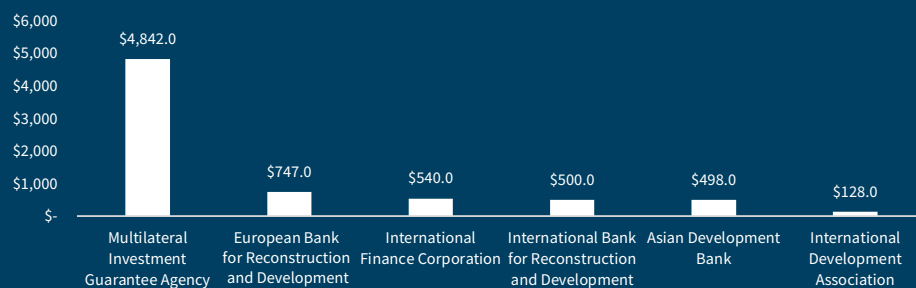
The most significant recent entrant to this field is the European Fund for Sustainable Development (EFSD), part of the European Union's External Investment Plan, which has allocated €4.5 billion to blended finance instruments and expects to leverage €44 billion of private sector capital. Of this, €1.5 billion is allocated to guarantees. The program is implemented in partnership with DFIs who design and manage products supported by the ESFD. These DFIs will sometimes use their own balance sheets to share the risk of the guarantees with the EFSD, in addition to contributing other financial products and technical assistance, to create the overall package. The ESFD works mainly (but not exclusively) with European DFIs. Among non-European DFIs, the African Development Bank accounts for an estimated 16 percent of the guarantee allocation to date, and the IFC 3 percent.²³ The ESFD is too new to show up in the data used for figure 2, and in some reporting formats the guarantees deployed may be reported as issued by the implementing DFI.

Beyond bilateral players, **major multilateral development banks (MDBs)** like the World Bank, the Inter-American Development Bank, the European Bank for Reconstruction and Development, the Asian Development Bank, and the African Development Bank also provide guarantees (see Figure 3). Unlike bilateral donors, which are backed by their host country's treasuries, MDBs are owned by multiple governments and raise most of their money from financial markets (except in the

case of the Multilateral Investment Guarantee Agency (MIGA)).²⁴ The largest MDBs share AAA ratings from the major credit agencies, which permits them to borrow in the international market at inexpensive rates. In order to preserve their ratings, MDBs are conservative, taking fewer risks in their operations. Moreover, their internal accounting rules require them to provision guarantees in the same way as they do direct loans, even if guarantees are rarely called. This creates internal disincentives for MDBs to issue guarantees. As a result, guarantees represent only a small share of the MDB operations. MIGA provides political risk insurance (both for equity and debt) which covers foreign investors using four types of products that address: war, terrorism, and civil disturbance; expropriation; breach of contract; and currency inconvertibility and transfer restriction. They also have a credit enhancement (launched in 2013) called “non-honoring of financial obligation (NHFO),” which covers commercial banks that provide loans to public sector entities for infrastructure and other productive investments resulting in failure of nonpayment.²⁵

Bilateral donors, DFIs, and MDBs also support **specialized guarantee providers**, such as GuarantCo, FrontClear, the Africa Guarantee Fund (AGF), the Credit Guarantee and Investment Facility (CGIF), InfraCredit, and InfraZamin.

Figure 3: Guarantees Issued by Multilaterals (\$ million, 2017)²⁶



Source: CSIS calculations based on information from institutions' websites

National governments from developing countries can also use their sovereign guarantees to back development projects in their own countries.²⁷ For example, credit guarantee schemes (CGSs) are institutions set up by national governments to promote SME finance, covering some portion of the losses incurred by lenders when SME default on loans.²⁸

Finally, it is important to note that the **private sector** also is active in the field, with companies such as AXA, Lloyds, and Swiss Re providing political risk insurance. Another set of actors are private monoline insurers, which have had a rich history of developing the municipal bond market—both in the developed and emerging market economies—by backing bond issuances. The global economic crisis of 2007–2008 drove this industry to the ground, however, as many borrowers who had insured themselves using a monoline started to default on their payment in quick succession.²⁹ As the subprime crisis hit the financial system hard, the monoline industry (that had insured assets worth nearly \$3.3 trillion) found themselves overextended, and most of their business was wiped out.³⁰

Guarantees can be used to back debt or equity. In the case of debt instruments, guarantees have helped to develop local financial markets (for example by backing bond issuances) and to provide loans to underserved sectors (by backstopping loan portfolios of banks in developing countries), as in the case of USAID's Development Credit Authority or Sweden's Sida. Guarantees have also been used to back infrastructure projects through project bonds or commercial loans.

The borrower can receive a partial or a full guarantee. Partial guarantees, as the name suggests, are used to cover only a portion of the lender's risk—that is, a certain percentage of the loan, or a specific type of risk involved. A full guarantee, on the other hand, is a promise that the guarantor will assume one hundred percent of the repayment obligation should the borrower default. Monoline insurers usually offer full guarantees, covering one hundred percent of the principal and interest payments. Although not always the case, the use of guarantees has the potential to create moral hazard, which happens when protection from risk causes underlying behavior to change for the worse. This can happen, for example, when a guarantee protects a financial institution from risks that may arise from its lending decisions, weakening its incentive to screen and monitor borrowers. There is also some evidence that default rates can be higher for loans protected by guarantee schemes.³¹ To mitigate this risk, development agencies usually only offer partial guarantees to intermediaries like banks, in order to ensure that they retain "skin in the game." For similar reasons, MDBs often only offer partial guarantee on bonds (see Box 4).

In other contexts, guarantees contain strict provisions governing the required conduct of the party whose payments have been guaranteed. Whilst a bank might shirk if its portfolio is guaranteed against defaults, the same is not true of borrowers: in general, the incentives they face to repay are not diminished by the existence of a guarantee. Pledged collateral will still be seized, credit history damaged, and so forth.

The types of risks covered by guarantees generally fall under one of the following two broad categories:

- **Political risk**, where the borrowing entity's capacity to fulfill its debt obligations is affected

by government actions (or lack thereof), such as nationalization, expropriations, regulatory changes, restrictions on foreign exchange transfer or convertibility, civil unrest, and wars;

- **Commercial/credit risk**, where the borrower's inability to meet its financial obligations is due to non-performance of the investment or asset.

On the other hand, some risks, such as devaluation risk and macroeconomic volatility, are not covered by standard guarantee products.³²

BOX 4: TYPES OF GUARANTEES PROVIDED BY MULTILATERAL AND BILATERAL DEVELOPMENT INSTITUTIONS³³

Political Risk Guarantee (PRG) also referred as *political risk insurance (PRI)*: this type of guarantee indemnifies losses from a specific government action or inaction (e.g., expropriation, nationalization, or failure to comply with a contractual obligation). PRGs are most frequently sought for projects or companies in sectors that intricately involve the state as an actor—infrastructure projects, for example. Decisions on matters of land acquisition, natural resource distribution, and inter-state (or inter-province) commercial dispute resolution all require direct intervention from national governments.

Partial Credit Guarantee (PCG): this is triggered when a payment is missed, regardless of whether the reason is political or commercial. PCGs are generally simpler, and their payments quicker, than in the case of PRGs.

The World Bank (IBRD and the International Development Association IDA) has slightly different products, namely Project-Based Guarantees and Policy-Based Guarantees. *Project-Based Guarantees* cover losses tied to a specific project or a debt issue. They can be sub-categorized into *credit or loan guarantees* (comparable to PRGs and PCGs) and *payment guarantees*.³⁴ Meanwhile, *Policy-Based Guarantees (PBGs)* are a specific form of credit risk guarantee covering private lenders against the risk of debt service default by the sovereign government.³⁵ PBGs are not tied to any specific project; the borrowing government may use the proceeds of the guaranteed debt for any budgetary purposes.³⁶ Recipient governments are usually committed to a package of policy reforms. PBGs help the sovereign government access capital markets to meet its budgetary needs.³⁷

Trade Credit Guarantees (TCG): also known by various names—such as trade credit insurance, export credit guarantees, or business credit insurance—are short-term guarantees offered by multilateral development banks, bilateral trade or export development agencies, and even private insurers, to businesses and companies engaged in one specific economic activity: international trade. The guarantee covers international banks that lend to local borrowers engaged in international trade and aims to address financial and political risks they may face.³⁸

Figure 4: Guarantee Approval and Call Volume

	<i>IBRD/IDA (1993–2018)</i>	<i>USAID-DCA (1999–2014)</i>	<i>OPIC³⁹</i>
APPROVED Volume	\$12,713 million	\$5,500 million	-
Called Volume	\$250 million	\$9.1 million	-
Loss Rate	1.96%	0.17%	~ 1%

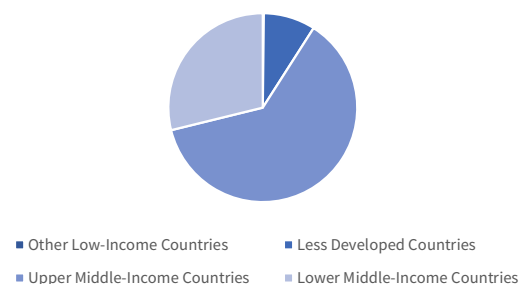
Source: Data for IBRD/IDA collected from <http://projects.worldbank.org/>; data for USAID Development Credit Authority can be found at “Development Credit Authority.”⁴⁰

However, there remain significant gaps in the issuance and usage of guarantees. This provides an opportunity for bilateral agencies to innovate and to collaborate with the MDBs. First, guarantees issued by MDBs and DFIs represent a very small percentage of their portfolios, even given the fact that they have been rarely called or claimed (see Figure 4). In 2018, guarantees constituted 8 percent of EBRD commitments, almost 4 percent of IFC commitments, and 2.9 percent of IBRD commitments.⁴¹ Moreover, only 13 of the 30 members of the OECD’s Development Assistance Committee structure guarantees for international development.⁴² Official Development Assistance (ODA) still exceeds the amount of private capital mobilized by guarantees.

Second, guarantees disproportionately target middle-income countries, while low-income and lower-middle-income economies remain underserved.⁴³ In countries with more developed capital markets, the regulators are well institutionalized and the risks to capital are better understood and priced, making it easier to structure guarantees. Countries with underdeveloped capital markets are dominated by banks, who exist to profit from taking credit risk; since there are no regulatory mechanisms that allow these banks to benefit from reducing risk exposure, there is less of a market for guarantees. In other words, in markets where risks are not properly priced and regulated, there is less to be gained from reducing exposure to risk.

In 2017, about one third of the \$14.9 billion mobilized by guarantees went to low-income and lower-middle-income countries, with upper-middle-income countries accounting for the rest. At the same time, despite having 80 percent of the global population, Asia and Africa were responsible for only 41 percent of the private capital mobilized by guarantees (see Figure 5).⁴⁴

Figure 5: Private Capital Mobilized by Guarantees, by Country Group (2016–2017, Percent)



Source: OECD, “Amounts mobilized from the private sector by development finance interventions in 2012–2017.”⁴⁵

Third, some sectors—such as infrastructure development, education, and health—are still underserved. Seventy percent of all the private capital mobilized by guarantees targeted only two sectors: financial services and energy (see Figure 6).⁴⁶ Guarantees have only minimally impacted health (6 percent), transportation (3 percent), and agriculture and water services (2.9 percent).⁴⁷

Figure 6: Private Capital Mobilized by Guarantees, by Sector (2016–2017 = \$26.6 billion)

Sector	\$bn
Energy	\$ 8.9
Banking & Financial Services	\$ 8.6
Industry, Mining, & Construction	\$ 2.0
Health	\$ 1.8
Communications	\$ 0.7
Agriculture, Forestry, & Fishing	\$ 0.5
Transport	\$ 0.5
Other	\$ 3.6

Source: OECD, “Amounts mobilized from the private sector by development finance interventions in 2012–2017.”

The majority of guarantees issued by MDBs and DFIs are actually used for shorter-term transactions, such as those supporting trade finance.⁴⁸ Data for 2016 reported by Pereira dos Santos and Kearney (2018) show that 50 percent of the Inter-American Development Bank (IADB)'s guarantees were trade-related; for the EBRD this share climbed to 80 percent, while for the AFDB it represented 100 percent of its guarantees.

Finally, guarantees could be structured to help mobilize domestic resources. Most of the private capital mobilized by MDB and DFI guarantees has originated from OECD countries.⁴⁹ In its final report, the G20 Eminent Persons Group on Global Financial Governance—which was established by the G20 Finance Ministers and Central Bank Governors in April 2017 with the mandate to recommend reforms to the global financial architecture and governance of the system of international financial institutions so as to promote economic stability and sustainable growth in a new global era—asked the stakeholders of the global financial system to accelerate their efforts to “develop deep, resilient, and inclusive domestic financial markets”⁵⁰ that would allow developing countries to absorb capital more effectively and to allocate resources more efficiently.

In this regard, there is a need for more local-currency guarantees, which cover debt obligations issued in local currency. Guarantees can also back municipal bonds and corporate bond issuances so that they can be bought by local institutional investors.⁵¹ Monoline insurers have had a rich history of developing municipal bond markets, both in developed and emerging market economies, by backing domestic bond issuance. The first step is to work on developing local money markets and the public corporate bond market at the national government level, before moving on to the subnational level or to private markets. Guarantees from DFIs can be instrumental in developing domestic public bond markets, which can then serve as a benchmark for the private capital market. Without it, domestic private markets struggle to develop.

The choice between a local-currency guarantee and a foreign-currency guarantee often depends on several factors. These include the amount of capital that needs

to be raised, the source of revenues, the depth and liquidity of local capital markets, and the structure of the deal. Local-currency guarantees work best for those borrowers or projects that generate revenues in local currency, but that cannot access financing in the domestic financial market of the proper tenor (i.e. amount of time).⁵² These guarantees help match revenues with their obligations in order to avoid a foreign currency misalignment. Local-currency guarantees can help develop local capital markets.

On the other hand, guarantees for foreign-currency projects are more suitable for borrowers or projects that need to access international markets, but that (in most cases) are constrained by the high sovereign risk of the country where the transaction is taking place.⁵³ When a borrower issues foreign-currency denominated bonds, for example, credit rating agencies cap the rating of the issue to the sovereign rating (i.e., the “sovereign ceiling”), which limits the creditworthiness of the borrower to that of the sovereign debt.⁵⁴ This is done to reflect the “transfer and convertibility” risk, that is, the chance of the government limiting foreign currency outflows of foreign currency when facing default (including the returns on the debt obligations of private entities).⁵⁵ The underlining assumption is that if the government (the sovereign) defaults, this will force domestic issuers to default. The guarantee may help the borrower get a rating uplift and pierce this “sovereign ceiling,” thus providing access to cross-border financing at more favorable terms. This can be particularly valuable for borrowers whose credit rating in the local-currency global scale is investment-grade, but whose rating in the foreign-currency global scale is not (see Box 5 for more information about credit ratings and their scales). A guarantee will potentially help them achieve investment-grade rating in the foreign currency global scale. This can apply to infrastructure investments, where studies have found that “one standard deviation in a country’s sovereign risk is associated with a 27 percent increase in the probability of having private participation in infrastructure investment.”⁵⁶

The use of guarantees can also provide a rating uplift to the particular transaction itself (bond or project), allowing the borrower to improve the financing

conditions of the deal and to access certain types of investors. Some examples of transactions that have received these kinds of uplifts include the sovereign bond issued by the government of Ghana in October 2015, which benefited from a partial guarantee from IDA, leading to a credit uplift (from B3 to B1). Similarly, in 2016, a guarantee provided by the EIB's Project Bond Initiative to the Concessioni Autostradali Venete SpA road project in Italy also resulted in a credit uplift (from Baa2 to A2).⁵⁷

However, the degree of credit uplift that can be obtained, especially for partial risk guarantees, can be uncertain. The requirements for achieving a credit rating uplift are sometimes unclear, and the change in rating does not always unlock significant new sources of capital. These questions are particularly important when trying to attract certain institutional investors—such as pension funds and insurance companies—that only invest in investment-grade assets, because of strict fiduciary rules or regulations. This requirement excludes many developing countries from the pool of investors, since many of these countries either do not have a credit rating or have speculative-grade ratings. An interesting recent case where a combination of credit enhancements resulted in a credit rating uplift to investment-grade is Turkey's 2016 Elazig Hospital project bond, a transaction of €288 million. This was a joint effort by two MDBs: EBRD provided unfunded liquidity facilities during construction and operation phases, and MIGA provided political risk insurance.⁵⁸ Another example is a 2018 wind farm transaction in Brazil, Santa Victoria do Palmar, in which IDB Invest provided a partial credit guarantee in local currency resulting in an uplift from sovereign BB- to investment-grade A+.⁵⁹

BOX 5: THE CREDIT RATING PROCESS

Credit rating agencies have an important role to play when borrowers are trying to access both local and foreign capital markets. Agencies evaluate the creditworthiness of a borrower through their rating processes and issue credit ratings that reflect the borrower's ability to meet its debt obligations.⁶⁰ Credit ratings are one tool among many that investors use when deciding whether to purchase bonds or other debt instruments that are traded in capital markets.

In general, there are three rating scales that investors typically use:⁶¹ 1) Global Scale—Foreign Currency, 2) Global Scale—Local Currency, and 3) National Scale. A global-scale rating is used by global investors who are comparing different debt instruments across the world, while national-scale ratings evaluate the creditworthiness of domestic instruments and are intended for domestic investors. Since political and macroeconomic factors will affect countries differently, these risks play a prominent role in global scales, but do not similarly affect the national scale. National scales also provide richer information on the issuer, and they are available for a broader array of issuers in each country; they are also not comparable to national scales of any other countries. Among global scales, on the other hand, the difference between local-currency and foreign-currency global ratings has to do with the ability of the issuer to service its debt in the currency of issue. In the case of foreign issues, risks like currency convertibility and controls on currency transfer are involved.

Credit rating agencies can rate an issuer (a corporation or government), a specific issue (a corporate bond, municipal bond, note, or other debt instrument), or a structured finance instrument (like a special purpose vehicle, or SPV).⁶² Credit rating agencies evaluate the probability of default of an issue. In the case of Moody's, this agency analyzes both the probability of default and the expected recovery rate (or conversely, the expected loss, in the

event of a default). The request for a rating comes from bond issuers; in certain cases, the borrower might request assessments from multiple credit rating agencies. The issuer has to pay a fee for this service. The credit rating follows a specific process for evaluating risk and assigns a rating to the debt instrument according to a scale that goes from AAA (top-notch rating) to D (default), in the case of S&P and Fitch, or Aaa to C for Moody's, with no default rating. These ratings fall into two overarching categories: investment-grade or non-investment grade.

Having an investment-grade rating signals that the borrower has a lower risk of defaulting on debt. This low risk of default is attractive to investors, incentivizing the borrower to offer a low-but-steady yield on their bond or loan. But investors come with different risk appetites, and they are also bound by the laws and regulations of each country. Institutional investors in the United States, for instance, such as public pension funds, have a fiduciary responsibility to the beneficiaries of the plan whose capital they manage, and they hold only investment-grade debt. Pension fund allocations in developing countries are driven by domestic regulations, the development of local capital markets, and the availability of investment opportunities.⁶³ Other investors have a significantly higher risk tolerance and seek to pursue a higher return on their investments—including domestic investors, who have a better and more reliable access to information on political risks. Hedge funds and impact investors might be more enticed to invest in these types of assets as well, but generally for very different reasons: the hedge funds for their potential to generate out-sized risk-adjusted return on investment, and the impact investor for the considerable social impact they can generate, once adjusted for risk. Assets with non-investment grade ratings, such as junk bonds and unrated assets, carry a higher risk that the investment will not pay off, which leads to higher financing costs. The risk is offset by borrowers offering a higher yield to maturity in order to incentivize investors.⁶⁴

Guarantees—A Silver Bullet?

One significant gap for guarantee usage is the lack of awareness about their purposes, functions, and limitations.⁶⁵ Debt and equity remain the preferred tools of development finance institutions. Guarantees are not a form of financial flow (unless they are called), and they create a contingent liability for the guarantor. In fact, they are quite different from other tools, in terms of structuring and pricing, costs, and desired objective (see Box 6). Given their distinct features and unique functions, guarantees provide a number of advantages vis-à-vis other forms of development assistance. It is critical, therefore, to understand the virtues and shortcomings of using guarantees as a development tool, as well as the challenges in scaling their use.

What Can Guarantees Achieve?

Guarantees improve the financing conditions of a debt instrument. Although a guarantee does not necessarily lead to a credit rating uplift for a bond, guarantees can reduce the cost of capital by transferring certain types of risks, which can then lead to longer tenors and lower rates for the borrower.⁶⁶ An excellent example can be found in the issue of a partial credit guarantee by IFC for TelecomAsia, a Thailand-based telecom company, to overcome the effects of the 1997 Asian Financial Crisis.⁶⁷ After Thailand suffered an economic collapse due to fast depleting foreign exchange reserves, the Thai Baht underwent sudden devaluation, losing up to half of its value. The resulting currency mismatch with the U.S. dollar had adverse implications for TelecomAsia. To overcome foreign exchange risks, the company sought to relieve itself from its sizeable external debt worth \$425 million by issuing local currency bonds. The bonds issued by TelecomAsia were in two tranches: Tranche A, worth \$270 million and payable over six years and Tranche B, worth \$155 million and payable over eight years. At the time, these bonds were also considered to have one of the longest maturity periods in Thai history. TelecomAsia also sought a credit enhancement from the IFC, which issued a partial credit guarantee for Tranche B, covering 50 percent of its outstanding principal amount. As a result, the guaranteed (Tranche B) bonds enjoyed a local credit rating of A, which was a three-notch increase from its initial BBB rating.

Because of the credit enhancement provided by IFC, TelecomAsia was able to successfully demonstrate local capital mobilization efforts for the country. The process also helped expose the Thai debt market to longer maturity terms. Finally, this pioneering effort created a benchmark for future local currency bond issues, which ultimately helped develop the Thai bond markets.

BOX 6: PRICING GUARANTEES

As with all financial instruments, guarantees can be used to confer subsidies: private investment is subsidized when a publicly backed provider charges a below-market-rate fee for a guarantee. As with other instruments deployed by DFIs in countries with undeveloped financial markets, it can sometimes be hard to know what market rates are; therefore, since a guarantee can often involve pricing idiosyncratic risks where there is no market comparator, in practice it can be hard to ascertain whether a development agency has underpriced a guarantee.

Subsidies should only be offered where there is a sound economic case for them: development institutions need to be careful not to offer redundant or excessive subsidies, since they could be crowding out commercial guarantee providers and distorting markets by offering concessions to only chosen firms or bidders. In fact, a joint MDB-DFI Working Group has developed a set of enhanced principles to govern the provision of concessional development finance, including guarantees.⁶⁸ Donors using public resources to subsidize instruments of development should adhere to the key principles of blended concessional finance. Essentially, the principles require such tools to add to the market and address the gap, maximize the crowding in of private capital, enable commercially sustainable projects, and reinforce market principles while promoting high standards of governance and transparency. Guarantees issued by development agencies are also a concessional blended financing tool and should be subjected to these principles.⁶⁹

When structuring guarantees, development institutions must ask whether they are really needed for the investment to go ahead, and they must avoid allocating them in a way that distorts markets. As noted in Anginer et al (2014), the provision and pricing of guarantees matters greatly, because it signals the risk levels and expected losses to investors.⁷⁰

Since guarantees come at a price, issuing guarantees involves giving up some financial returns to reduce investors' exposure to risk. Some investors prefer higher risks and higher returns. Thus, issuing guarantees will not always make investments more attractive to private financiers. If the guarantee is priced at market, we should not expect this risk-return transformation to change investor behavior very often. All else being equal, a subsidy may be more likely to affect investor behavior than a financial instrument offered on market pricing, but as discussed above, subsidies must be allocated with great care to avoid the risk of crowding out and market distortions.

Guarantees facilitate project implementation.

Infrastructure projects in developing countries—such as the development of transport networks, provision of water and sanitation, and access to reliable electricity—often lack proper financing, and guarantees can help secure private investment. Since the amount of finance that governments and MDBs can provide is not enough to meet infrastructure needs, governments have turned to the private sector to help them finance, design, build, and operate infrastructure projects. By nature, many of these projects require long-term commitments from governments, including payment obligations, contract enforceability, regulatory stability, and more. Some private investors lack the confidence that governments will honor their commitments, and guarantees can help address the risk of non-payment. A recent innovation in this space is GreenCo, an independently managed power intermediary seeking guarantees from Agence Française du Développement (AFD) and the European Fund for Sustainable Development. The AFD and EFSD guarantees would be called if the national power utility failed to

make payments when due and GreenCo’s liquidity instruments were exhausted. This enables GreenCo to provide capital protection to commercial lenders who invest in renewable electricity generation companies.

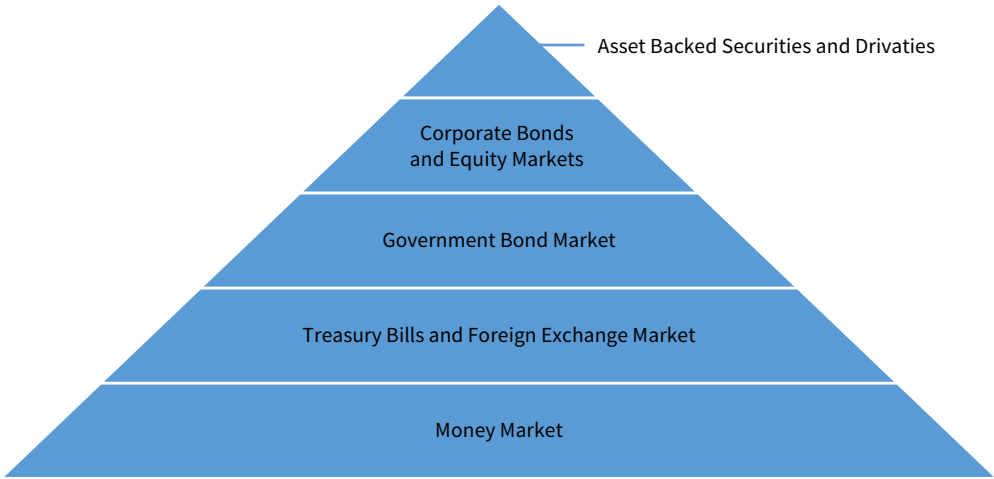
Guarantees can mobilize more private capital per dollar committed. Guarantees can help mobilize more funds per dollar than direct lending or equity investments. More than 40 percent of the private finance mobilized between 2012 and 2017 was through the use of guarantees.⁷¹ Due to data inconsistencies and methodological differences between the OECD and MDBs, it is currently difficult to calculate or to compare leverage ratios of different financing instruments—that is, the amount of private finance mobilized per dollar invested.⁷² For example, as of 2015, the World Bank (IBRD and IDA) structured 48 guarantees, utilizing a total of \$7.4 billion in commitments. These guarantees supported \$30.2 billion of commercial financing, resulting a leverage ratio of 4 (that is, four dollars of private financing mobilized per dollar invested); the guarantees also supported \$20 billion of public financing. Currently, the World Bank is in the process of approving 13 guarantees utilizing \$1.7 billion in IBRD/IDA commitments; these are expected to mobilize \$5.9 billion in commercial financing, resulting in a leverage ratio of 3.5.⁷³

Guarantees can help strengthen domestic bond markets. In most developing countries, especially in lower-middle-income and low-income countries,

capital markets remain underdeveloped.⁷⁴ Capital markets take a long time to develop, and they do so in stages—with money markets and government bond markets easier to create than local bond markets, especially for corporate bonds (see Figure 7). Corporate bond markets require stronger legal architecture and a more developed private sector than government bonds do.⁷⁵ Yet local capital markets offer a range of benefits to borrowers and investors alike, including better risk sharing and more efficient allocation of capital. Local bond markets can be a source of long-term financing, and they can improve access to local currency financing, which helps manage the exchange rate risk; when the local bond market is weak, guarantees can strengthen it. For example, in 2001, Sida helped MTN, a mobile operator in Uganda, to expand their network to 24 unserved villages by guaranteeing 60 million Swedish krona in local bonds issued by Stanbic Bank over five years.⁷⁶ Similarly, in Mexico, IFC worked with homebuilder Vinte by providing a partial credit guarantee to its 2011 long-term bond issuance, promoting affordable housing and providing a demonstration effect for the local bond market.

As long as there are developed national government bond markets, guarantees can also be used to effectively to strengthen local municipal bond markets. This is especially true at a time where many countries are rapidly urbanizing, creating bottlenecks in public services and other urban infrastructure. Guarantees can

Figure 7: Hierarchy of Capital Market Development



Source: Karacadag, Sundarajan, and Elliott, “Managing Risks in Financial Market Development: The Role of Sequencing.”⁷⁷

back municipal bonds and corporate bond issuances to provide better financing terms to borrowers and to diversify the asset pool for investors.⁷⁸ In the United States, monoline insurers were active guarantors of municipal debt until the financial crisis of 2008. In Africa, guarantees have helped develop and launch municipal bonds in Cameroon and South Africa.⁷⁹ As a specific case in point, the City of Johannesburg's success in issuing a municipal bond is an example of how municipalities can develop strong domestic bond markets through the use of guarantees (see Box 7).

However, the development of bond markets does not occur in a vacuum. It requires a critical mass of available local savings and investors, sound macroeconomic policies, strong institutional and legal frameworks, and a well-functioning financial infrastructure (i.e., a trading platform, regulations, and investor information, including ratings).⁸⁰

BOX 7: GUARANTEES BACKING MUNICIPAL BONDS: THE CASE OF THE CITY OF JOHANNESBURG

After the end of apartheid in 1994, a more democratic South Africa began to expand the jurisdictions of its municipalities to integrate formerly Black townships and enfranchise their residents. However, this expansion left municipalities (including the City of Johannesburg) in great financial distress. Having been neglected by the government (on both national and local fronts) for several decades, municipalities were now put under great pressure to rapidly reinvest in a dilapidating urban infrastructure. To address this, they began to borrow heavily from commercial and development banks alike. Unfortunately, this only added to the municipalities' public debt levels and made them increasingly unsustainable.

It was in 2003 that the City of Johannesburg acknowledged the need to mobilize private capital to overcome its fiscal strains and considered issuing its first municipal bond. The City launched its pioneering initiative by issuing its bond in two equal tranches of 1 billion South African rand (or \$153 million). The first tranche was issued as a six-year bullet bond (i.e., a bond whose full principal value is paid upon maturity). Meanwhile, the second tranche was issued as a twelve-year municipal bond. Most importantly, each of these tranches was backed by two partial credit guarantees. One was issued by the IFC (which provided a AAA international rating) and the other from the Development Bank of Southern Africa (or DBSA, which provided a AAA local rating). Together, these two institutions provided guarantees for the city's bond obligations up to 40 percent of the principal amount.⁸¹ The pioneering efforts undertaken by the City of Johannesburg-IFC-DBSA spurred the development of South Africa's municipal bond markets, which has allowed DFIs to explore the use of guarantees to back sub-sovereign bonds.

What Are Some of the Shortcomings of Guarantees?

Although guarantees can be powerful development finance instrument, it is important to understand their shortcomings. And even as MDBs enjoy greater political influence over the behavior of borrowing governments, they have an additional set of institutional challenges that hinder the use of guarantees vis-à-vis other instruments (see Box 8).

Guarantees on their own cannot fix problems created by weak legal and political environments or make projects bankable. Many developing countries lack basic legal and political institutions such as a robust judicial system, independent central banks, or even clear legal codes on anti-trust, bankruptcy, contracts, and taxation. In the absence of such features, no number of guarantees can change the commercial viability of projects in markets that are unpredictable, restrictive, and easily manipulated by political interference. Nor can guarantees fix business challenges such as an incompetent management team, inadequate human capital, or low demand. Moreover, guarantees will not make poorly structured projects bankable. As Matsukawa and Habeck assert, “risk mitigation instruments are not a panacea; they do not make poorly structured projects, or borrowers with unpredictable future prospects, bankable.”⁸²

Guarantees can lead to moral hazard. The presence of full credit guarantees could create “moral hazard” and encourage borrowers to take on excessive risk, by relaxing their incentives to honor their obligations and to behave prudently. This can be more pronounced in countries that lack strong institutions whose sovereign governments can invalidate contracts, property rights, and regulations. Thus, the use of full-credit guarantees could in theory incentivize imprudent behavior on the part of the governments. As described earlier, guarantees can also create a moral hazard situation for the lenders, with the dependence on a guarantee incentivizing them to shirk off their responsibility of performing due diligence on the borrower.

Guarantees are more complex to structure than other financing instruments. Although guarantees are flexible and highly customizable as a development finance tool,

they are more difficult to structure compared to other development finance instruments like grants and loans. Since each borrower has different financial expectations and confronts unique sets of risks, structuring and using financial guarantees can become a time- and resource-intensive effort. Moreover, guarantees’ complexity leads to more preparation time and administrative costs, in comparison to other products. Scaling the use of guarantees, when it is this bespoke of an instrument, thus becomes a difficult goal.⁸³

This is particularly the case of infrastructure projects, which are not easy to standardize. In 2016, the World Economic Forum conducted a survey on risk mitigation instruments (financial guarantees, insurance, and other credit-enhancement schemes) among 40 major infrastructure stakeholders doing business across the globe.⁸⁴ The survey showed disappointing results in terms of availability, market adequacy, and size of these instruments. For example, in Africa, respondents perceived these instruments as too complex, with high costs and numerous obstacles to their use, such as how long they take to structure and their lack of transparency.

BOX 8: INSTITUTIONAL CHALLENGES FOR MDBS IN STRUCTURING GUARANTEES⁸⁵

There is a set of challenges that hinder the ability of MDBs to expand the use of guarantees. First, although guarantees rarely get called, MDBs book them the same way they do loans, with the objective of minimizing the risk exposure to their balance sheets and preserving their top-notch risk rating. From an MDB perspective, this incentivizes the use of loans over guarantees, since they are easier to structure and understand. Second, from a borrower perspective, given that loans and guarantees are accounted in the same way, MDBs price these instruments similarly, which also incentivizes borrowers to opt for loans.⁸⁶ Third, MDB staff lack the incentives to scale up the use of guarantees, since they are rewarded by the size of the deal and not its complexity, development impact, or amount of private capital mobilized. Fourth, the governance structures of MDBs prevents them from being more innovative. These institutions have multiple shareholders from different countries with diverse—and sometimes conflicting—interests. Shareholders do not prioritize mobilization, making innovation very hard. Finally, the existing OECD methodology for measuring Official Development Assistance (ODA) potentially disincentivizes the use of guarantees. Since guarantees are not presently counted as ODA, some institutions do not get “rewarded” for structuring guarantees.

2 | Innovations in Guarantees for Development

By issuing guarantees, multilateral and bilateral development institutions (aid agencies and DFIs) can add unique value to a transaction that goes beyond their financial role as guarantors.⁸⁷ Development agencies are considered to be independent and trusted parties, having a strong process for selecting and preparing projects, high standards for environmental safeguards, social considerations, good governance, and a highly transparent decision-making process. Their endorsement of a transaction therefore brings in the expectation that their involvement will result in high-quality projects. Moreover, these institutions are engaged with all the stakeholders throughout the transaction, allowing them to manage projects towards better outcomes.⁸⁸

Despite their shared goals and unique values, multilateral and bilateral development agencies have key institutional and operational differences that can be leveraged in the guarantee space. Bilateral aid government agencies, and some DFIs, have the potential to be more innovative and flexible than MDBs in the use of guarantees, because they are not constrained by the interests or mandates of multiple shareholders and they can take on more risks without worrying about their credit ratings (see example in Box 9). In cases where the value of a guarantee rests on the credit rating of its issuer, specialized guarantee providers can obtain investment-grade ratings whilst leveraging their balance sheets more effectively than MDBs. On the other hand, MDBs have unique relationships with country governments through their shareholder positions and country programs, and they can exercise more influence on governments to meet financial

obligations, carry out policy reforms, and achieve development results.

BOX 9: INNOVATIVE GUARANTEES BEYOND FINANCE

Although beyond the scope of this report, it is worth bearing in mind that guarantees can do more than just cover financial obligations and mobilizing private capital can mean more than just inducing private investors to participate in projects backed by a DFI. For example, MedAccess, a wholly owned subsidiary of CDC Group, uses a combination of guarantees and technical assistance to develop new markets for medical products.⁸⁹ MedAccess works with drug and medical device manufacturers and buyers to design and issue volume guarantees. The goal is to demonstrate the viability of producing medical products in a given market, given the existence of demand at certain price points. Protected by a guarantee, producers are willing to enter new markets they would have otherwise avoided. Once commercial viability has been demonstrated, MedAccess can step aside, and private investment is mobilized in the form of follow-on investment by the producer in question.

The main differences among these two groups of development actors include:

- **Risk Appetite:** Unlike most bilateral donors, that are backed by their host country's treasuries,

MDBs operate like banks and raise most of their money from financial markets.⁹⁰ The largest MDBs share AAA ratings from the major credit agencies, which permits them to borrow in the international market at inexpensive rates. In order to preserve their ratings, MDBs are conservative in terms of risk-taking in their operations. Their business model and stakeholder expectations pressure them to maintain AAA credit ratings, and their internal accounting rules require them to provision guarantees like they do as direct loans, even if guarantees are rarely called. This creates internal disincentives for MDBs to issue guarantees. On the other hand, since most bilateral agencies are backed by their sovereign governments, they do not have to maintain a certain credit rating, and thus they can take on riskier investments. Specialized guarantee providers can leverage without borrowing, and credit rating agencies can tolerate a higher level of leverage, because when guarantees are called it is usually only necessary to cover a few payments before the underlying obligation is restructured.

- **Size and Capacity:** MDBs have the capacity to structure a higher amount of larger deals, since they have the financial resources, staff, and country presence. MDBs are owned by national governments, and this multilateral structure allows for significant clout and influence over sovereign borrowers. On the other hand, given their large and complex bureaucracies, they remain resistant to change. Bilateral agencies, by contrast, are substantially smaller in size and are not subject to oversight from competing shareholders, which allows them to be more flexible and to respond to evolving challenges relatively faster.⁹¹
- **Governance:** Being supranational entities, MDBs abide by their own rules, which are agreed, established, and enforced by multiple shareholders. MDBs are owned by multiple countries with diverse—and sometimes conflicting—interests, so it is difficult to push them to be more innovative. Conversely, bilateral institutions usually have only one shareholder, and this allows them to be more expeditious and more innovative. Yet, a limitation is that some bilateral agencies' financing comes in

the form of tied aid; that is, they impose conditions to recipient countries, such as contracting with firms from the donor country or buying products made in that country.

Given these key differences, bilateral development institutions have a strategic advantage in addressing current gaps in the usage of guarantees. Bilaterals can also work with MDBs to offer a more creative way of structuring guarantees in developing countries.⁹² In the section below, we offer five recommendations for how bilaterals can address the gaps in the guarantee space.

One of the main gaps is the need to mobilize more private resources to fund development projects and back local currency transactions. By supporting specialized guarantee providers (like private monoline insurers), DFIs can help develop local capital markets and scale up investments. Second, bilaterals can use guarantees to back securitization and other structured finance products in developing countries, in order to allow capital to be recycled more quickly. A third major gap is that many of the investments and guarantee deals are structured in “easier” places (i.e., upper-middle-income countries), or are skewed towards certain sectors, such as energy and financial services. DFIs can use guarantees to help coordinate investments in frontier markets, leading to the development of investment clusters. A fourth gap that investors point out is that there are not enough bankable projects in riskier countries. DFIs could partner with MDBs and governments to support national project development funds to help create a pipeline of bankable projects. Finally, in order to increase the scale and development impact of guarantees, MDBs and DFIs could collaborate in challenging contexts by sharing risks in projects that target underserved geographies or sectors, as well as by combining guarantees with policy reforms.

This section unpacks each of these recommendations, laying out the conceptual framework underlying each idea, tracing its history and past track record, and looking at how it can be applied justly to modern development challenges.

Recommendation 1: Support Specialized Guarantee Providers

Developing countries have many pools of local savings that remain on the sidelines but that could potentially be mobilized to finance development efforts. Specialized financial intermediaries, such as monoline insurers, could be of great utility in developing local bond markets to channel these savings. These in turn can be instrumental in financing infrastructure, urbanization, and public services, as well as a limited number of private enterprises, such as utilities, local banks, or commodity exporters (see Box 10). Development agencies can, in theory, back monolines or other financial intermediaries by providing capital or by issuing guarantees on their transactions to help crowd in private capital (both local and foreign). InfraCredit in Nigeria and InfraZamin in Pakistan are some examples of such institutions, and bilateral donors could help replicate this model across Africa and Asia (see Box 12).

BOX 10: CAPITALIZING ON URBANIZATION

Rapid urbanization in the developing world remains an inescapable reality of the twenty-first century: according to the World Bank, most of the population growth between now and 2030 will occur in cities of developing countries.⁹³ Financing such urbanization will remain a challenge for the developing world. Municipal authorities will find themselves under much pressure to provide public services to their constituents, such as water, transportation, sustainable energy, and housing.⁹⁴ The development of local-currency bond markets, especially municipal bonds, can help local governments address numerous challenges to urban economic growth. There are also broader challenges to developing bond markets, including weak institutions and regulations, poor account-keeping practices, and poor fiscal practices.

A monoline insurance company has one line of business (hence the name “mono”-line), which is insuring debt against the risk of default.⁹⁵ When a company or public

entity issues a bond, for example, it may contract with a monoline insurer and pay a fee for this service, which is how the monoline makes money.⁹⁶ If the bond issuer defaults, the monoline insurer does not accelerate the repayment of the entire debt obligation, but instead assumes responsibility for the annual interest and principal payments while working out a recourse for the defaulting party repaying their obligations on time and in full. Bonds insured by monolines can be divided into two broad categories: those guaranteeing the performance of physical infrastructure (like municipal bonds in the United States or PPPs in other nations) and those guaranteeing the performance of structured finance deals (like mortgage securitizations in the United States or bank remittance “future flow” financings in emerging market nations).⁹⁷

Debt issuers contract with monoline insurance companies, generally through investment bankers, to lower their cost of financing as a result of the improved credit ratings their securities receive via guarantees from higher-rated insurers. The monoline insurers receive a global credit rating, and the investors rely on this investment-grade rating for confidence in the quality of their guarantee. In turn, the bond that is credit-wrapped by a monoline insurer reflects the global credit rating of the monoline.⁹⁸ So, if a monoline has a top-notch global rating, the rating gets transferred to a lower-rated bond, making the financing cheaper for the issuer. In local-currency bond markets, the global rating of the insurer, if it exceeds the global rating of the sovereign, elevates national bond ratings up to the sovereign level, again providing access to financing at cheaper levels.

At first, the big U.S. monoline insurers exclusively insured municipal bonds (tax-exempt bonds issued by a government entity), which had low default rates. As the market matured, the monolines were not terribly profitable, so many ventured into product lines that they did not fully grasp. They expanded into asset-backed securities (securities that use loans, leases, credit card debt, royalties, or receivables as collateral) and collateralized debt obligations (structured financial products that pool assets such as mortgages, loans, and bonds and then repackage them into tranches to sell to investors), which exposed them to higher risk.⁹⁹ During the 2008 financial crisis, most monoline

insurers—including the most prominent players—went bankrupt or had to leave the business. However, some monolines survived, like Assured Guaranty.

In the international development context, monolines have enjoyed a successful track record since 1994. They have structured 208 guaranteed deals in emerging markets worth \$43 billion, with only nine basis points of loss.¹⁰⁰ Some of this activity was local-currency infrastructure finance (in Chile, Mexico, and El Salvador) but a much larger proportion was dollar-denominated commodity export and bank remittance financing in lower-rated countries (see Box 11).

Both MDBs and bilaterals can leverage their investment-grade credit ratings to provide a backstop to monoline insurance companies that credit-wrap local-currency bonds in emerging markets. These institutions could provide capital to the monoline business, or they could reinsure part of the transactions. Ultimately, these actions can help lay the foundations for the development of the local bond market in the long term, which can make sustainable financing a reality for local governments. However, regulations of the country in question must allow investors to buy these securities. Thus, donor efforts to establish monolines and other financial intermediaries must be accompanied by policy reform efforts, which can be expensive, and which take a long time to accomplish.

BOX 11: MAIN ELEMENTS OF THE MONOLINE BUSINESS IN DEVELOPING COUNTRIES

- Full guarantees: guarantor pays investors full principal and interest per original debt amortization schedule in the event of default
- Matched currency requirement: guarantees in local currency for projects generating local revenues; in U.S. dollars for projects (like international airports) or structured financings (like bank remittances or commodity exports) with U.S. dollar revenues
- Focused on bond market, but helpful also for local currency bank loans

- Global scope, which is optimal for diversification
- Projects monolines could insure: physical infrastructure, social infrastructure, securitization of assets (e.g., mortgages), bank remittance, commodity export finance
- Projects monolines should not insure: pure greenfield projects, undercapitalized projects, projects with weak sponsors, projects in countries that do not meet the governance and institutional standards for the monoline, projects that are commercial but non-essential to the country

Source: Cappon and Stevens, “The Monolines Are Dead! Long Live the Monolines! Reconsidering the Record—and the Promise—of This ‘Failed’ Business Model,” 2018.

Moreover, guarantee vehicles that target local markets do not need to obtain the same AAA rating as an MDB that borrows on international markets, because what counts as investment-grade credit differs across markets. An A rating by international standards can often be enough to stand behind a guarantee that would be considered AAA locally, and is treated as such by local pension funds, insurers, and other regulated investors. Specialized guarantee providers—who do not use rules intended for lenders when accounting for guarantees—can exploit business model efficiencies, such as the ability to leverage their balance sheet without borrowing, because guarantees are unfunded. Rating agencies will often allow specialized guarantee providers to be more leveraged than they would a bank, at a given rating notch, because they know it is usually only necessary to cover a few payments when a guarantee is called before the underlying obligation is restructured. This can allow them to offer lower prices whilst still generating the same return on capital as a bank. Pricing matters, because lenders still require a small premium for risk when a loan is guaranteed (i.e., they do not regard the loan as truly risk-free), which means that if risk is priced by the guarantor in the same way that loans are priced, the overall cost of a guaranteed loan can exceed the cost of the original loan. In many developing countries, for example, a high-quality borrower might do a guarantee deal at

a 2 percent fee but would refuse it at a 3 percent fee. Therefore, if the international guarantor cannot offer 2 percent due to its business model and leverage constraints, then it is not meeting local investors' needs effectively.

BOX 12: EXAMPLES OF MONOLINES IN DEVELOPING COUNTRIES

InfraCredit in Nigeria.¹⁰¹ InfraCredit is a private company set up in 2016 by GuarantCo and the Nigerian Sovereign Investment Authority (NSIA), with a total capital of \$200 million. It provides local-currency guarantees to enhance the credit quality of debt instruments issued to finance infrastructure in Nigeria. The aim of InfraCredit's guarantees is to attract institutional investors—including pension funds, insurance firms, and other long-term investors—thereby deepening the Nigerian debt capital markets. The company operates on a commercial basis and has so far structured two guarantees in the energy sector. By replicating this model across Africa and Asia, bilateral donors can mobilize local savings and support the development of domestic bond markets.

Ascending Markets Financial Guarantee Corporation (AMF): The idea of a donor-backed monoline insurer is not an unprecedented one. In 2015 there was an initiative to set up a private-sector monoline insurer that would credit-wrap local currency loans and bond issuances at significant scale across multiple developing countries. The Ascending Markets Financial Guarantee Corporation (AMF) had \$545 million equity capital subscribed, with \$45 million stemming from three DFIs (EBRD, the Development Bank of Latin America (CAF), and IDB Invest). In addition, USAID had agreed to provide a \$200 million coinsurance facility for AMF, with projects jointly determined by AMF and USAID. The launch of this initiative failed because it did not get the desired single-A global-scale credit rating. The initiative's exclusive focus on emerging markets was viewed unfavorably by the rating agency.

The team behind AMF is now working on a more diversified platform that can help develop the local currency bond markets in the developing world while also conducting some business in the developed world. Apart from the traditional monoline business, it is adding two lines of business: trade credit insurance and reinsurance of development banks. The monoline business could guarantee bonds or bank loans in several asset classes: infrastructure project finance, utilities, municipals, securitizations (including mortgages and microfinance), and sub-sovereign debt (these asset classes mostly in local currency); and international ports and airports, bank remittances, and commodity financing (these in foreign currency). The new venture could segment its business so that a given development institution can participate with the monoline only in the developing countries it specifically targets, and not in the developed-world segment of the entity. AMF is also considering expanding its insurance portfolio geographically, such that a portion of its portfolio caters to more stable markets in developed economies. With geographic and sectoral diversity established, AMF can bring down its risk perception significantly; with the subsequent backing of a donor agency, it can obtain an investment-grade credit rating and attract greater private capital.

Recommendation 2: Support Structured Finance for Risk Sharing

Securitization and other forms of structured finance can help countries overcome their financing gaps. Securitization gives commercial banks and financial institutions the flexibility to off-load viable assets from their balance sheets onto the capital markets, creating more headroom to finance new projects. The ability to recycle assets more quickly will increase the investment in markets where local institutions able to identify viable investments have already reached capacity, as can be the case in some developing countries, where local commercial banks have reached their exposure limits. DFIs could play a critical role in facilitating the increased use of securitization in developing countries,

either by creating new conduits or by structuring guarantees to back securitizations in order to attract a wider pool of investors. As will be seen below, there are two distinct applications where guarantees from DFIs can support structured finance for risk-sharing in developing countries.

APPLICATION 1: BACK SECURITIZATIONS IN DEVELOPING COUNTRIES BY ISSUING GUARANTEES

A major challenge for infrastructure financing in developing countries is that the commercial banking sector is unable to scale up its lending due to high capital requirements. Moreover, a well-regulated securities market may be underdeveloped. Commercial banks which provide loans to infrastructure projects during the initial stage often remain tied to the loan obligation for several years—if not decades—past the stage when projects are fully developed and (in the case of infrastructure projects) successfully constructed. At the same time, the balance sheets of these relatively well-functioning commercial banks often reach overcapitalization long before market demands are even met.¹⁰² By securitizing some of their high-quality assets—like infrastructure debt and SME loans—and off-loading them into international capital markets, banks can get the capital headroom needed to scale up their lending capacity for development projects and turn local savings into new assets. It is, of course, critical that only assets that belong to fully constructed projects be considered for the pool when infrastructure debt is being securitized, in order to keep the construction risk at bay for institutional investors.

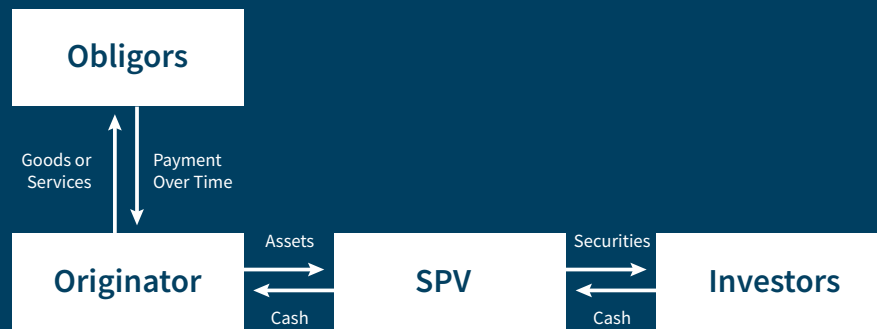
Just like in developed economies, securitization in emerging markets begins with the creation of an off-balance sheet special purpose vehicle (SPV) (see Box 13). The banks then identify suitable assets from their portfolio, which are then pooled together and transferred into the SPV. This business model does not necessarily translate successfully to emerging market economies, where high commercial and political risk could undermine the demand for securities, given the returns available.¹⁰³ Additionally, when emerging economies do issue asset-backed securities, many do so with such low frequency that there is insufficient information on asset performance, which also hinders market development.¹⁰⁴

In order to attract capital from investors like pension fund managers, these securities require an investment-grade rating. DFIs can play a pivotal role in this, by providing PRGs and PCGs that are exclusively structured to tackle the risks pertaining to a given asset pool. These guarantees can provide coverage to the mezzanine and junior tranches (or the riskier portions) of well-diversified asset pool, thereby giving the asset-backed securities (ABS) a significantly improved risk rating. Additionally, policy-based guarantees (PBGs) can be used to support governments to make some fundamental and structural reforms to mitigate some of the political risks involved, as will be discussed in the next section. These interventions by DFIs are critical for developing securities trade in the early years of a market, with a reliable asset-performance record and strong regulatory capacity emerging over time.

BOX 13: THE SECURITIZATION PROCESS

Securitization is the process by which a financial institution takes assets with steady cash flows—like bonds, loans, or mortgages—and turns them into tradeable financial instruments called asset-backed securities (ABS).¹⁰⁵ Securitization (see Figure 8) begins with originators (such as banks, MDBs or DFIs), who issue an array of debt instruments to their obligors (also known as borrowers).¹⁰⁶ The debt instruments are serviced through fixed and recurring payments, like bond annuities, loan repayments, mortgage payments, credit card debt payments, and so on. Originators then choose specific assets from their portfolios, pool them together, and sell the pool in the form of a special purpose vehicle (SPV) to an issuer in return for a cash payment. This SPV is usually set up by a financial institution off the balance sheet, primarily to protect the risk exposure of the sponsor but also to minimize legal and accounting complexities. The issuer packages this asset pool into a tradeable security (expected to bear interests and payments, as well as often incurring future flows)¹⁰⁷ before selling it to investors (or capital markets) for a market-determined price.

Figure 8: The Securitization Process



Source: Adapted from Zeta Financial, "Securitization—Pros & Cons."¹⁰⁸

While financial products with the semblance of debt securities were being offered in Europe between the seventeenth and nineteenth centuries, the modern practice of securitization finds its origins in the United States during the 1970s.¹⁰⁹ The creation of **Fannie Mae**, or the Federal National Mortgage Association (FNMA), during the Great Depression allowed bankers and lenders to create and sell securities off their housing loans and assets, freeing up the capacity to increase their lending. Following World War II, as the U.S. economy entered a period of phenomenal expansion through the 1950s and 1960s, Congress created the Government National Mortgage Association (GNMA), or **Ginnie Mae**, and the Federal Home Loan Mortgage Corporation (FHLMC), or **Freddie Mac**.¹¹⁰ These financial institutions helped drive debt securities to the center of capital markets, expanded liquidity in the housing sector, and increased commercial bankers' ability to meet growing demand for housing.

Asset-backed securitization, as a refinancing and risk transfer tool, did not become popular in emerging markets until the late 1980s, when many crisis-struck economies were looking for innovative ways to reduce their external debt obligations.¹¹¹ It was especially popular in resource-rich countries like Brazil and Venezuela, whose public-sector entities issued debt instruments secured by future flows that they anticipated from their commodities export, in order to repackage and lower their external (foreign-currency) debt to favorable levels. By the early 2000s, several other developing countries, including India and Thailand, were open to the idea of securitizing future flows to meet the fast-rising demand for new infrastructure investments.

The IFC provides several examples of how guarantees can be used to help banks in developing countries to securitize their portfolios and to mobilize debt-based investments. The IFC has a risk-sharing facility (RSF) that it uses to allow lenders who work with key social development sectors to share the credit risk on a targeted portfolio of their loan assets, therefore increasing their ability to take on more risks on their balance sheet. The IFC also uses partial-credit guarantees to provide first-loss coverage to a debt portfolio, boosting the creditworthiness of the portfolio's senior tranche.¹¹² The IFC has also helped its clients structure their debt and financial obligations. Of the several structured finance projects it has undertaken, the most notable is the residential mortgage backed securitization (RMBS) project in South Africa. Through this project, a portfolio of home loan assets (backed by mortgages) worth \$128 million were pooled into an SPV. To provide a credit enhancement, the IFC invested \$1.5 million in the junior tranche of the debt portfolio. As a result of this process, South African Home Loans (SAHL) was able to successfully create close to \$200 million in new residential mortgages.¹¹³

The idea of using ABS to expand the lending volume of the banking sector maybe more limited in low-income and lower-middle-income economies, which lack the critical mass of local capital markets and local savings needed to trade securities. Similarly, banks in such economies do not have sufficient deals on their books to give ABS the granularity and diversification it needs to give the security a lower risk rating. In these cases, commercial banks from developed economies can be a good substitute. Globally, commercial banks have a large emerging market portfolio that spans into billions of dollars' worth infrastructure debt.¹¹⁴ To put it in context, in 2018, commercial banks created new loans worth over \$282 billion to finance infrastructure projects globally.¹¹⁵ With the help of partial guarantees offered by DFIs, banks in developed markets can securitize some of their risk exposure and increase their ability to lend to emerging markets.

APPLICATION 2: CREATE A STRUCTURED INVESTMENT VEHICLE TO FINANCE SUSTAINABLE DEVELOPMENT

Many pools of savings managed by institutional investors could be channeled for development purposes. Yet

investors shy away from these markets due to lack of liquidity, foreign currency mismatches, lack of country ratings, and lack of track record in the market, among others. To better reach these investors, Dan Preston from Indiana University suggests creating an innovative securitization mechanism: a special investment conduit to help finance development projects for institutional investors to buy.¹¹⁶ This conduit would pool securities originating from developing countries related to specific development goals. It would issue medium-term notes, sold to long-term investors, that match the duration of assets in the fund. There would be full transparency regarding the underlying assets, and the conduit would contain the right risk protections and liquidity assurances, offered by MDBs or DFIs. These design features would avoid introducing the systemic risk created by combining securitization with “shadow banking,” which led to the 2007 global financial crisis.

To develop such a conduit, Preston suggests a several-step process. In the first place, an investment grade institution—a bilateral development agency, DFI, or MDB—should establish a separate entity, called a structured investment vehicle (SIV). This SIV serves as a bankruptcy-remote entity which separates the credit and bankruptcy risks of the asset pool from the conduit sponsors.¹¹⁷ Second, the assets being pooled and securitized should emerge from different sectors and different regions of the developing world, serving a specific development goal. For example, this could include bank assets or infrastructure projects past the construction phase. This cross-sectoral and cross-regional qualification to the assets helps diversify the pool and spread the risk across the SIV. Third, the SIV should issue medium-term securities in U.S. dollars, of varying maturities matching the weighted average remaining life of the assets in the SIV (unlike shadow banks, which bought long-term assets financed by short-term paper). These securities would be registered according to Security and Exchange Commission guidelines, and they would be highly liquid; the SIV would also be rated by all three major credit rating agencies and structured to achieve at least a BBB rating. Fourth, DFIs and MDBs should leverage their unique standing by providing credit enhancements. These can include a cash reserve account funded by excess spread, a subordinated debt tranche, or a

liquidity backstop to serve as a guarantee for investors concerned about lags in pay-out and funding. This backstop will significantly enhance the risk rating of the conduit. The MDBs and DFIs could also provide guarantees for specific securities in order to achieve a certain desired credit rating.

Although the combined effect of the highly-rated conduit, the support of credit enhancements and guarantees, and the diverse asset pool makes the idea of a conduit attractive to institutional investors and to capital markets at large, it remains a somewhat speculative idea.¹¹⁸ An SIV would be complex to set up, since it would involve multiple assets, sectors, countries, and currencies. There may simply be too few suitable assets originating from developing countries to make the business model viable.

CHALLENGES OF APPLYING THESE APPROACHES IN DEVELOPING COUNTRIES

There are some challenges to applying these approaches in developing countries. First, the legacy of the 2007–2009 financial crisis hovers over any conversation on securitization. It is no secret that securitization produced unintended consequences and generated unforeseen risks, which has given the world a good reason to be skeptical about securitization as a financial tool. While there are measures that can be taken to avoid repeating the same mistakes, it will take a great deal of persuasion to get more risk-averse stakeholders to consider the above ideas in good faith.

Second, there is a concern that banks in some emerging markets would find the process of securitizing their assets too costly. This concern is particularly acute in emerging markets whose track record is not long enough for investors and financial institutions to assess the quality of assets. Investors typically look at the risk of default and performance record of the asset class being securitized. The lack of data on assets results in the originator (or lender) seeking a guarantee for risk management. But the higher-risk premium involved will certainly erode the profitability of securitization, thus making it a potentially unrewarding and commercially unviable operation.

Third, in order to support such securitization approaches with bespoke guarantees, DFIs and bilaterals will need

to commit significant amounts of time, resources, and expertise. Bespoke partial guarantees are needed to facilitate the securitization of riskier commercial bank portfolios, as every asset pool will have a unique set of risks caused by a range of factors including political structures, borrower credit history, and maturity period. Similarly, managing the assets of an SIV requires a personnel structure that can perform due diligence on a diverse range of assets, ensure proper documentation, and administer timely and coordinated payments to the investors.

Recommendation 3: Structure Guarantees to Help Create Investment Clusters in Fragile Countries

Much of the developing world today is fundamentally different than it was twenty years ago. Many countries have moved up the development ladder and are able to attract financing, both from domestic and from international investors. However, a set of low-income countries (the latest OECD report classifies 58 countries as “fragile” in 2018) are plagued by conflict, fragility, and violence, and are unable to build a critical mass of state capacity to ensure the proper functioning of political and market institutions.¹¹⁹ Collier et al (2019), in a recent study, characterized this problem as a vicious cycle caused by a fractured society capturing different elements of the state and inhibiting its proper cohesive function.¹²⁰ This robs public institutions of their legitimacy and their capacity to uphold the rule of law, and it deters the growth of the private sector. The lack of a functioning private sector—and of private-sector investment—thus perpetually reinforces poverty, social despair, and conflict.

In these more difficult contexts, it takes an average of six to seven years for significant private investments to materialize once the conflict is over. Lee (2017) argues that post-conflict countries and fragile states require an even more differentiated approach to mobilizing private capital. Fragile states need more than money: they require a combination of diverse financing tools, technical advice, and a degree of experimentation on development approaches.¹²¹

Given the high risks involved, MDBs and DFIs are best placed to play a significant role in helping governments in these countries break this vicious cycle of fragility.

The emergence of a cluster of interdependent firms can help turn the vicious cycle into a virtuous one. DFIs must be strategic with their interventions in order to support pioneer firms, whose success can yield direct social benefits and whose presence in the market will lead to the development of an interdependent cluster of other firms.¹²² Conditional on the political, economic, and cultural context of each country, this intervention can be made by deploying different financial instruments and technical expertise.

To champion these kinds of pioneer firms, DFIs can employ a three-pronged strategy: the development of a subsidy mechanism that mitigates the firm's initial entry costs; the provision of technical assistance that helps the country build its public-sector capacity to legislate policies and regulate activities needed for any market to function (labor relations, banking sector, tax code, etc.); and, lastly, the use of political risk insurance and partial credit guarantees to mitigate various risks threatening investments into such pioneer firms.

The use of guarantees and equity can help jumpstart these investments. DFIs could actively support pioneer firms through first-loss loans or first-loss guarantees, which indemnify the investor against a certain amount of loss.¹²³ Typically, this instrument is used to cover the junior tranche of a given project—that is, the guarantor is the last to be paid in case the project fails, making it more likely for other investors to recoup their money and hence decreasing their risk. These guarantees can help catalyze finance for projects that have high risks but also have high social and environmental impact, finance that might not have been mobilized otherwise.¹²⁴ When considering first-loss guarantee structures, it is hugely efficient to cluster a number of transactions into a single financing pool to be funded simultaneously. These types of guarantees can be used to create a demonstration effect and to develop a market in fragile contexts: if the investment performance is strong, this brings new investors into the development of a new sector.

Moreover, bilaterals and DFIs can strategically use guarantees to effectively mobilize a series of potential complementary investments. Basu (2014) shows how coordinated guarantees can reduce the risk of failure when individual projects are complementary, and

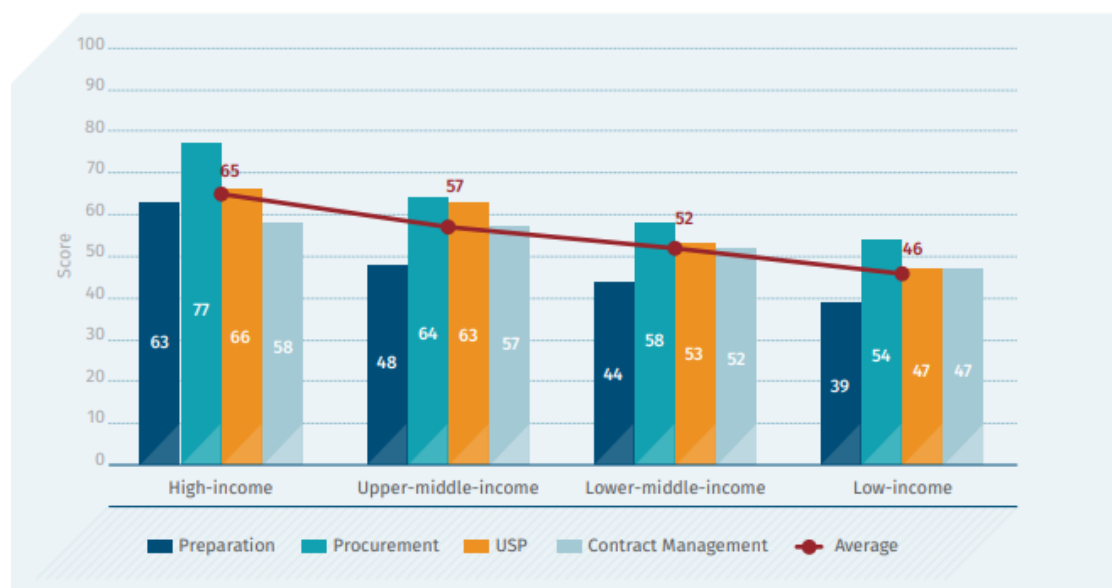
how by so doing they can reduce the probability of the guarantees being called. Sovereign governments receive various proposals to guarantee infrastructure projects. Issuing guarantees for these proposals individually could be fiscally reckless, but the government could work with MDBs and DFIs to coordinate project selection to reduce the overall risk. Basu qualifies that this outcome is only possible if the country enjoys strong contract enforcement and governance, which can be a challenge in more fragile contexts—suggesting MDBs and DFIs could have a role in strengthening these aspects.¹²⁵

Recommendation 4: Support National Project Development Funds to Help Develop Bankable Projects

Another way that bilaterals and MDBs can support countries mobilizing private funding for infrastructure projects is by supporting the use of sovereign guarantees. Development agencies can help governments set up national project development funds that would create a pipeline of bankable projects and provide investors with guarantees against early-stage risks. In this regard, the role of bilaterals would not be to provide guarantees, but rather to support these national development funds by providing advisory services and by holding governments accountable to their commitments. A project development fund complemented by carefully designed sovereign guarantees would essentially create a mechanism for the government to insure developers against the risk that it will renege on its promises.

Investors often point to the lack of bankable (i.e., commercially viable) projects as a major challenge in developing countries. This is the case of infrastructure, where countries are seeking investments to the tune of \$3.7 trillion.¹²⁶ Meeting global infrastructure needs will require a more concerted effort in preparing a sound pipeline of bankable projects. In this regard, the project preparation stage is of paramount significance.¹²⁷ A 2018 World Bank assessment of PPP infrastructure projects in the developing world found that the lowest scores received by low- and lower-middle-income countries were for the project preparation phase, worse than other phases such as procurement, contract management, and transparency over the handling of unsolicited bids (see Figure 9).¹²⁸

Figure 9: Scores by Phase of Project and Income Category



Source: World Bank Group, *Procuring Infrastructure Public-Private Partnership*.¹²⁹

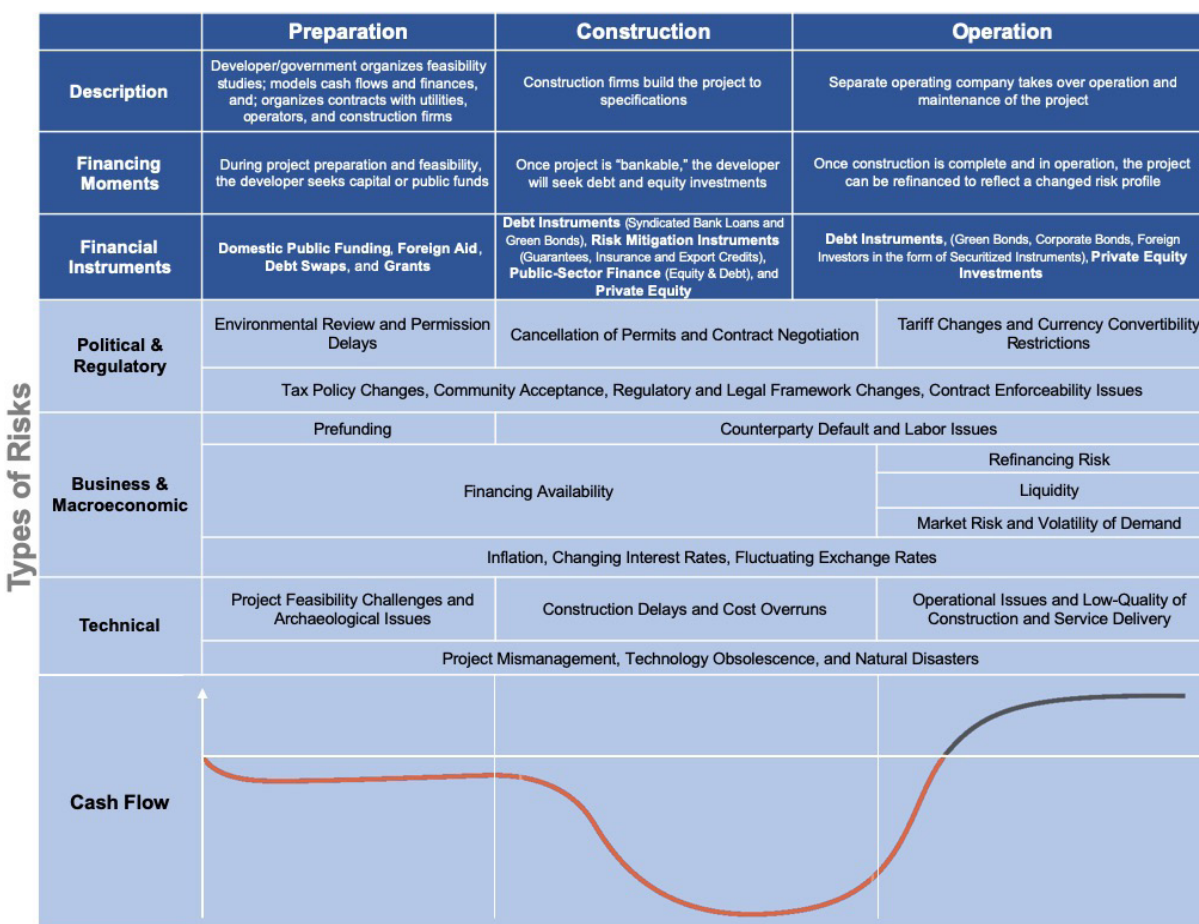
Broadly, there are three stages to the development of an infrastructure project: the preparation stage, the construction stage, and the operation stage (see Figure 10).¹³⁰ The project preparation stage encompasses activities such as conducting feasibility studies, environmental impact assessments, and life-cycle cost analyses. This phase presents early-stage risks which are often political or bureaucratic in nature, including changes in regulations, evolving environmental standards, or planning alterations. The construction stage is among the riskiest of the three stages, owing to uncertainties of construction delivery (cost overruns, delays, or defects in the construction phase), macroeconomic risk factors (interest rates, commodities trade, unemployment, inflation, economic slowdown, and worsening fiscal health) and political risk factors (changes in legal and regulatory framework surrounding land acquisition, labor relations, property rights, contracts, and general neglect of the rule of law).¹³¹

However, it is often the preparation stage that becomes a stumbling block for projects vying for private investments.¹³² A 2019 Global Infrastructure Hub report estimates that the cost of preparing and packaging projects can range between 5 and 10 percent of project value, with developing countries seeking over \$188 billion annually to finance project preparation efforts.¹³³

To help countries prepare and package their projects better, major MDBs like the EBRD, the Inter-American Development Bank, and the World Bank have set up project preparation facilities around the world, with a focus on helping to increase the commercial viability of project proposals.¹³⁴ Other initiatives include Infracore in Asia and Africa, funded through the Private Infrastructure Development Group (PIDG)'s publicly funded trust, from government entities in the United Kingdom (DFID), the Netherlands (DGIS), and Switzerland (SECO). However, these facilities have received limited levels of funding, and there is little understanding of them among officials responsible for infrastructure procurement duties in the developing countries.¹³⁵

These project preparation facilities are valuable, but private investors may remain reluctant to commit funds to project development given the highly uncertain returns and the considerable length of time needed to realize them. Perhaps development agencies could try to design guarantees such that private project developers would be protected against the myriad reasons why a project might not come to fruition, but this role would be better played by national governments, who already control many of the levers that determine whether a project will succeed. Issuing a guarantee would signal commitment on the part of the government, as well

Figure 10: A Typology of Project Phases and Risks



Source: Corfee-Morlot et al., *The Sustainable Infrastructure Imperative*; OECD and World Bank Group, *Risk and Return Characteristics*.

as creating incentives to honor promises made.¹³⁶ The role of MDBs and bilaterals would then be on the technical assistance side, rather than on the financing side; they would help governments design these project development funds and deliver joint trainings in project preparation and procurement processes to government employees. The scope of any guarantee would have to be designed carefully so as not to unduly limit a future government’s democratic right to amend previous policy decisions, without becoming liable for unreasonable payments to private parties. Project development funds can be supported by MDBs, DFIs, and other development aid agencies, allowing them to secure sufficient technical assistance in the early stage of the project development process, and therefore increasing the number of bankable infrastructure deals available.¹³⁷

In turn, to provide assurance to private investors against political risks, developing country governments can issue sovereign government guarantees for their national project development funds. To that end, these guarantees can be issued as a partial-risk insurance covering two specific forms of risk:

- **Procurement risks**, which can include delays in signing contracts, bureaucratic corruption, or arbitrary changes to the procurement rules; and
- **Regulatory risks**, such as a change in government or its priorities, as well as a failure to secure clearance from relevant environmental protection authorities.¹³⁸

Given their political nature, these risks require the intervention of actors who can affect upstream changes.

By allowing governments to guarantee investors against these limited sets of risks, the three stakeholders—the investor, the borrower, and the government (the guarantor)—are encouraged to work closer and to seek the optimal outcome from project development.

Recommendation 5: Increase Collaboration Among MDBs, DFIs, and Bilaterals for Scaling Guarantees in Challenging Contexts

MDBs and DFIs could be more effective if they worked in a coordinated and systemic manner. There is both scope and need for substantially improved system-wide coordination among these institutions, in order to ensure that development finance better supports reform processes and highest-value operations. As global challenges evolve and as MDBs are called on to address more complex situations in fragile and conflict-affected states, a coordinated, lessons-learned approach to financing could lead to more successful development outcomes.¹³⁹

The goal of mobilizing trillions of dollars to meet development challenges by 2030 will require more collaboration among MDBs and DFIs, especially in riskier countries. In its final report to the leaders of the G20, the Eminent Persons Group on Global Financial Governance recognizes this reality, and calls for the adoption of a “practical, risk-based approach” that will help MDBs make a strategic shift to their business models. Further, the report asks that MDBs, DFIs, and other development partners ensure greater “complementarity and synergy” through collaboration. It also emphasizes the need to “refocus on risk mitigation to catalyze private investments.”¹⁴⁰

In the area of guarantees, there are some collaborative approaches that have emerged in recent years and that can be replicated and scaled up. These approaches include high-level initiatives (such as adopting shared principles, signing memorandums of understanding (MOUs), or setting up platforms to exchange best practices) or more concrete, on the ground approaches. Stakeholders can collaborate to support specialized guarantee providers, or they can establish risk-sharing arrangements so that DFIs can diversify the exposure

created by issuing guarantees for individual projects in target underserved countries or sectors (healthcare, education, and others). They can also work jointly to combine the use of guarantees with policy reforms. All these efforts offer some blueprints for DFIs to pursue a more coordinated approach when structuring credit enhancements.

The most effective way of promoting coordination between MDBs and DFIs is probably in the field, through co-finance or co-guarantees where operation interests and incentives are better aligned. High-level initiatives, such as MOUs and others, have not been very effective in leveraging resources to date.

HIGH-LEVEL INITIATIVES TO EXCHANGE BEST PRACTICES

Across the MDB and DFI community, several platforms have been set up to exchange data and ideas, as well as to set up facilities, with the aim of increasing the amount of private capital available to finance development challenges. One such platform is the DFI Working Group on Blended Concessional Finance for Private Sector Projects, which consists of heads of the MDB and the European Association of bilateral DFIs (EDFI),¹⁴¹ and which adopted the Enhanced Blended Concessional Finance Principles for DFI Private Sector Operations (also known as the DFI Enhanced Principles) in October 2017.¹⁴² These principles are common standards to be used when structuring blended finance transactions (i.e., when combining commercial tools with concessional finance). Guarantees are considered among of these transactions. The principles highlight several needs: avoiding to crowd out the private sector; following a commercial approach; addressing market failures; and promoting high social, environmental and governance standards.¹⁴³ Institutions are meant to implement the principles through their operations, governance structures, and staff training, and to report annually on progress and results.

Other platforms that aim to coordinate the work of MDBs and DFIs in mobilizing private finance include thematic initiatives. For example, the G7’s “2X Challenge” was established in June 2018 to mobilize \$3 billion by 2020 for women’s economic empowerment.¹⁴⁴ The commitment allows G7 DFIs to explore new and innovative paths, in addition to existing blended finance

tools, that would help advance the many commercial roles played by women—such as entrepreneurs, business leaders, employees, and consumers. More recently, on April 11, 2019, the Overseas Private Investment Corporation (OPIC) signed a memorandum of understanding with FinDev Canada and European Development Finance Institutions (EDFI), in order to establish a “DFI alliance.”¹⁴⁵ The goal of this alliance is to improve cooperation among these institutions on transactions, operations, and policy-related work.

SUPPORT SPECIALIZED GUARANTEE PROVIDERS

Development institutions have also collaborated in more concrete ways to increase the use of credit enhancements in developing countries by setting up and funding specialized institutions that have a geographical or sectoral mandate. MDBs and bilaterals can join forces to support and replicate initiatives across Asia and Africa that have already proven successful, such as GuarantCo or the Africa Guarantee Fund (AGF). GuarantCo, which was founded in 2006 as part of the PIDG, provides guarantees for local-currency debt transactions for infrastructure projects across Asia and Africa. It is funded by the governments of Australia, the Netherlands, Sweden, Switzerland, and the UK. The Africa Guarantee Fund (AGF), established in 2012, is another example, where the governments of Denmark and Spain collaborated with the African Development Bank to set up a specialized company with the aim of increasing SME lending in African countries through the use of loan guarantees and equity investments. The Agence Française de Développement (AFD) joined AGF in 2015, followed by the Nordic Development Fund (NDF)

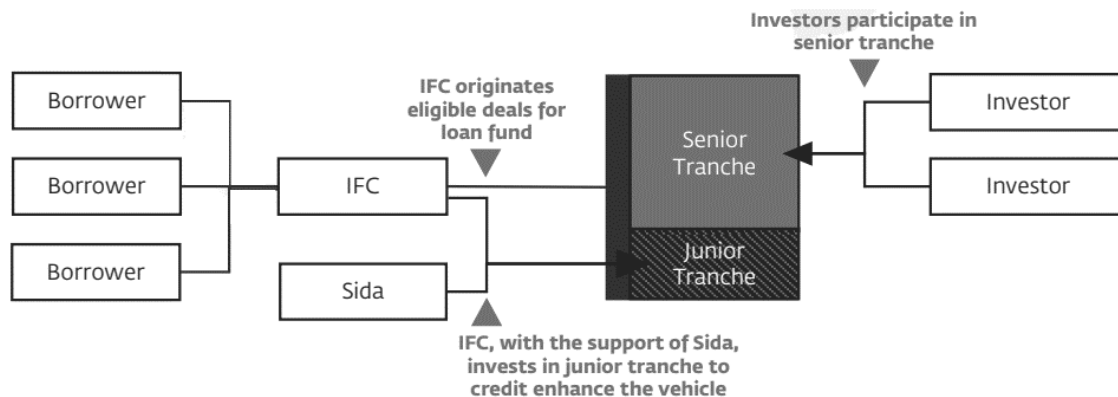
in 2016; the Investment Fund for Developing Countries (IFU) and KfW Development Bank joined later, in 2018 (see Appendix B for more information on these entities).

RISK-SHARING ACROSS PROJECTS TARGETING UNDERSERVED COUNTRIES AND SECTORS

Many countries and sectors lack financing. There are good examples where MDBs and DFIs have forged innovative partnerships to address these gaps, either by co-guaranteeing projects or by using their guarantee products to backstop transactions. Infrastructure is among one of the more underserved sectors. In the case of project financing, IFC launched the Managed Co-Lending Portfolio Program facility (MCP) in 2013. The MCP serves as a syndication platform for institutional investors, which works with insurance companies and development partners to create a diversified loan portfolio for infrastructure investments (see Figure 11). IFC provides a first-loss coverage on the debt portfolio by taking up the riskier exposure from the junior tranche, leaving the investment-grade exposure from the senior tranche of the portfolio for institutional investors. IFC has, in turn, partnered with Sida to share the risk exposure from the first-loss coverage. By 2018, the MCP facility was able to raise over \$1.6 billion, more than two-thirds of which has been committed to projects in Africa and Asia.¹⁴⁶

Similarly, there are huge needs around the world in the sector of social infrastructure. The Elazig Hospital PPP in Turkey is one successful example of how EBRD and MIGA partnered to launch the first ever “social

Figure 11: MCP Structure



Source: “MCP Infrastructure An innovative structure to mobilize institutional investment in emerging market infrastructure loans,” International Finance Corporation.

and green bond” to finance the construction of a €360 million healthcare campus (see Appendix B). These and other successful examples showcase that collaboration is possible, and that there is room for development institutions to work closer together in scaling up the use of guarantees.

COMBINE GUARANTEES WITH POLICY REFORMS

In many low- and lower-middle-income countries, weak macroeconomic fundamentals and the absence of strong institutions and transparent governance inhibits private investments and long-term economic development. But it is precisely these countries that need to mobilize private capital the most. Considering these challenges, guarantees combined with policy reforms can provide powerful results in terms of promoting private investment. DFIs and MDBs could coordinate their work better in this area, with DFIs providing development finance tools (such as guarantees) in tandem with the policy work that MDBs and other institutions, such as the European Commission, carry out in developing countries.

There are approaches to incentivize low- and lower-middle-income countries to undertake structural and macroeconomic reforms, therefore enhancing their ability to mobilize domestic capital and to attract international investors. One approach is the use of policy-based guarantees, which are less well-known type of guarantee. Another approach is for bilateral agencies and DFIs to work together to combine three instruments: guarantees, policy reforms, and the development of bankable projects. This latter is the case of the European Union’s External Investment Plan (EIP).

A policy-based guarantee (PBG) is a variation of a partial-credit guarantee that covers debt instruments issued by sovereign governments. PBGs were initially targeted to IBRD countries (i.e., middle-income countries), and the first PBG was issued to Argentina in 1999. Since then, the World Bank has issued a total of 12 PBGs to 11 countries. Incidentally, after Argentina defaulted on its \$132 billion sovereign debt obligation and called on the PBG, the World Bank stopped using the instrument. It was not until after the 2008 global financial crisis that PBGs were revisited as a tool to

facilitate structural reforms. In 2013, the World Bank relaxed the eligibility criteria for PBGs, expanding their use to IDA countries.¹⁴⁷ The most recent PBG was structured in Benin—the first low-income country to receive this guarantee.

PBGs insure private lenders against the risk of sovereign default. For governments, PBGs facilitate access to commercial funding and improve the borrowing terms of the sovereign undertaking structural reforms (i.e., provide lower interests and higher tenors). Unlike a partial credit guarantee that supports a particular project, capital raised using a PBG is used for general budgetary support) as the country undergoes a series of macroeconomic reforms. The borrowing country is therefore able to diversify its creditor base. This is because countries are able to leverage the World Bank’s AAA rating to improve their borrowing terms and expand their access to international capital markets. Borrowing countries use the expertise and resources that the World Bank has to offer to achieve their stated policy reforms. There are, however, potential drawbacks to the use of PPGs. Using guarantees for debt obligations that are substantially large could potentially disincentivize borrowing countries from making good fiscal choices and could place less focus on mitigating fiscal and macroeconomic risk.

Although the World Bank is currently the only institution issuing PBGs, other institutions have modified versions of this instrument. Most prominent among them is the European Union’s External Investment Plan (EIP), an initiative which was launched in 2017. The EIP aims to attract private investment into partner countries in Africa and the European neighborhood to create jobs, support entrepreneurs, and help tackle the root causes of migration. It has the ambitious target of leveraging €44 billion in investments by 2020 from initial commitments of €4.5 billion.¹⁴⁸ Three pillars that constitute the EIP: 1) a new guarantee program with blended finance instruments 2) technical expertise and non-monetary resources to help national and local public officials develop bankable projects, and 3) policy dialogue to improve the investment climate and business environment in developing countries (see Box 14). To implement the plan, the European Commission will need to work with EU financial

institutions, multilateral and bilateral aid agencies, and DFIs.

By combining technical assistance with guarantees, these models aim to overcome some of the key obstacles that deter private investments materializing, specifically in least-developed and fragile states. This is an area where DFIs and MDBs could collaborate more closely by designing new approaches that bring together policy reforms and guarantees into one financing package.

BOX 14: THE THREE PILLARS OF THE EU EXTERNAL INVESTMENT PLAN (EIP)¹⁴⁹

Pillar 1—Mobilizing Finance: The European Fund for Sustainable Development (EFSD) is a €4.5 billion financing mechanism to support investments made by both public and private sectors. It combines a new guarantee program with blended finance instruments to help transfer risks that would otherwise prevent private debt-based investments in the participating countries in Africa and Europe. The partial EFSD guarantee instrument is worth €1.5 billion and is intended to attract risk capital to the initial phases of projects by acting as a pledge if a borrower fails to comply with the terms of the loan. One of the main priorities of the guarantees program is to support agriculture development and rural communities, by backing lending to SMEs and MSMEs and by encouraging investments in rural areas. It consists of 28 guarantee programs and has a blended facility budget of €3 billion. The use of EFSD funds is limited to five priority investment areas: Sustainable Energy and Connectivity; MSME Financing; Sustainable Agriculture; Rural Entrepreneurs and Agribusiness; and Sustainable Cities and Digital for Development.

Pillar 2—Providing Technical Assistance to Make Projects Viable for Investment: Recognizing that a number of developing countries lack a critical mass of bankable and financially viable projects that can benefit from private investments, the European Union uses this pillar to draw upon its own technical expertise and non-monetary resources to help national and local public officials in partner countries develop projects that can be sustainable in the long run. Within the context of the EIP, technical assistance can take the following forms:

- market intelligence and investment climate analysis;
- policy dialogues on priority sectors;
- targeted legislative and regulatory advice;
- efforts to strengthen the capacity of partner countries, local financial intermediaries, and investors;
- value chain upgrades; and
- resources to identify, prepare, and help implement necessary investment.

Pillar 3—Improving Investment Climate and Business Environment: This third pillar, which is interrelated to the second one, seeks to improve the investment climate and business environment in the economies of countries participating in the EIP. This pillar, ostensibly the most difficult of the three, focuses on facilitating policy dialogues (sometimes at a granular level) with the EU delegations. The following elements characterize the third pillar:

- structured dialogue with businesses at country, sector, and strategic levels;
- policy and political dialogue with partner governments to address key constraints to investments and promote good governance;
- support to regulatory, policy, and governance reforms, building upon market, sectoral, and value-chain intelligence at the country level; and
- effort to ensure coherence with other European Union policies, aid modalities, and EU country initiatives.

Conclusion

The increasing economic, social, and infrastructure needs of developing countries can only be met through the creative deployment of official aid resources and the mobilization of private capital investments. Developing countries pose high levels of risk for investors, making guarantees a critical tool for development partners as they strive to reduce investors' exposure to these risks.

Although guarantees are far from being a silver-bullet solution to mobilizing private capital to the developing world, bilateral aid agencies and DFIs can be more active in this space, given their higher tolerance to risk, their more flexible governance structures, and their lower bureaucratic impediments vis-à-vis MDBs. With newly established DFIs like FinDev Canada and the United States International Development Finance Corporation (DFC), there is an opportunity to scale up the use of guarantees and implement some of the innovations highlighted in this report.

Many countries, especially fragile and conflict-afflicted states, have underdeveloped domestic capital markets and cannot easily access international investors. In such contexts, the mere deployment of guarantees will remain ineffective so long as countries lack strong institutions and good governance frameworks. For development to be truly sustainable, countries need to effectively mobilize different pools of local capital. Bilaterals and MDBs could also work together by drawing upon their unique strengths to be more effective in structuring guarantees and providing technical assistance across challenging contexts. Development agencies' efforts, therefore, need to

focus on helping create or strengthen domestic bond markets, as well on implementing financial innovations to address gaps in development finance.

Appendix A: List of Organizations Consulted for this Report

Africa GreenCo
African Development Bank
African Guarantee Fund
Ascending Markets Financial Guarantee Corporation
AXA Investors
British Embassy in Washington, D.C.
Cardano Development
Center for Global Development
Citibank
European Bank for Reconstruction and Development
European Commission
EVS Global Consulting
Fission Ventures
InfraCredit
Institute for International Finance
Inter-American Development Bank
International Finance Corporation
Investec
Liberty Mutual
Lions Gate Asset Management
Millennium Challenge Corporation
Moody's Investor Service
Multilateral Investment Guarantee Agency
Organisation for Economic Co-operation and Development
Overseas Development Institute
Overseas Private Investment Corporation
Rock Creek Global Advisors
S&P Global Ratings
Shire Oak International
Total Impact Capital
United States Agency for International Development
Vitas Group
Volta Capital
Water.org
World Bank

Appendix B: Select Examples of MDB and DFI Collaboration

Support Specialized Guarantee Providers

GuarantCo is a private limited company based in Mauritius which provides guarantees for infrastructure projects in low-income countries in Asia and Africa. It is a part of the Private Infrastructure Development Group (PIDG) and is supported by multiple governments, including Australia, the Netherlands, Sweden, Switzerland, and the United Kingdom.¹⁵⁰ The company is rated investment-grade by the major rating agencies. Depending on the type of project proposed, GuarantCo offers a range of guarantee services, including partial credit guarantees, partial risk guarantees, first-loss guarantees, tenor extension, liquidity guarantees, joint guarantees, and counter-guarantees. Their services also provide the credit rating improvement required for projects, depending on the location of the investment. They mainly provide services to private-sector entities, although occasional exceptions occur. GuarantCo has over 50 projects in 17 countries across the world, in sectors ranging from agribusiness to energy, from transportation to social infrastructure, with \$4.4 billion mobilized in private investments. GuarantCo also offers funds for technical assistance to develop, structure, and support local capacity building and capital market development.¹⁵¹ GuarantCo not only facilitates project development through its products and services but also helps develop local capital markets and alleviate poverty in low-income countries.

The African Guarantee Fund (AGF) was launched in 2012 with headquarters in Nairobi. It was designed

and funded by the African Development Bank, in partnership with the governments of Denmark and Spain, to facilitate financial assistance to small and medium enterprises (SMEs) in Africa. It is estimated that only around 20 percent of African SMEs have a direct line of credit to a financial institution, severely limiting their ability to grow in the continent.¹⁵² The AGF, therefore, seeks to fix this mismatch between supply and demand by working with these financial institutions through two lines of activities. It provides partial financial guarantees, to cover risks associated with lending to SMEs, and capacity development, to increase financial institutions' abilities to appraise and manage SMEs).¹⁵³ The AGF is a public-private partnership model and, thus, has an enormous propensity for growth, which it is currently seeking to make good on. The company has so far been successful, having achieved an AA- rating from Fitch Ratings in 2017, and having made guarantee commitments worth \$500 million with nearly 90 partner financial institutions in 38 different countries by the end of that year. The AGF is currently increasing its capital base, per its 2017–2021 strategy plan, and seeks to raise \$500 million over this five-year period to fulfill the burgeoning demand of its SME loan guarantee product.¹⁵⁴

Risk-Sharing Across Projects Targeting Underserved Countries and Sectors

IFC Managed Co-Lending Portfolio Program (MCP) with Sida is a loan syndication platform designed by

the International Finance Corporation (IFC) to reach global institutional investors who may not have had much prior exposure to emerging markets. The MCPP facility does this by creating a diversified emerging market debt portfolio and taking on the risk exposure from the junior tranche. This gives the institutional investors access to the investment-grade exposure from the senior tranche, which makes them able to provide project debt to emerging markets on commercial terms. The portfolios which the IFC builds for these investors are often similar (and in many cases, identical) to the ones which the IFC uses itself, akin to an index fund. The outside investors commit certain amounts of capital to the portfolios, and the IFC helps them to find the investments that can limit their exposure to the best degree possible.

The IFC has partnered with eight organizations, raising \$7 billion as of 2018. These include the People's Bank of China, Eastspring Investments, Allianz Global Investors, and the Hong Kong Monetary Authority.¹⁵⁵ In order to further target infrastructure investments, Allianz and Eastspring have set up two infrastructure funds worth \$1 billion to support lending to IFC projects. The IFC provides first-loss coverage on the portfolio by taking a junior tranche so that investors can take investment-grade exposure in a senior tranche. This way, the outside investors are still able to take on the investment-grade exposure, which should in turn create credit enhancement for them.¹⁵⁶ The IFC, in turn, has partnered with the Swedish International Development Cooperation Agency (Sida) to assist in sharing the risk burden on the first-loss tranche of the portfolio (10 percent). Sida counter-guarantees the IFC in all projects related to renewable energy, as well as in investments in the poorest countries (except for investments in fossil fuel and mining projects). Sida's counter-guarantee is expected to cover 20–25 individual projects, with a maximum guarantee coverage of \$57 million.¹⁵⁷

OPIC–Liberty Mutual Co-Investment Platform: For lessons on successful partnerships with the private sector, DFIs can also look towards OPIC and its \$1 billion co-investment platform, which was launched in 2018 in partnership with Liberty Mutual Insurance. Through this deal, Liberty Mutual (a private insurance

company) underwrites OPIC's forthcoming FI portfolio. Liberty did this with a partial credit guarantee that covered up to 50 percent of OPIC's risk exposure, capped at \$25 million per project if the borrower is a commercial bank or \$10 million if the borrower is a NBFI. The deal frees up headroom for OPIC to undertake new investments in high-exposure countries while drawing upon the resources of an institution with an excellent credit rating, all geared towards catalyzing investments that can support and grow benefits to hundreds of women-owned businesses and SMEs in developing countries.¹⁵⁸

Africa Local Currency Bond Fund (ALCB) was created in 2012 by German development institution BMZ and KfW Development Bank to develop local currency corporate bond markets in African countries. Other investors in the fund include IFC, OPIC, AfDB, Calvert, FMO, and FSD Africa. The fund's mission was inspired by the strategies laid out in the G20 Action Plan to Support the Development of Local Currency Bond Markets (LCBMs). This action plan was created and approved in 2011 during the French Presidency.¹⁵⁹ The ALCB Fund does not provide guarantees, but rather acts as an anchor investor and provides technical assistance—specifically for local currency bond issuances by financial service providers and for companies that operate in the financial inclusion, agriculture, housing, education, and renewable energy sectors. The Fund's Technical Assistance Facility (ALCBF TAF) is a pool of financial resources designed to ensure that bankable deals come to market and that appropriate incentives are in place for issuers, investors, and intermediaries. The services funded by the TAF include legal support, financial advice, and credit ratings for new issuers. The TAF also helps issuers improve their financial management capacity, reporting, and governance in preparation for an issuance.¹⁶⁰

Since its inception in 2012, the Fund has taken on a wide-ranging investment portfolio. Some of its holdings include a micro-lending service in Kenya, a Nigerian power company, and a South African mortgage provider. For these companies and the others included in the Fund's portfolio, financing had been a huge impediment to their expansion. The companies within the portfolio also make contributions to a variety of sustainable

development goals (SDGs), such as ending poverty or reducing inequality.¹⁶¹ By having the ALCB act as an anchor investor, the level of risk these companies had to take on in the bond markets dropped significantly. The ALCB will continue to use EFSD guarantees to make investments in bond issuances across Africa to support financing for renewable energy, low income housing, agriculture, and more.¹⁶²

The Elazig Hospital PPP Project in Eastern Anatolia, Turkey, is a greenfield PPP health facility which aims to help increase access to quality health services for 1.6 million people. It will consist of more than 1,000 beds and include a general hospital, a hospital for women, maternity, and pediatrics, a psychiatric hospital, and a dental clinic. The project is anticipated to employ 5,000 people during its construction and operation phases.¹⁶³

The 28-year concession was awarded by the Turkish Ministry of Health to a consortium of companies—ELZ Saglik Yatirim—to design, build, finance, equip, and maintain the hospital campus at Elazig. The total value of the project was €360 million. 80 percent of the project was financed through the issuance of a (€288 million) 20-year “green and social bond” by ELZ Finance S.A., who will on-lend the proceeds to the project consortium.

There were two principal risks that confronted the development of this PPP greenfield project: the construction risk posed by the contractor and the political risk posed by the Turkish Ministry of Health. Turkey’s previous political and economic climate had lowered the country’s credit rating, which acted as a disincentive to investors. These two risks were mitigated by an innovative collaboration offered by the European Bank for Reconstruction and Development (EBRD) and the World Bank—within which the IFC and MIGA both played a pivotal role. While the EBRD provided €89 million to mitigate the risks of construction and operation, MIGA provided a political risk insurance for the bond and protected the investors from delayed payments due to a long arbitration process. This also included the collaboration of two bilateral DFIs, PROPARCO, and FMO, through bond subscriptions. Although the transaction took three years, this innovative approach to risk mitigation, involving

public and private players along with international financial institutions, improved the hospital’s risk rating while enabling the participation of a larger pool of investors to provide the necessary €360 million of support.¹⁶⁴ The guarantee gave the bond a Baa2 rating by Moody’s, which represents a credit uplift of two notches compared Turkey’s sovereign debt rating in November 2016. As of 26 July 2019, the bond rating remains at Baa2 stable, now five notches above Turkey’s sovereign rating of B1 negative.¹⁶⁵

Multilateral support consisted of the following:¹⁶⁶

- €80 million IFC investment in the project bond on a parallel basis in an unenhanced and unrated tranche;
- €89 million EBRD liquidity facilities supporting the construction and operational phases of the project to complement MIGA’s political risk cover;
- A 20-year MIGA political risk guarantee in support of the investment-grade portion of the bond (€208 million) and MIGA guarantee to equity investment in the project; and
- Institutional capacity for PPP contract management and monitoring as part of their broader support to the Government of Turkey’s health reform program.

Co-Guaranteeing Platform in Africa was created in July 2018 via a MOU between the African Development Bank (AfDB), the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC), the African Trade Insurance Agency (ATI), and GuarantCo. The overarching intention of the platform is to facilitate greater amounts of investments that otherwise would not be likely to occur in Africa. The Platform would effectively be a collective de-risking instrument, designed to tackle issues such as the continent’s perceived risks and the inability of traditional lenders to provide more comprehensive risk mitigation for projects. Prior to the MOU coming to fruition, many guarantee providers and mitigation instruments already existed in Africa; however, cooperation between them was inefficient or non-existent. The Co-Guarantee Platform provides a means for more formal collaboration amongst actors.

About the Project Directors and Authors

Daniel F. Runde is senior vice president, director of the Project on Prosperity and Development, and holds the William A. Schreyer Chair in Global Analysis at CSIS. A global thought leader and change agent, his work centers on leveraging U.S. soft power and the central roles of the private sector and good governance in creating a more free and prosperous world. Mr. Runde has been recognized for influencing the debate on USAID-State Department relations, as an architect of the BUILD Act, and for leading the debate surrounding the role and future of the World Bank Group. Mr. Runde has also influenced thinking about U.S. economic engagement with Africa (of which he is in favor of much more) and domestic resource mobilization. Mr. Runde holds the Officer's Cross in the Order of Isabel la Católica, a Spanish Civil Order.

Previously, Mr. Runde held senior leadership roles at the International Finance Corporation (IFC). From 2005 to 2007, he was director of the Office of Global Development Alliances (GDA) at the U.S. Agency for International Development (USAID), and he led the GDA partnership initiative by providing training, networks, staff, funds, and advice to establish and strengthen public-private partnerships. His efforts at USAID leveraged \$4.8 billion through 100 direct alliances and 300 others through training and technical assistance.

Mr. Runde is the chairman of the Advisory Committee on Voluntary Foreign Aid (ACVFA) and serves on the board of the International Foundation for Electoral Systems (IFES), the Millennium Challenge Corporation (MCC) Advisory Council, and the Ashesi University Foundation (a private university located in Accra, Ghana). Mr. Runde is a regular contributor to The Hill and hosts a podcast series, Building the Future with Dan Runde: Freedom, Prosperity, & Foreign Policy.

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