Guarantees & risk mitigation instruments

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Recap: risks of water sector

1. Generic risks
   - Political
   - Credit
   - Exchange rate
   - Commercial
2. Specific & disproportionate risks of water
   - Project profile
   - Rate of return
   - Sub-sovereign
   - Contractual & regulatory

Purpose of guarantees

- *encourage lending and investment in developing countries and emerging markets by mitigating key risks.*
- *apply both to physical infrastructure projects & to promotion of local capital markets as suppliers of finance.*
- *works through credit enhancement of local borrowers and bond issuers, and development of new types of local financial institutions.*

How guarantees work

- Mitigating specific risks which are the critical sticking points on a project
- Enhancing securities (e.g. bonds, share issues) to take them over a critical threshold of creditworthiness (e.g. investment grade)
- Improving terms on which borrowers and project sponsors can get access to loans & equity
- Giving lenders & investors exposure to unfamiliar markets & products

Principal risks covered

- **Political**: war, civil disturbance, terrorism, kidnappings, nationalisation, expropriation , restrictions on conversion & transfer of foreign exchange .
- **Regulatory & contractual:** Breach of contract by public partner, adverse decisions by regulators etc. due to political pressure.
- **Credit:** late payment or default on loans made, or for goods and services provided
- **Foreign exchange:** devaluation, increasing local currency cost of debt servicing, dividend remittances & other forex commitments.

Sources & types of guarantees

Sources:

- IFIs (IFC, AfDB)
- bilateral donor agencies (USAID, JICA, DFID, AFD)
- bilateral official insurers (ExIm,Hermes)
- private insurance cos (Swiss Re).
- Multinationals (Dow)

Types

- **Political:** MIGA, other IFIs (through B loans), bilateral official agencies, private companies. A large, well established and active market, with supply well matched to demand.
- **Regulatory & contractual:** MIGA Breach of Contract policy, World Bank Partial Risk Guarantee. Few policies issued so far. The product is case-specific, complicated to draw up & recovery difficult.
- **Credit:** Partial Credit Guarantees by IFC & other IFIs; bilateral donor Partial Loan Guarantees; insurance policies of private Monoline companies.
- **Foreign exchange:** in practice, not widely available from either private or official agencies (n.b. OPIC, & Camdessus proposal). Local currency guarantees have a similar effect.

Examples of impact

Impact of Partial Credit Guarantee on loan terms	Without guarantee	With guarantee
Philippines	3% 7 years	2.5% 15 years
Uganda	8% n.a.	3.1% 16 years
Bangladesh	3% 1 year	2% 13 years
Ivory Coast	3% 1 year	2.75% 12 years
China: maturity	7 yr	15 yr
Pakistan: maturity	3 yr	15 yr
Jordan: maturity	2 yr	7 yr

Other risk sharing methods

- Using Output Based Aid to underpin microcredit programmes (K-Rep Bank, Kenya)
- Adjusting terms to project profile (e.g. “blended value”, conversion of debt to equity, structured finance)
- Collective security (pooled municipal bonds)
- Linking finance terms to project outcomes
- Drought insurance (e.g. Mexican “weather derivatives”)
- Balancing portfolios – bundling water with other projects (ICICI)

Developmental impact of risk sharing

- Distortion of market, or correction of market failure?
- Comfort, prop or stimulus?
- Going with the flow, or swimming against the tide?
- Moral hazard, or moral virtue?