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Proposed Policy for a Flexible Guarantee Instrument for Sovereign Guaranteed Operations

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Acronyms

AfDB	African Development Bank
AfDF	African Development Fund
ALCO	Assets and Liabilities Committee
AsDB	Asian Development Bank
AsDF	Asian Development Fund
BDMG	Banco de Desenvolvimento de Minas Gerais
BMCs	Borrowing Member Countries
CDM	Clean Development Mechanism
CG	Counter Guarantee
CS	Country Strategy
CUR	Capital Utilization Ratio
DEM	Development Effectiveness Matrix
DSF	Debt Sustainability Framework
DSF/EPBA	Debt Sustainability Framework/Enhanced Performance Based Allocation
DSL	Development Sustainability Line
EPBA	Enhanced Performance Based Allocation
FFF	Flexible Financing Facility
FIN	Finance Department
FIV	Inspection and Supervision Fee
FSO	Funds for Special Operations
GAAP	Generally Accepted Accounting Principles
GDL	Guarantee Disbursement Loan
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IDB	Inter-American Development Bank
IEG	Independent Evaluation Group
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
ITE	Information Technology Department
IMA	Independent Macroeconomic Assessment
IMM	Income Management Model
IPS	Instituto de Prevision Social
LAC	Latin American and the Caribbean
LC	Local Currency
LFI	Local Financial Institutions
LMS	Loan Management System
LTFP	Long Term Financial Projection
MDB	Multilateral Development Bank
MSA	Macroeconomic Sustainability Assessment
NDB	National Development Bank
NLF	New Lending Framework
NSG	Non-Sovereign Guaranteed
OC	Ordinary Capital
OMJ	Opportunities for the Majorities

PBA	Policy-based Borrowing Authority
PBG	Policy-Based Guarantee
PBL	Policy-Based Loan
PCG	Partial Credit Guarantee
PFGI	Policy for a Flexible Guarantee Instrument
PPP	Public-Private Partnership
PRG	Political Risk Guarantee
SCF	Structured and Corporate Finance Department
SCG	Sovereign Counter-Guaranteed
SG	Sovereign-Guaranteed
SMEs	Small and medium enterprises
TFFP	Trade Finance Facilitation Program
UBC	Unused Borrowing Capacity
WAL	Weighted Average Life
WB	World Bank
WBG	World Bank Group

I. EXECUTIVE SUMMARY

1.1 The purpose of this document is to establish the Policy for a Flexible Guarantee Instrument (PFGI) for Sovereign-Guaranteed (SG) operations. It seeks to provide a flexible framework for borrowing member countries (BMC) to use Inter-American Development Bank (the IDB or the Bank) Sovereign Counter-Guaranteed (SCG) Guarantees.

1.2 The PFGI defines the key terms and conditions for SCG Guarantees, and provides a broad policy framework to accommodate the diverse developmental needs of BMCs.

1.3 The PFGI preserves net income neutrality, avoids cross-subsidies with loans, and offers the same flexibilities provided under the Flexible Financing Facility (FFF) for SG loans. Under the Income Management Model (IMM)[1] and the Ordinary Capital (OC) Long Term Financial Projection (LTFP)[2], sovereign guarantees are treated equally as sovereign loans for the purposes of capital utilization, borrowing capacity consumption and pricing. The PFGI does not include terms and conditions for Non-Sovereign Guaranteed (NSG) operations, which are subject to their own policies and procedures[3].

1.4 The PFGI allows for structuring SCG Partial Credit Guarantee (PCGs)[4] and Political Risk Guarantees (PRGs), both for investment projects and policy-based interventions, which can be designed to cover political risks or all categories of risks (PRG & PCG, respectively).

1.5 The potential of guarantees to scale up financing and mobilize investments towards infrastructure and other sectors is of outmost importance given the investment gap identified in Latin American and the Caribbean (LAC). In addition to potential needs in infrastructure and its use in Public-Private Partnerships (PPPs), management identified potential for guarantee usage in various sectors, such as climate change, energy efficiency, agriculture finance, and commodity price volatility risk coverage.

1.6 Notwithstanding Management's view of the developmental role of this product, it is possible that demand for SCG guarantees may be limited, given the comprehensive range of policy requirements being proposed, which includes safeguards, procurement, macroeconomic conditions, scoring and pricing among others. In such case, Management would consider presenting to the Board policy adjustments and enhancements based on lessons learned once experience is gained in the implementation of this proposed policy.

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1 See pricing section 3.17 for explanation on the IMM.

2 The OC LTFP is an annual process for establishing the Bank's loan charges on a forward looking basis, and a key component of the IMM, which is utilized in the Bank for making decisions with regards to the uses of its OC income.

3 The Bank has been providing PRGs and PCGs for NSG investment projects for a number of years according to the following key policies: GN-1858-2 (Use of Bank Guarantees), FN-552-1 (Reinsurance Guidelines for Political Risk Guarantees for NSG window), GN-2411 (Local Currency Partial Credit Guarantees Without Sovereign Guarantee), GN-2365-6 (Operational Framework for lending in local currency) and GN-2400-17 (NSG Lending Policy).

4 PCGs may cover up to 100% of project costs.

1.7 Chapter II describes the objective, policy rationale and background of the PFGI, including lessons learned and demand aspects; Chapter III describes the key terms and conditions for OC guarantees; Chapter IV describes the key terms and conditions for guarantees financed through the Fund of Special Operations (FSO)[5]; Chapter V provides the financial impact analysis of the PFGI; Chapter VI describes risk management aspects; Chapter VII describes implementation aspects; and Chapter VIII contains conclusions and recommendations.

II. OBJECTIVE, RATIONALE AND BACKGROUND

A. OBJECTIVE OF THE PFGI

2.1 This document seeks to establish the PFGI for SCG Guarantees, a flexible framework for BMCs to use guarantee products.

2.2 The main advantages of the proposed policy are:

a. Clearer product definition and policy framework in line with current financial/risk management policies;

b. A more solid categorization of guarantees based on risk coverage, which can be issued in support of either an underlying investment project or a policy based intervention (See section III.A);

c. Flexibility to choose that all or a portion of a Flexible Financing Facility (FFF) loan is disbursed in the form of a guarantee[6];

d. Product knowledge dissemination.

B. RATIONALE OF THE PFGI

1. Strategic aspects

2.3 As stated in the "Report on the Ninth General Increase in the Resources of the Inter-American Development Bank" (AB-2764), the Bank's distinct and structural comparative advantage is based on its cooperative nature, which underlies the Bank's role as a trusted partner driven by the needs of its constituents. This core advantage underlies other comparative advantages such as country focus and the capacity to provide a "*diversification of financial and nonfinancial products that allow the Bank to be more responsive to country needs and more consistent in its support for development over time*".

[5] FSO terms and conditions are defined separately given the need to comply with the concessionality requirements imposed by the Debt Sustainability Framework and Enhanced Performance Based Allocation" (DSF/EPBA) (GN-2442).

[6] Subject to financial, risk management and operational considerations to be reviewed on a case-by-case basis. See paragraph 3.34 for details.

2.4 The latter is highlighted in the "Agenda for a Better Bank" in the IDB-9[7] as one of the two main areas for action, calling for: "*improvements in what the Bank does by providing innovative products, services and modalities of engaging with clients*" and "*to design and implement (...) financial and nonfinancial products and services and different modalities of engagement with a diverse client-base*"[8].

2.5 To provide the Bank with more flexibility to respond to its clients' needs, the Board of Governors adopted Management's proposal to establish a set of new instruments presented in Document "Proposal to Establish Contingent Lending Instruments of the IDB" (AB-2890). Similarly, the FFF for OC SG loan operations was approved by the Board of Executive Directors (FN-655-1) and has been implemented since January 1, 2012.

2.6 The establishment of a SG policy, as proposed here, is not only consistent with IDB-9 but also with the efforts from other Multilateral Development Banks (MDBs) that show that "guarantees have further potential"[9]. A recent evaluation[10] of the World Bank's experience with guarantees shows that "*Guarantees have been effective in promoting key [World Bank Group] WBG strategic objectives particularly in facilitating the flow of investment to high-risk sectors and countries.*" and "*the diverse range of these instruments has helped to meet the demand for risk mitigation under a variety of circumstances*"[11].

2.7 The experience of the World Bank (WB) demonstrates that the issuance of guarantees has potential for leveraging effects: At the World Bank, PCGs and PBGs with a nominal amount of $1.9 billion reached closure and mobilized commercial debt of $5 billion, between 1994 and 2012. This leverage capacity is particularly significant as the external evaluation of WB guarantees concluded that guarantees "*have helped further both policy reforms and the environment for private investment"*[12].

2. Developmental aspects

2.8 The developmental rationale for guarantee instruments is based on the fact that guarantees allow for the trade and isolation of specific risks, thus addressing market failures when they restrict access to credit or make credit less favorable in terms of cost and/or tenor. This result in better risk allocation and risk management among market participants, based on their comparative advantages, and increases BMCs' access to credit, which stimulates investment, expanding and improving the financing of projects, in support of the development of the region.

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[7] The Board of Governors agreed to vote on a proposed resolution as part of the ninth general capital increase in the resources of the IDB on July 21 2010 that would provide for an increase in IDB's Ordinary Capital of US$70 billion (IDB-9). [AG-7/10]

[8] "Report on the Ninth General Increase in the Resources of the Inter-American Development Bank" (AB-2764), Chapter IV.

[9] "Modernizing the World Bank's Operational Policy on Guarantees: an Approach Paper"; page 1.

[10] "The World Bank Group Guarantee Instruments 1990-2007: An Independent Evaluation", Independent Evaluation Group (IEG).

[11] Idem, page xi.

[12] Idem, page xiii.

2.9 Multilateral institutions such as the IDB can have a relevant role in mitigating risks for investors and mobilizing financing for BMCs through guarantee instruments, as further described in Box 1[13] (below).

Box 1: Guarantee as a Development Instrument

A relevant question for MDBs is what is the portfolio of instruments that makes best use of their capital to deliver the chosen development objectives? The IDB borrows from the international capital markets and lends to clients in BMCs, taking advantage of its excellent credit standing to offer funds at competitive rates relative to the rates clients would obtain directly from global capital markets, while providing development knowledge and expertise in the process. An alternative is for BMCs to borrow directly from private lenders and for IDB resources to be used as guarantees to mitigate credit risk and improve financial terms. If capital markets operated perfectly and IDB policy maintains neutrality in pricing with loans, from the standpoint of the borrower, a guarantee structure and a standard lending product would be identical. However, capital markets are imperfect, which provides a unique role for guarantees in certain scenarios. A classification of the role of guarantees from a development perspective is offered below:

1. Guarantees to disaggregate risk

Different market actors may have different capacities to bear risk. This suggests that there may be advantages in disaggregating the risks of a standard lending structure. For example, a partial guarantee on a loan implies reducing part of the risk associated with that product. A more specific example is that of a guarantee on a commodity linked instrument. The commodity price risk is separated from the "credit" or "performance risk" with the guarantee operating on the latter. A third example is a political risk guarantee which may separate a particular regulatory risk from other risks of the project.

While other structures, including creating special purpose vehicles and similar methods may also be able to disaggregate risks, guarantees may be a more efficient way to allow different market actors to bear the risks they have greater capacity or willingness to bear. A guarantee from the IDB to a private creditor may give comfort to that creditor as typically a guarantee can be more directly related to the particular risk to be covered and the implied collateral can be perfected to a greater extent.

2. Guarantees to create and develop missing market

A second motive to use guarantees rather than loans is to create or develop markets. For example, if a Government aims to create a new long-term market in its debt, and the sovereign issued a bond, with that issue backed by a partial guarantee, this may help to kick-start or extend the bond market for the sovereign. Another example is the use of guarantees to back loans to Small and Medium Enterprises (SMEs), which could make lending to SMEs more attractive for commercial banks. A third example is fostering the creation of insurance markets that remain underdeveloped in the region, requiring substantial capital and development of relations between insurers and clients. In these cases, a direct loan from the IDB may replace rather than create the market so it may not be the most appropriate approach. A guarantee may be an effective instrument to create or develop missing markets in which the relationship between counterparties is important but the market requires a kick-start.

3. Guarantees to enhance credit standing; leveraging effect

A third role of guarantees is to address certain regulatory features in the international capital markets. An example is that certain investors may be limited to purchasing only investment grade papers and yet a sovereign or a public entity backed by a sovereign guarantee may fall short of such a rating by a few notches. In such case, a partial guarantee may improve the credit standing of such a claim to yield investment grade, thereby allowing the issuance to comply with regulatory requirements. In addition, guarantees provide leverage as every dollar of guarantee coverage enables access to market (or improved access terms) for more than a dollar of credit in the form of loans or bonds (see paragraphs 2.7 and 4.1).

[13] See Annex I for additional information on the objectives and benefits of using guarantees in covering capital market bonds.

2.10 n the IEG review for WBG Guarantees it was found that there are at least four areas in which guarantee instruments "*can fill gaps that the private sector cannot overcome on its own: (1) Where there are failures in making credible commitments, honoring pledges, enforcing contracts (...) (2) Where there is a need for provision of public goods in governance, transparency, and social and environmental performance (...) (3) Where there are information asymmetries and problems of moral hazard (...) (4) Where a demonstration effect is needed after a breakdown in public order*"[14].

2.11 Nevertheless, the introduction of a third party through the issuance of a guarantee can entail higher transaction costs, increasing its complexity and fragmentation. As a result of the potential benefits and the developmental role of guarantee instruments, the WB incentivizes the use of guarantees by counting only 25% of the guarantee amount against the WB's country approval allocation[15]. Similarly, the African Development Bank (AfDB) discounts 25% of the guarantee amount to the total concessional allocation of countries that receive financing through the African Development Fund (AfDF).

C. BACKGROUND AND EXPERIENCES

1. Policy Background

2.12 So far, the IDB's guarantee products comprise the PCGs and PRGs, which have been primarily used for NSG investment projects[16]. PRGs cover the risk of non-performance by the sovereign or a government-owned entity of certain contractual obligations, which are critical to the sustained viability of projects. PCGs credit-enhance all or a portion of the financing provided by private financiers and can be designed to cover all categories of project risks that could ultimately trigger a credit event; this last structure is used when it is not possible to segregate risks (commercial or credit risk vs. sovereign risk) as is typically the case for public sector projects.

2.13 The Bank's Charter provides that "*the Bank may make or guarantee loans*" to any member or agency or political subdivision thereof; to any enterprise in the territory of a member; and to the Caribbean Development Bank by guaranteeing, with the ordinary capital resources or the resources of the Fund, in whole or in part loans made, except in special cases, by private investors [17].

2.14 The first guarantee policy was approved in 1995 by the name of "Use of Bank Guarantees" (GN-1858-2). This document described the role of guarantees, and stated that: "*Bank guarantees will offer targeted and limited support aimed at reducing private sector exposure to those specific risks that it is least able to manage on its own. Mitigation of these risks can have an important effect in helping to mobilize private sector financing for individual projects. The Bank can play a catalytic role in mobilizing*

[14] "The World Bank Group Guarantee Instruments 1990-2007: An Independent Evaluation", IEG; Page 6.
[15] At the WB, the capital usage of the guarantees is counted 100%, the same as loans. The International Bank for Reconstruction and Development (IBRD) has a US$2 billion reserve dedicated for potential guarantee calls.
[16] See Footnote 3 for NSG guarantee policies. In 2000, the Board approved a US$1 billion pilot Guarantee Disbursement Loan (GDL) program to provide the option of disbursing loans in the form of guarantees ("Pilot Program to Provide the Option of Disbursing Loans in the Form of a Guarantee" (GN-2106)). On 31 December 2004, this pilot program expired.
[17] "Agreement Establishing the Inter-American Development Bank", Article III, Section 4.

private funding for infrastructure development by offering guarantees related to government contractual obligations to the project." While the document was drafted primarily for the Bank's private sector lending window, it also provided with the basic principles for guarantee operations related to SG projects[18].

2. SCG Guarantee Experiences

2.15 To date, the Bank has approved only three SCG Guarantees: a PCG for Peru in 2006, a PRG for Guyana in 2006, and a PBG[19] for Panama in 2012. In all cases, the guarantee was instrumental in promoting the development of specific infrastructure projects. In the case of Peru, the Bank guaranteed the Government of Peru's payment commitments to a concessionaire for executing the road rehabilitation and improvement of 960 kms of the Northern Amazon Hub road system. In the case of Guyana, the Bank approved a loan and a guarantee for the Georgetown Solid Waste Management Program, under an integral approach in which the loan aimed to implement sustainable solutions to solid waste management, including a sanitary landfill with a private operator, while the PRG guaranteed the payments to the private operator due by the government[20].

2.16 In the case of Panama[21], the Bank supported the macroeconomic, financial and fiscal management and contributed to reducing Panama's fiscal risk from macroeconomic and financial shocks. The operation complied with all the requirements applicable to policy-based loans (PBLs); all the standard conditions previous to disbursement were necessary conditions for the effectiveness of the guarantee, including fulfillment of the matrix policy conditions and maintenance of an appropriate macroeconomic policy framework.

3. NSG Guarantee Experiences

2.17 Over the years, the Bank has issued several PCGs and PRGs for private sector investment projects through three of its four NSG windows[22]. Most projects guaranteed by the Bank are financed by private investors. However, current market trends have evolved such that certain NSG projects are funded by public sector entities that can facilitate local currency financing on terms that would otherwise not be available to satisfy the needs of NSG clients, such as the cases of the *Instituto de Prevision Social* (IPS)[23] and the *Banco de Desenvolvimento de Minas Gerais* (BDMG)[24]. These projects represent innovative and

[18] See paragraph 2.3 of GN-1858-2, which refers to guarantees with and without government counter-guarantees.
[19] See PBG definition in paragraph 3.2 and in Box 2 of Chapter III.
[20] See documents PR-3018 and PR-3035 for Peru and Guyana transactions.
[21] See document PR-3948.
[22] Those are the Structured and Corporate Finance Department (SCF), Opportunities for the Majority (OMJ) and the Inter-American Investment Corporation (IIC).
[23] The IPS is the largest Paraguayan pension fund and a long term local currency provider. IDB and IPS executed a strategic partnership on December 2012 to enable IPS to offer local currency financing to private sector companies in Paraguay through IDB issuance of local currency guarantees covering 100% of the underlying credit risk.
[24] See document OP-1056.

special cases[25], in which the participation of public sector entities that benefit from an IDB guarantee enables long-term local currency funding of NSG transactions.

2.18 NSG PCGs are tailored on a case-by-case basis to provide the most effective credit enhancement of the guaranteed amount according to the needs of each client and the necessities of local capital market participants. By raising credit ratings, these guarantees help to improve placement with investors and achieve better overall financing terms. Although NSG guarantees initially focused on large infrastructure and financial institutions, the Bank has been moving towards issuing guarantees directly to corporations and covering a spectrum of commercial and political risks. Another growing trend is the demand for guarantees in local currency, guarantees that are complemented with co-loans, co-guarantees and/or syndicated loans depending on market conditions, risk sharing facilities and partial credit guarantees supporting asset-backed securities. More information on the NSG guarantee activities is contained in Annex II.

D. LESSONS LEARNED

2.19 One of the main lessons learned and challenges related to guarantees is the need to ensure that financial efficiency is obtained when using guarantees over other means such as direct loans. For example, if the "all-in cost" of financing is not reduced as a result of the guaranteed financing, it may not be financially efficient to use a guarantee instrument. Therefore, in the case of guarantee operations, one should undertake an initial assessment of the financial efficiency in comparison with other options.

2.20 Although the Bank has approved only three SG guarantees thus far, some internal and external discussions illustrate the potential for a more active use of the instrument in the short and medium term. Additionally, it is expected that demand will be further generated if this policy is approved by the Board of Executive Directors and the product is actively and adequately marketed, which in turn requires appropriate training for Bank staff. In fact, the experience of similar institutions suggests that the adequate promotion of the product is essential to generate demand. In the WB, the evaluation performed by the IEG indicated that weaknesses in marketing and limited internal awareness, skills, or incentives among WB staff were among the factors that explain why SCG guarantee demand has fallen short of expectations. This aspect is key because the reviews of other MDBs suggest that clients, especially in the lower income countries, are not fully aware of the advantages of guarantees. Lessons learned from other MDBs' guarantee experiences are summarized in Annex III.

[25] Section 4(iii) of Article III of the Bank's Charter provides that the Bank may make or guarantee loans in several ways, including "by guaranteeing, with the ordinary capital resources or the resources of the Fund, in whole or in part loans made, *except in special cases*, by private investors". Projects in which the loan that is guaranteed is made to an entity that is eligible to receive NSG financing in accordance with NSG policies and guidelines shall be considered as "special cases".

E. DEMAND ASPECTS

1. Revealed Demand

2.21 SCG guarantees may catalyze investments that would otherwise not take place because of perceived political and sovereign credit risks, providing the opportunity to unlock private investments in conditions in which the markets create equilibriums characterized by credit rationing. As such, potential demand is difficult to predict, as evidenced by the experience of other MDBs, in which demand has tended to fall short from expectations. Nonetheless, there are different factors that suggest that there may be unmet demand for SCG guarantees in the region (See Annex IV). The potential of SCG to scale up financing and mobilize investments towards infrastructure is of particular importance for LAC given the region's investment gap[26]. In fact, the importance of SCG guarantees for infrastructure development was also highlighted by the 2011 G-20 High Level Panel on Infrastructure, which called for MDBs to allocate a larger share of their balance sheets to risk mitigation products rather than to direct loans for the infrastructure sector in order to crowd in more private capital while using less of the MDBs own capital.

2.22 In terms of PRGs, potential demand has been traditionally associated with PPPs in infrastructure. While the experience of the WB suggests that demand for PRGs in middle and upper middle income countries tends to be limited[27], there is a potential "niche" for MDBs to support large and complex PPP infrastructure projects through this instrument. In general, the use of SCG guarantees to finance public obligations under PPP contracts is an area where the Bank foresees great potential, particularly in Small and Vulnerable Countries and Sub-nationals without a track record on PPPs[28]. With respect to PCGs, there is a significant potential for credit guarantees to support state-owned utility companies or sub-national entities access to commercial finance and to promote local currency markets in the region. It is expected that demand for these guarantees may also be found in low and lower-middle income economies, as higher income countries find it increasingly easier to mobilize private financing. Finally, while demand for PBGs[29] might be low when markets are highly liquid, the critical role and demand of PBGs could be related to the downward part of the economic cycle, as PBGs could help countries regain access to capital markets. PBGs can also facilitate liability-management operations, which are likely to emerge at all phases of the economic cycle.

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[26] Latin America has been investing less than 2% of its GDP on infrastructure over the last decades. Recent studies conclude that the region should target an investment of approximately 5% (Infrastructure Strategy for Competitiveness, Profile (GN-2710), paragraph 3.6).

[27] 60% of the PRGs approved since 2005 have been in low-income International Development Association (IDA) countries.

[28] The size of the infrastructure investment gap challenge cannot be only covered with fiscal resources so it will be critical to bring in the private sector in order to increase the investments on infrastructure. In order to do that many countries in our region have embarked in PPP programs. PPPs projects are complex in nature comprising long term commitments between the public and the private sector, which exceed the tenure of the political authorities that signed those contracts. A recent study has identified public sector guarantees provided in PPPs or concessions as the most effective tool to make projects bankable ("Best Practice in Public Private Partnerships Financing in Latin America: the role of guarantees", World Bank Institute 2012). Nonetheless, technical assistance to develop PPP capacity in LAC countries is still necessary to fully take advantage of this potential; IDB actions in this regard include the Regional Public-Private Partnerships Advisory Services, the InfraFund and other technical support for feasibility studies.

[29] PBG is defined in paragraph 3.2 and explained further in Box 2.

2. Potential Sectorial use of Guarantee products

2.23 Discussions among sector and country specialists have shown that there is potential in the use of guarantee products especially in the areas of infrastructure, climate change, energy efficiency, agriculture financing and commodity price volatility risk coverage.

2.24 Table I (below) shows examples of SCG guarantees and related risks. The rest of the section provides illustrative descriptions of guarantee interventions in specific sectors[30].

Table I: Examples of SCG guarantees and risks

SG GUARANTEE	RISK
Energy efficiency guarantee	Performance risk and credit risk
Water and sanitation guarantee	Project risk (to extend tenor)
Agriculture insurance guarantee	Farmers' performance risk
Agriculture pool guarantee	Weather risk
SME facility guarantee	SME loan default risk
Carbon delivery guarantee	Carbon price fluctuation risk

2.25 **Climate change mitigation.** To promote climate change mitigation projects, some MDBs, such as the IFC[31], have been using guarantee mechanisms to improve price and performance of emissions reduction, particularly for projects and credits from the Clean Development Mechanism (CDM) of the Kyoto Protocol. IDB could provide guarantees for similar purposes when there is certainty of demand for carbon credits issued according to recognized certification and verification schemes (such as the CDM). Guarantees could also be issued to cover the risks related to biofuel production.

2.26 **Energy efficiency.** Local financial institutions often refrain from financing energy efficiency projects due to their perceived high credit and performance risks and the clients' inability to provide sufficient collateral. PCGs can be used to mitigate credit and performance risks and provide additional collateral. These guarantees could be offered by the IDB through national development banks, as risk-sharing mechanisms to local financial institutions[32] (See Annex V for an example).

2.27 **Agriculture Finance**. Agricultural finance is an inherently risky type of lending; as such, risk management techniques have traditionally relied on high collateral to loan value ratios in order to reduce default risk. This approach limits access to larger scaled

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[30] Several of these examples describe typical uses of guarantees in NSG transactions for which SCF has an extensive expertise (54 transactions and US$3 billion in volume), highlighting the scope for collaboration between the SG and NSG windows. Please note that this section does not cover all sectors that could potentially utilize guarantee instruments, but rather attempts to provide examples of some sectorial cases.

[31] IFC has completed three Carbon Delivery Guarantee (CDGs) transactions with structured carbon finance exposure for IFC's account. A mature carbon market with a clear and long-term price signal is a precondition for offering this product to clients.

[32] Such type of IDB Guarantees would address two different institutional priorities of the Bank under the GCI-9. First, it responds to the priority associated with Institutions for Growth and Social Welfare to the extent that it strengthens credit institutions so that they, in turn, are able to promote sustainable private sector growth and development. Secondly, it supports the priority of Protecting the Environment and Responding to Climate Change to the extent that it facilitates the financing of energy efficiency and projects through second-tier NDBs and their first-tier clients. It would also be consistent with the IDB Climate Change Strategy and its Action Plan for 2012-2015 (section D. II in particular).

commercial farmers and excludes small and medium-sized farmers. Guarantees to promote agricultural lending and broaden access to credit by smaller farmers could be developed based upon the value chain approach[33]. A guarantee mechanism could be coupled with other incentives such as knowledge transfer in lending methods and assistance in organizing and expanding value chains. (See Annex VI for more information.)

2.28 **Commodity price risk and food security.** Guarantees could be used to address the volatility in commodity prices. Countries heavily dependent on specific commodities' imports may seek to hedge price volatility. However, investment banks might be reluctant to provide such hedge contracts due to the perceived risk associated with the willingness to pay by governments in situations in which commodity prices are lower, resulting in an incentive for governments to break the hedge and to simply purchase the cheaper priced commodity. An IDB guarantee may potentially assist in such cases to cover the "right-way risk" for the commodity price volatility risk. (See Annex VII for further details.)

2.29 **Infrastructure.** Guarantees have been successfully used to support PPPs and the mobilization of private financing for infrastructure projects, due to its positive leveraging effect. For example, water utility projects tend to require longer financing terms than those available to local governments from local private banks. In such cases, a guarantee from an MDB could assist in lengthening the tenor to improve financing terms[34]. Other examples for using guarantees in infrastructure development, including the energy sector, are described in Annex VIII.

III. KEY TERMS FOR OC GUARANTEES

3.1 This chapter describes the key elements of the PFGI, including Types of SCG Guarantees, Operational Aspects and Financial Terms.

A. TYPES OF SCG GUARANTEES

3.2 SCG guarantees can be categorized into Partial Credit Guarantees (PCGs) and Political Risk Guarantees (PRGs), based on the type of risks being covered (commercial or credit risk vs. sovereign risk, respectively), which can be used to support investment projects or policy-based interventions (PBGs)[35]. The PFGI allows for structuring SCG PCGs and PRGs for investment projects or policy-based programs.

Figure I: Types of Guarantees[36]

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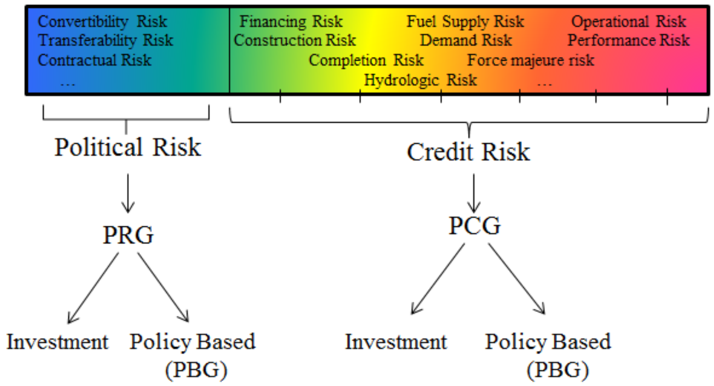
[33] The value chain approach in agricultural financing involves either lending to i) the anchor firm in a supply chain who then on lends to smaller scale, high risk producers with whom the anchor firm has a longstanding -informal or formal- relationship or ii) directly lending to collateral constrained smaller-scale producers who have guaranteed market sale contracts with a well-established agribusiness or trader as well as access to high quality and timely technical assistance. A PRG to a local finance institution can enhance credit terms and expand the volume of lending to dynamic, well-articulated agricultural supply chains.

[34] Local governments could benefit from such guarantees if a counter guarantee from the federal or national government is obtained (See paragraph 3.7).

[35] See Box 2.

[36] The risks in the two compartments of the diagram only intend to be illustrative and by no means are exhaustive.



3.3 **PCGs** credit-enhance all or a portion of the funding provided by private financiers, such as the repayment of loans, bonds or other debt financing instruments (scheduled or bullet)[37], and can be designed to cover any category of risk, including financing risk, construction risk, operation risk, fuel supply risk, hydrologic risk and other project risks, which could ultimately trigger a debt payment default to creditors. As such, PCGs could support mobilization of private funds for project finance, financial intermediation, government borrowing from commercial lenders or government bond issues to finance public investment projects by improving financial terms & conditions, such as a longer maturity, more favorable pricing, or improved market access.

3.4 **PRGs** cover the risk of non-performance by the sovereign or a government-owned entity of certain contractual obligations undertaken in relation to a private party, which could ultimately trigger a debt payment default to creditors. PRGs typically cover currency convertibility and transferability, and contract frustration. As such, PRGs could attract private financing in project finance transactions, particularly in sectors such as infrastructure, in which project success typically depends on certain government undertakings.

Box 2: PBGs

What are PBGs? A sovereign Guarantee can be issued directly to support a specific investment project or as a result of compliance by a sovereign with agreed policy reforms (a “Policy-Based Guarantee” or “PBG”). In the latter case, the sovereign can use the guarantee coverage to cover either commercial or credit risks (PCGs) or political risks (PRGs).

Recent experiences. In the last couple of years, the Euro zone crisis has severely deteriorated financial market access in the region. In light of these circumstances, the WB has issued PBGs for the European countries of Serbia, Macedonia and Montenegro, with encouraging results. In 2011, Macedonia undertook a EUR 130 million commercial loan with the support of a WB PBG covering EUR 100 million tied to reforms aimed at strengthening the sustainability of public finances, the resilience of the financial sector, the functioning of labor markets and the performance of social protection. The PBG extended the maturity of the commercial loan by 50 percent and produced savings of at least 300 basis points[37].

[37] IDB SG guarantees will not cover debt acceleration, meaning that disbursements would only follow the original repayment schedule of the underlying obligation thus avoiding the risk of (i) accelerated/concentrated payments and (ii) distorting the incentive structures under stress conditions.

[38] The PBG in Montenegro (up to EUR 60 million) allowed the country to borrow EUR 100 million while improving the borrowing costs by at least 400 basis points; In 2011, the PBG in Serbia (up to EUR 300 million) helped to raise EUR 292 million, improving its tenor by a factor of two and achieving estimated savings of 400 basis points.

B. OPERATIONAL ASPECTS

3.5 **Country Eligibility.** All BMCs are eligible for SCG guarantees, as determined by the Charter. While there will be no specific limitations to countries borrowing from the OC, eligibility for Group D2 countries borrowing from the FSO and OC in blended terms ("FSO countries") will be subject to specific conditions, as detailed in Chapter IV. Guarantees will be subject to the same eligibility conditions applicable for direct lending.

3.6 **Sector Eligibility and Country Strategies.** All cross-sector policies applicable to SG loans will be applicable to SCG guarantees. In terms of eligibility, the underlying project or program must be in areas consistent with the priority areas agreed with each country in their respective Country Strategies (CSs) and applicable sector strategies. As in the case of loans, SCG guarantee operations in areas that are not part of the CS will be considered on a case-by-case basis if worth of justification by its own merits.

3.7 **Subnational Eligibility**. SCG guarantees can be issued to support sub-nationals or local government projects by credit enhancing debt issued by or granted to sub-nationals of a BMC so long as the sovereign (i.e., federal or central government) agrees to reimburse the Bank (through a counter-guarantee agreement or any other similar instrument) for any disbursement made under the guarantee, in accordance with the terms and conditions set forth in this policy.

3.8 **Beneficiary Eligibility**. As set forth in Section 4 (iii) of Article III of the Bank's Charter, the Bank may guarantee, in whole or in part loans made, except in special cases, by private investors. Special cases shall include projects where the SCG Guarantee covers loans made by development financial institutions or issuances of freely negotiable debt instruments as well as any other projects considered as such on a case-by-case basis[39].

3.9 **Macroeconomic Policy conditions.** The programming and approval of SCG guarantee operations will be subject to the same process as regular loan operations in terms of the requirements related to Macroeconomic Sustainability Assessments (MSAs)[40]. Therefore, payments related to previously approved guarantee operations that are part of the portfolio are considered as Bank's exposure and shall not be affected by the results of the MSAs[41]. In the specific case of PBGs, macroeconomic policy-related requirements for their approval will be substantially the same as the requirements for the approval of PBLs, namely, an independent macroeconomic assessment (IMA) as set forth in Document CS-3633[42]. Notwithstanding the foregoing, given the irrevocable nature of the guarantee instrument once it becomes effective, PBGs will only require an IMA as a condition prior to the effectiveness of the guarantee and not prior to any disbursement by the Bank under the guarantee, should such guarantee be called.

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39 The beneficiary of a Bank guarantee may be from any member or non-member country, as long as the project being supported by the Bank guarantee contributes to the economic and social development of a regional developing member country of the Bank.

40 Document GN-2633-14.

41 Although Document GN-2633-14 establishes that "*Since disbursements from the loan portfolio cannot be held up once they meet eligibility conditions, such disbursements shall not be affected by the results of the MSAs*", the reference to only loan disbursements is as misnomer as it should refer to loan disbursements *and* guarantee payments.

42 As further amended or superseded from time to time.

3.10 **Application of Safeguard and Integrity Policies.** The same requirements in terms of social and environmental safeguards applicable to SG loans will apply for SCG guarantees. The integrity requirements applicable to SG and NSG loans, as appropriate, will apply to SCG guarantees. Nonetheless, since the nature of the instrument requires it to be irrevocable, the timing of assessments and requirements and the remedies to be available to the Bank in case of non-compliance will have to be tailored to every specific operation. The Bank will work closely with the client to avoid a potential breach of safeguard and integrity policies and to explore remedial options and their operationalization[43].

3.11 **Procurement Aspects**. PCGs and PRGs will follow the Bank´s procurement policies. Such policies require that goods, works and services financed by the guaranteed loan will be procured with due attention to economy and efficiency principles and that such procedures cause the project to be carried out diligently and efficiently. Said goods, works and services must comply with three aspects: (i) be of a satisfactory quality and compatible with the balance of the project objectives; (ii) be delivered and completed in a timely fashion; and (iii) be priced so as not to affect adversely the economic and financial viability of the project. Guarantees supporting policy-based interventions will follow the same fiduciary principles set out for PBLs, where the Bank’s procurement aspects refer to the government’s fiduciary capacity, including the adequacy of the national procurement system. The irrevocability of guarantee instruments requires every operation to be tailored in order to ensure a balance between compliance with Bank’s standards such as procurement aspects and irrevocability of such guarantee instruments.

3.12 **Financial Management Aspects.** The same requirements applicable to investment projects and policy-based programs shall apply to SCG guarantees. The irrevocability of guarantee instruments requires every operation to be tailored in order to ensure a balance between compliance with Bank’s standards such as financial management aspects and irrevocability of such guarantee instruments.

3.13 **Project Identification and Appraisal**. The same requirements applicable to SG loans apply to SCG guarantees. Nonetheless, given the nature of the instrument, project appraisal would require a strong risk assessment and a justification of the intervention on the basis of its financial leverage, improved market access, and developmental impact among other factors. Screening and assessment requirements for environmental and social risks would also be informed by the limitations to enforce management measures downstream and the related need to minimize the risk of non-compliance with safeguards.

3.14 **Development Effectiveness.** As in the case of SG loans, the Development Effectiveness Matrix (DEM) will be applied to the underlying policy matrix in the case of PBGs and to the underlying investment project in all other cases.

3.15 **Supervision.** Guarantee operations would be supervised, to determine whether the guaranteed party is carrying out the project to achieve the development objectives and

[43] Potential remedial measures might include corrective action plans, cash trapping mechanisms, escrow payments, and higher fees, among others.

comply with Bank environmental and social safeguards, in conformity with legal agreements. Supervision of the underlying project supported by a Bank guarantee will be required until the guarantee expires.

C. Financial Terms

3.16 The following tables summarizes the key financial terms of the PFGI for OC SCG guarantee operations. FSO guarantee terms are described in Chapter IV.

Table II: Key Financial Terms of the Proposed PFGI

Summary of Key Financial Terms		
Pricing	Sovereign guarantee fee	OC SG variable lending spread
	Other fees	Stand-by fee will be the same as credit fee, charged for the difference between the maximum guarantee amount and actual guarantee amount charged from the effective date[44]. FIV will be the same as in loans, charged as one-time fee upon effectiveness.
Maximum Guarantee period		As per FFF, up to 20 years for policy-based interventions and 25 years for investment operations regardless of the risk being covered (political/sovereign vs. commercial/credit).
Weighted Average Life (WAL) requirement		For PCGs/PRGs tied to policy-based interventions up to 12.75 years; for PCGs/PRGs supporting investment projects up to 15.25 years from signature of guarantee contract.
Grace Period		Not applicable due to diversity of guarantee profiles
Repayment profile of the underlying loan/financing covered		Flexible. Subject to WAL requirement.
Reimbursement of Claim (Counter-Guarantee)		Payable upon demand, unless otherwise determined by the Bank on a case by case basis. A default in repayment of the Counter-Guarantee triggers same treatment as non-performing loans.
Cancellation of Guarantees		Pass-through to borrower of any costs incurred by the Bank
Treatment for small-sized claim disbursements		Considered on a case-by-case basis and subject to operational and risk management considerations
Non-payment of guarantee fee		Non-payment of guarantee fees by counter-guarantor triggers same treatment as non-performing loans <u>without</u> affecting the irrevocability of the guarantee.

44 The effective date is the date the guarantee coverage becomes effective, in accordance with the conditions precedent thereto as set forth in the guarantee contract.

Trigger Event	Trigger Event is defined according to each guarantee contract. Claim payment is irrevocable.

Table III: Financial Options of PFGI

Flexible Options for Guaranteed parties		
Type of Guarantee		PCGs or PRGs for investments projects or policy-based interventions
Currencies	Approval	US$, Major Currency[45] or BMC Local Currency (LC), subject to risk management and operational considerations
	Claim payment	Currency of Approval (LC if available)
	Counter guarantee	Currency Disbursed **(**LC, MC or US$ in equivalent amount) according to the Counter-Guarantee agreement
Local Currency guarantees		LC denominated guarantee can be offered subject to market availability as long as counter guarantee provided fully covers Bank's LC exposure.
Coverage %		Up to 100%
Flexible guarantee coverage		Flexible and coverage is based on contractual WAL defined.
Disbursement in the form of guarantee		Borrower can receive disbursement of all or part of a FFF loan in the form of guarantees[46].

a) Pricing, fees

3.17 **Pricing principle**. Guarantee pricing methodology of SG operations has always been based on the principle of net income neutrality with loans, i.e. no cross-subsidies between loan and guarantees[47]. Since the introduction of the IMM, approved as part of the IDB-9 by the Board of Governors[48], the Bank's pricing methodology for all sovereign-lending operations is based on the IMM. The OC sovereign lending spread is defined and approved in accordance with the annual OC LTFP. Accordingly, the pricing of any SG product (except for the Contingent Lending Instruments defined in AB-2890) will be determined in the OC LTFP, annually approved by the Board of Executive Directors.

3.18 **Guarantee fee**. Management proposes that the current methodology of net income neutrality and no cross subsidy be maintained in this policy. Based on this, it is proposed

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[45] The Bank's four Major Currencies (MC): US$, €, CHF and ¥.

[46] This option is permitted so long as such option is considered in the Board proposal upon approval, and the specific guarantee structure is approved by the Board once such option is elected. For details, see section 3.34.

[47] Previous policies related to pricing includes; FN-508, FN-568-3 Rev.

[48] AB-2764 Annex II "Ordinary Capital Income Management Model" July 2010

that the guarantee fee be equal to the OC sovereign loan spread, which is the Bank's current pricing applicable to sovereign loan operations as defined annually in the OC LTFP. The guarantee fee will be charged on the actual covered amount of the guarantee[49]. The sovereign guarantee fee will be variable, consistent with the OC SG lending spread for FFF loans[50]. If the LTFP exercise determines any variations in the OC sovereign lending spread pricing methodology, the guarantee fee levels must be adjusted accordingly to ensure consistency and net income neutrality with loans.

3.19 **Payment of guarantee fee**. Consistent with the loans, the sovereign guarantee fee is payable semi-annually unless otherwise defined on a case by case basis. The guarantee fee could be paid upfront for the total period of the guarantee (with the purpose of mitigating the non-payment risk of the guarantee fee), however at the end of the guarantee period, adjustments must be made to cover the difference between the actual variable guarantee fee levels and what has been paid upfront ("true-up, true-down").

3.20 **Stand-By Fee.** To maintain income neutrality with SG loans, a stand-by fee must also be paid with respect to any guarantee on the difference between the maximum guarantee amount and the actual guarantee amount. This stand-by fee will be charged from the effective date of the guarantee agreement[51]. The stand-by fee for the guarantees is equivalent to the credit fee for SG loans as defined in the OC LTFP.

3.21 **Reimbursement of transactional cost and legal expenses of the Bank**. Reimbursement of any due diligence cost, including legal expenses, incurred by the Bank in connection with each specific guarantee transaction shall be made by the beneficiary and/or the counter-guarantor, as applicable, prior to the financial closing.

3.22 **Other MDBs' pricing**. Based on public information and research with counterparts, other MDBs such as IBRD, Asian Development Bank (AsDB) and AfDB also follow the net income neutrality approach. Their guarantee fee is equivalent to their respective sovereign loan pricing. See Annex IX for comparison table.

b) Maximum Guarantee Period, WAL requirement

3.23 Consistent with the FFF loan platform, the maximum guarantee period is up to 20 years for guarantees tied to policy-based interventions and up to 25 years for guarantees supporting investment projects. Respectively, the maximum WAL[52] for guarantees tied to policy-based interventions is up to 12.75 years, while for guarantees supporting investment projects is up to 15.25 years from the entry into force of the respective guarantee contract.

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[49] In each guarantee transaction, the specific definitions of the Actual Covered Amount need to be defined case by case, consistent with the Bank's guarantee exposure to the transaction.

[50] According to the previous policies prior to the IMM introduction, the guarantee fee was fixed at the signing date.

[51] The effective date is the date the guarantee coverage becomes effective, subject to all necessary conditions precedent being met in accordance with the guarantee contract.

[52] The WAL is defined, per the FFF, as the weighted average time period from the date of signature of the guarantee to the date of repayment of the respective installments calculated on outstanding covered exposure. On the WAL concept, please refer to document FN-655-1 Section 4.23 - 4.26 and Annex II.

c) Reimbursement terms (Counter-Guarantee (CG))

3.24 It is proposed that if a guarantee is called, the associated CG shall be payable upon demand by the Bank. However, the Bank shall have discretion to modify this on-demand payment requirement on a case by case basis, both *ex ante* (i.e., at the time the transaction is structured and approved by the Board of Executive Directors) and *ex post* (after the guarantee has been called). Such flexibility is considered essential, given the diverse nature of the transactions that may be structured under the PFGI, and the varying circumstances under which guarantees may be called[53]. CG terms in the case of local currency guarantees are described in section 3.31. A default in repayment under the CG will trigger the same treatment that applies to non-performing loans.

d) Repayment profile of the underlying financing, grace period

3.25 Under the PFGI, sovereign borrowers will have the flexibility to cover with the guarantee any type of loan, as established under the FFF, provided that the guarantee coverage is consistent with the WAL requirement. Due to diversity of guarantee profiles, a standard grace period is not applicable.

e) Cancellation of guarantee

3.26 If a guaranteed party chooses to cancel part or the entire guarantee amount approved under the PFGI, the Bank will pass on to the guaranteed party or counter-guarantor any costs incurred to cancel such guarantee.

f) Irrevocability of guarantee

3.27 Due to the irrevocable nature of guarantees, once they become effective, the guarantee coverage will not be affected by the non-compliance of the relevant borrowing member country in respect of any obligation under any existing contract entered into with the Bank.

g) Non-payment of fees and costs associated with guarantee

3.28 The non-payment by the counter-guarantor of the guarantee fee (paragraphs 3.18 and 3.19), stand-by fee (paragraph 3.20) or any transactional costs and legal expenses incurred by IDB in connection with the guarantee (paragraph 3.21) will trigger the same treatment that applies to non-performing loans, without affecting the irrevocability of the guarantee.

h) Trigger Event and Claim payment

3.29 The trigger events applicable to each guarantee will be defined on a case-by- case basis but in any case IDB’s payment obligation under any guarantee would only be triggered to

[53] In any case, the repayment terms agreed between the Bank and the Sovereign will be within the tenor of the remaining WAL (after deducting the guarantee period from the original WAL), in consistency with the principle of financial neutrality between SCG guarantees and loans.

the extent that the non-performance of the contractual obligations being guaranteed by IDB would ultimately result in a debt payment default to creditors. Upon the occurrence of a trigger event, as defined in the respective guarantee agreement, IDB will be required to pay the claim in favor of the beneficiary of the guarantee on an irrevocable basis.

i) Currencies

3.30 SCG Guarantees may be approved, denominated disbursed and repaid in US$, Major Currency or BMC LCs. This flexibility will be subject to the Bank's ability to adequately source and/or hedge itself against currency exposures, and operational and risk management considerations. Local currency terms are defined in Section j) below.

j) Local currency guarantees

3.31 This proposal will replace the local currency provisions for SCG guarantees contained in GN-2365-6. SCG guarantees can be denominated and/or disbursed in LC subject to the Bank's ability to adequately source and/or hedge itself against currency exposures, and subject to operational and risk management considerations[54]. For guarantees approved in LC, the US$ equivalent of the LC amount of the guarantee will be informed to the Board of Executive Directors at the time of approval. For guarantees approved in LC, fees associated with the guarantee (i.e. guarantee fee and stand-by fee) will be charged in LC, reflecting the IDB's fee structure applicable at the time of approval. In the case of a call, all or a portion of the guarantee amount will be paid by the Bank in LC to the beneficiary. The counter-guarantor must fully reimburse the Bank for all amounts disbursed under the guarantee as well as any costs and/or expenses incurred by the Bank in connection with a disbursement in LC, as provided in the CG agreement.

k) Coverage per transaction

3.32 NSG guarantees only cover a portion of project costs due to the mandate to mobilize private sector financing and promote private sector development. However, it is proposed that SCG guarantees can cover up to 100% of project costs if merited by their developmental impact. In all cases, it is required that the government provides a CG for the full guarantee amount. Each SCG guarantee transaction should be structured to be as financially efficient as possible.

l) Flexible Guarantee coverage

3.33 Guarantee coverage for each transaction will be decided on a case-by-case basis, subject to the requirement that the Bank's guarantee exposure shall not exceed the WAL applicable to each type of guarantee.

m) Disbursement in the form of guarantees in FFF loans

[54] NSG Guarantees are denominated, disbursable and reimbursable in LC, irrespective of the relevant LC, because they are funded by equity (see document GN-2411). This is differes from the treatment being proposed for SG LG guarantees, which will be subject to the Bank's ability to fund itself in the respective LC either through the debt or swaps markets, and is consistent with the LC approach in FFF.

3.34 For the OC-financed operations, the borrowers will have the option to have both a guarantee and a loan structure within one project; a combined loan/guarantee proposal defining the structure and conditions of both portions would be presented for approval[55]. In such a case, the guarantee portion will be governed by the PFGI. In addition, borrowers may have the flexibility to disburse all or a portion of either a policy-based loan or an investment loan in the form of a guarantee, as long as such option is analyzed in the design of the relevant loan proposal (or a supplement thereto) and approved by the Board of Executive Directors. In such a case, if the borrower elects to receive disbursement in the form of a guarantee, the specific guarantee structure and financial terms and relevant background must be approved by the Board of Executive Directors upon election of such option; such guarantee proposal will be also be governed by the PFGI.

n) Scoring of Sovereign Guarantees

3.35 As stated in "Scoring of Bank Guarantees" (CC-5800)[56], "*the purpose of "scoring" is to determine the overall financial exposure of the Bank's OC to both loans and guarantees. The measurement of the total exposure of the OC can facilitate management of loan and guarantee programs, by ensuring that limits on operations are not breached, and that financial indicators remain within (or at) acceptable levels, but ultimately safeguarding the lending capacity of the OC.*"[57]

3.36 Bank limits and scoring related to SG operations mainly consist of the following: 1) Programming approval limits per year; 2) Unused Borrowing Capacity; 3) New Lending Framework limit; and 4) Liquidity Policy. The Bank limits and scoring related to sovereign guarantees are explained below[58]. It is proposed to maintain equal treatment of loans to be consistent with the Bank's current financial and risk management policies[59].

3.37 **Programming Approval limits**. The total approval amount for loans and guarantees for all borrowing member countries is set by Senior Management and reflected in the OC LTFP document for each year. The annual per country approval amount is defined by VPC, as part of the programming exercise, based on the lending capacity of the Bank, the IDB-9 small and vulnerable countries lending target, the average share of total lending per country in the post-realignment period, the demand for resources and the undisbursed loan balance, among other criteria. Both loan and guarantee approvals are currently counted against such annual country approval amount on a 1 to 1 basis.

3.38 **Unused Borrowing Capacity (UBC).** Gross guarantee exposure is included as part of the calculation of the UBC, in which guarantees are counted equally as loans. The UBC is represented by the difference between the callable capital stock of the non-borrowing

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55 FSO guarantee structures are separately defined in Chapter IV.

56 This document was presented for Information to the Coordination Committee in 2002. This document was drafted primarily for the private sector guarantees; however this document states that for scoring purposes, there is no difference between guarantees with a sovereign counter-guarantee.

57 "Scoring of Bank Guarantees" (CC-5800), page 3.

58 The Bank has a scoring limit for NSG operations as per the IDB-9 (AB-2764).

59 Parallel to this document, Management is presenting for approval by the Board of Executive Directors a proposal that reviews the definition of credit exposure with respect to guarantees.

member countries and the Net Borrowings[60]. In the OC LTFP, UBC is one of the factors for calculating the lending capacity of the Bank.

3.39 **New Lending Framework (NLF) limits for guarantees supporting policy-based interventions**. PCGs/PRGs tied to policy-based interventions will count against the PBL limit of 30% of total approvals of 2011-2014, according to the New Lending Framework (NLF) revised version approved in 2011[61].

3.40 **Liquidity Policy**. Guarantee exposure is included in the calculation of the liquidity policy band of the bank, as defined in policy FN-600-2[62]. Specifically, expected guarantees (net of reinsurance) callable within the year, is included in the maximum of the Liquidity Policy band. Management plans to review and revise the liquidity policy which is expected to be presented during year 2013.

3.41 **Capital adequacy**. Guarantee with sovereign CG exposures are treated equally with loans with sovereign guarantee, in determining the Bank's capital requirements for credit risk. See section 6.1 for further details.

IV. SCG GUARANTEES FOR FSO COUNTRIES

A. BACKGROUND AND SPECIFIC ELIGIBILITY CONDITIONS APPLICABLE TO FSO COUNTRIES

4.1 The role of development banks in mitigating specific risks through guarantee instruments is of particular relevance in low and lower-middle income economies given the potential for attracting private investment and contributing to the promotion of infrastructure and other public goods in a context of generally insufficient national and multilateral funds to address large investment gaps. As the WBG IEG evaluation[63] concluded with respect to IDA's PRGs, these guarantees achieved a mobilization rate of 9.7 to 1 and had helped introduce complex PPPs in high risk, low-income countries, in addition to provide a platform for reforming PPP policies. Furthermore, these countries are progressively accessing markets previously restricted or unavailable, generating opportunities for guarantees to have an impact by improving the terms and conditions offered by new markets or creditors[64]. This combination of higher risk perception and partial or incipient market access suggest that future opportunities and demand for guarantees may increasingly be found in low and lower-middle income economies; in fact, 75% of all the

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[60] Policy-based Borrowing Authority (PBA) is a constraint introduced in 1990 which limits the amount of debt that the Bank can issue in order to fund its lending operations. It states that Net Borrowings are limited to the callable capital stock of the non-borrowing member countries; where Net Borrowings are defined as total borrowings (after swaps) and gross guarantee exposure, less qualified liquid assets (after swaps). 1990 "Review of financial policies" (GP-117 2.12)

[61] GN-2494-6 "Review of the New Lending Framework. New revised version.", Section 3, Resolution AG-9/11

[62] This liquidity policy is currently under review by management and it is expected that a proposal will be sent to the Board during 2013.

[63] The World Bank Group Guarantee Instruments (1990-2007): An Independent Evaluation.

[64] Precisely because a growing number of IDA countries fit the profile of well-performing countries with restricted access to markets, the 2009 independent evaluation recommended extending Partial Credit Guarantees (PCGs) to IDA countries, who have had access only to PRGs.

SCG guarantees approved by the WB from 1994 to 2012 were extended to countries classified as low or lower-middle income economies at the time of approval. In response to these benefits and opportunities, MDBs are currently establishing or expanding the use of guarantees with sovereign CG for member countries receiving financing from their concessional funds[65].

4.2 Nonetheless, while guarantees have the potential to leverage private sector financing for development, the underlying borrowing or liability should only be assumed by the government if it is consistent with debt sustainability, a key principle for countries that benefited from debt relief initiatives and receive concessional financing. Moreover, considering the opportunity cost of scarce concessional resources, their use in guarantee instruments should be considered when the intervention result in the mobilization of additional sources of financing or in enhancements that achieve terms and conditions that are consistent with the objective of preserving debt sustainability. These benefits and the potential for mobilizing private investment are, in turn, the incentives that eligible countries would have to use concessional resources in the form of a guarantee instead of a loan.

4.3 **Eligibility Criteria**. Recognizing both the potential of guarantee instruments for mobilizing key financing to the Bank's poorest member countries and the prerequisite to ensure prudent borrowing to preserve debt sustainability, the following principles will determine eligibility for specific SCG guarantee operations in Group D2 countries borrowing from the FSO and OC in blended terms, in addition to general criteria as determined in section B. of chapter IV:

i. **Compliance with debt sustainability**. For eligibility, the underlying borrowing or obligation, including the enhancement obtained through the guarantee and the associated all-in cost, must not threaten the borrower's fiscal and debt sustainability. To this end, a Debt Sustainability Framework (DSF) analysis that incorporates all the obligations of the underlying project must be performed to determine compliance.

ii. **Financial Leverage.** Financial leverage is a major consideration in providing Bank guarantees, a concept that is particularly important in the case of guarantees that will utilize scarce concessional resources. As such, a SCG guarantee that will use blended resources will be considered when such intervention results in a clear leverage of the limited resources, improved terms and conditions, or any other benefit that would make the underlying debt consistent with debt sustainability and that has lead the respective BMC to choose a guarantee instead of a loan. The respective analysis and justification should be clearly presented as part of the guarantee proposal to be considered by the Board.

[65] The WB will present a proposal to extend PCGs and Policy Based Guarantees (PBGs) to IDA countries as part an initiative launched in 2012 to modernize the World Bank's operational policy on guarantees. The AfDF offers PRGs since their 12th replenishment and will propose extending access to PCGs as part of their 13th replenishment. The Asian Development Fund (AsDF) has started discussions to fund both PRGs and PCGs with their concessional resources.

B. PRICING AND OTHER FINANCIAL ASPECTS

4.4 The following tables summarizes the key financial terms for SCG guarantees to FSO countries.

Table IV: Key Financial Terms of the Proposed SCG Guarantees to FSO countries

<table>
<tr><th colspan="4">Summary of Key Financial Terms</th></tr>
<tr><th colspan="2"></th><th>OC Portion</th><th>FSO portion</th></tr>
<tr><td rowspan="2">Pricing</td><td>Sovereign guarantee fee</td><td>OC SG variable lending spread</td><td>FSO lending rate of 0.25%</td></tr>
<tr><td>Other fees</td><td>Same as OC guarantee fees</td><td>N/A</td></tr>
<tr><td colspan="2">Maximum guarantee period</td><td colspan="2">It is equal to the maturity of the OC portion of the blended loans (30 years)</td></tr>
<tr><td colspan="2">Maximum weighted average life (WAL)</td><td colspan="2">It is equal to the WAL of the OC portion of blended loans (17.75 years).</td></tr>
<tr><td colspan="2">Repayment Profile of the underlying loan/ financing being covered</td><td colspan="2">Flexible, subject to WAL</td></tr>
<tr><td colspan="2">Reimbursement of claim (counter-guarantee)</td><td colspan="2">Payable upon demand, if consistent with DSF. If payment on demand is not consistent with DSF, "Maximum Repayment Terms" (established at approval of the guarantee) will apply. A default in repayment of the CG triggers same treatment as non-performing loans.</td></tr>
<tr><td colspan="2">Maximum Repayment Terms</td><td>Equal to the remaining OC WAL requirement of 17.75 years, depending on timing of call</td><td>The remaining tenor of standard FSO portion of a blended loan, depending on timing of call</td></tr>
<tr><td colspan="2">Cancellation of guarantee</td><td colspan="2">Pass-through to borrower of any costs incurred by the Bank</td></tr>
<tr><td colspan="2">Treatment for small-sized claim disbursements</td><td colspan="2">Considered on a case-by-case basis and subject to operational and risk management considerations</td></tr>
<tr><td colspan="2">Non-payment of guarantee fee</td><td colspan="2">Non-payment of guarantee fees by counter-guarantor triggers same treatment as non-performing loans <u>without</u> affecting the irrevocability of the guarantee.</td></tr>
<tr><td colspan="2">Trigger event</td><td colspan="2">Claim payment is irrevocable</td></tr>
</table>

Table V: Financial Options of SCG Guarantees to FSO countries

Options for Guaranteed parties		
Type of Guarantee		PCGs or PRGs for investment projects or policy-based interventions
Currencies	Approval	US$
	Claim payment	US$
	Counter guarantee	US$
Coverage %		Up to 100%
Flexible guarantee coverage		Flexible and coverage is based on contractual Weighted Average Life defined.

4.5 **Source of funding and blend.** SCG guarantees for group D2 countries financed with blended resources will be funded from the respective biannual allocation of concessional resources approved by the Board every two years under the "Debt Sustainability Framework and Enhanced Performance Based Allocation (DSF/EPBA) framework" (Document GN-2442)[66]. As such, SCG guarantees will also have the same blend of FSO and OC resources as the one approved for the biannual period in which the guarantee is approved.

4.6 **Pricing Methodology**. The principle of net income neutrality with loans and the premise of no cross-subsidies between loans and guarantees applicable to the pricing of OC guarantees also apply for guarantees financed with blended resources.

4.7 **Guarantee fees**. The guarantee fees will be equal to the fees charged to blended loans: the OC sovereign loan spread for the OC portion, and the 0.25% lending rate for the FSO portion. To maintain net income neutrality, the sovereign guarantee fee applicable to the OC portion will be variable, as defined in the annual OC LTFP.

4.8 **FSO project structure.** For the FSO operations, the borrowers will have the option to have both a guarantee and a loan structure within one project; a combined loan/guarantee proposal defining the structure and conditions of both portions would be presented for approval. The portion of the loan must follow the standard then-applicable FSO loan structure.

4.9 **Maximum guarantee period and maximum WAL.** The maximum guarantee period is equal to the maturity of the OC portion of the blended loans of 30 years. The maximum WAL of each blended guarantee is 17.75 years, equivalent to a loan with 5.5 years grace

[66] Under this Framework, the overall allocation of resources is determined by a combination of country needs and performance (the EPBA), which determines the allocation of highly concessional FSO resources; and the risk of debt distress classification (stemming from the DSF), which defines the appropriate blend of OC resources with the individual countries' FSO allocation.

period and 30 years maturity. The structure of the guarantee is flexible subject to compliance with the WAL requirement of 17.75 years of the guarantee coverage[67].

4.10 **<u>CG agreement</u>:** An underlying principle of the DSF/EPBA framework for group D2 countries is the use of the DSF for managing the risk of debt distress and defining the appropriate terms and conditions for providing financing that is consistent with debt sustainability. In order to apply this principle to the specific case of guarantee instruments and to ensure consistency with 1) the DSF and 2) the principle of net income neutrality with loans, the following structure is proposed for SCG guarantees financed with blended resources:

i. As a general principle, and as it is applicable to guarantees funded with OC resources, the CG agreement will stipulate that if a payment is made under the guarantee, the reimbursement to the Bank will be payable upon demand. A payment under the guarantee will be made only according to the original guaranteed scheduled payment, regardless of whether the lender has the right to accelerate the guaranteed loan, or even if such debt is accelerated upon default. The repayment to the Bank would be in principle consistent with the DSF since it must have shown that the underlying obligation that is being guaranteed is consistent with debt sustainability.

ii. However, recognizing that a full reimbursement on demand may put the DSF at risk if the baseline changes significantly from the time of the guarantee approval to the time of a payment under that guarantee, the CG agreement will also stipulate the "Maximum Repayment Terms" that would be applied in case the DSF, to be performed at the time a payment is made, indicates that a full reimbursement on demand may not be possible and that such reimbursement must be in the form of an amortizing loan.

iii. The Maximum Repayment Terms in case the reimbursement will be in the form of a loan will be established as follows: 1) for the OC portion, the maximum repayment time will be equal to the remaining OC WAL requirement of 17.75 years, depending on timing of call; and 2) for the FSO portion, the remaining tenor of standard FSO portion of a blended loan. The interest rate and service fee will be the same as for the blended loans.

iv. A default in repayment of the CG will trigger the same treatment that applies to non-performing loans.

4.11 **<u>Implications for concessionality</u>:** A full reimbursement on demand or a reimbursement in the form of a loan subject to the terms described herein entails that the grant element or concessionality of the resources used for the guarantee will be lower than the concessionality that each country receives for loans under the blended structure, given the

[67] A guarantee could cover debt service of a loan, bond, or any defined payment according to each guarantee contract. The WAL requirement for the guaranteed loan has a purpose to neutralize the financial impact of the diverse guarantee structures and maintain equivalency to FFF loans. On the WAL concept, please refer to document FN-655-1 Section 4.23 - 4.26 and Annex II.

faster amortization period. As such, the DSF performed for the guarantee proposal must show that there would be enough space to absorb a potential reimbursement under the Maximum Repayment Terms in a scenario less favorable than the baseline, which by definition showed that the underlying obligation is consistent with the DSF.

4.12 **Irrevocability of guarantee; non-payment of fees and costs associated with guarantee:** The treatment of these issues will be substantially the same as described in paragraphs 3.27 and 3.28.

V. FINANCIAL IMPACT ANALYSIS

5.1 This PFGI proposal aims to offer a flexible policy for SG product that maintains the net income neutrality and no cross-subsidy with loans. SG operations will be offered with the same flexibilities offered to SG loans in the FFF platform. Under the IMM[68], through the OC LTFP, guarantees are treated equally as loans for the purposes of CUR and borrowing capacity consumption.

5.2 Since in the PFGI sovereign guarantees will be priced and scored equally as FFF loans, no additional impact to the lending capacity is expected with the introduction of the PFGI given that income generation and exposure of loans and guarantees are expected to be neutral.

5.3 Similar to FFF loans, the long term financial impact of the take-up of sovereign guarantees under the PFGI, will be monitored through the OC LTFP. If through the monitoring of the sovereign guarantees, it is observed that the trend is such that it could materially impact the lending capacity of the OC, then Management would introduce limits to the take-up of guarantees through the OC LTFP exercise.

5.4 Similarly, loans and guarantees for the FSO will be treated equally for liquidity consumption and pricing. Therefore, the financial impact of the FSO guarantees is expected to be equal to FSO loans.

VI. RISK MANAGEMENT ASPECTS

6.1 **Capital Adequacy**. Given the similarity of the characteristics of a guarantee with sovereign CG to loans with a sovereign guarantee, both exposures are treated equally in determining the Bank's capital requirements for credit risk. If in the simulation of non-accrual events a BMC is assumed not to pay amounts due on loans then it is also assumed that it would not be able to perform on any underlying transaction of guarantees with sovereign CG. Thus, it is presumed that those guarantees would be called, requiring the Bank to pay-out the callable amount, while, at the same time, the member country would not pay-out on the CG. Therefore, at each point in time the full callable amount is counted as exposure for capital adequacy purpose and the Capital Adequacy Policy (FN-568-8) is applied accordingly.

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[68] See section 3.C.a), paragraph 3.17, for explanation on the IMM.

6.2 **Market Risk Management.** With respect to market risk SCG guarantees could expose the Bank to changes in interest or exchange rates.

6.3 **Interest Rate Risk**. As long as a guarantee is not called, it remains unfunded and it is not carried on the Bank's balance sheet. As such, the Bank does not incur any interest rate risk. In the event a SCG guarantee is called, the Bank mitigates its exposure to interest rate risk by passing-through the Bank's cost of funds to the member country, similarly to the cost-pass through mechanism of the FFF loans, effectively hedging any exposure it might have.

6.4 **Exchange Rate Risk**. In the event a non-US dollar SCG guarantee is called, the Bank mitigates the exposure to exchange rates risk by structuring the counter guarantee in a way that the sovereign accepts full pass-through of such exposure. That is, in case of a call, the member country reimburses the Bank either the units in local currency, if the Bank used available funding in the respective currency or the US dollar equivalent amount if the Bank needed to convert to local currency in order to pay out the called amount.

VII. IMPLEMENTATION STRATEGY

7.1 The following aspects will guide the implementation strategy of PFGI: 1) Effectiveness of PFGI; 2) Knowledge dissemination and expertise building; 3) Transactional set-up of sovereign guarantee operations; 4) Risk management and monitoring of guarantee operations; 5) Legal documentation to support the sovereign guarantee transactions, 6) financial reporting aspects, 7) resource considerations, 8) future enhancements and adjustments.

7.2 **Effectiveness of PFGI**. The terms and conditions of the PFGI, as described in this document, will apply to all new OC SCG guarantee proposals submitted for considerations by the Board of Executive Directors starting as of the date this policy document is approved by the Board of Executive Directors and enters into effect.

7.3 **Knowledge dissemination and Expertise Building**. Training and knowledge dissemination of the PFGI would be conducted to facilitate origination and structuring of sovereign guarantee operations. Through discussions with peer institutions, it was identified that possible reasons for low usage of the product was due to the lack of knowledge and expertise by internal and external users. To ensure successful implementation and usage of the PFGI, the Bank will develop knowledge dissemination and training sessions aimed at raising the understanding of the product. Other MDBs have been implementing similar efforts to train internal and external staff for their guarantee products[69]. Dissemination of knowledge, training and marketing of the PFGI would be done through various means, including presentations, training sessions, web site enhancements.

[69] For example, the AsDB has conducted a workshop to provide training for more than ten Asian countries' governmental officials in order to disseminate knowledge about credit enhancement products.

7.4 **Transactional set-up.** System and reporting enhancement requirements, preparation for the servicing of guarantee operations will need to be developed to support the product. Additional monitoring and control mechanisms specific for guarantees will be required and would be identified as the Bank implements the product.

7.5 **Risk Management and controls / financial planning and monitoring of guarantee operations**. On-going risk management and monitoring will be necessary to handle of sovereign guarantee transactions. Implementation of the PFGI will be done so as to reflect: (i) demand on the flexibilities being offered by this proposal; and (ii) the prudent management and monitoring within the Bank's financial and risk management policies through the Assets and Liabilities Committee (ALCO)[70]. (iii) Guarantee approvals and exposure will be monitored as part of the annual OC LTFP process and the quarterly reporting of the Bank's Capital Adequacy.

7.6 **Legal documentation to support the sovereign guarantee transactions.** In the initial implementation, LEG will be responsible for preparing new model legal documentation with the assistance of external counsel.

7.7 **Financial reporting aspects.** The Bank follows United States Generally Accepted Accounting Principles (US GAAP) for its external financial reporting purposes. Current US GAAP includes specific reporting and disclosure provisions for financial guarantees. Among other things, those provisions require that guarantees be regularly assessed for collectability and a provision be recorded, as applicable, similar to allowance for loan losses. As the volume of the guarantee portfolio increases, or if US GAAP changes, the Bank may need to re-assess its existing model for guarantee accounting.

7.8 **Resource considerations.** Resource needs to cover the implementation costs, training and servicing of PFGI will be addressed through the Bank's regular budgetary process.

7.9 **Other considerations regarding programming approval limits**. In light of the lessons learned from other MDBs and as a mean to incentivize the use of guarantees, Management will consider exploring mechanisms that could allow for counting less than the full nominal amount of a guarantee against the annual country approval amount. Such mechanisms may include building up dedicated reserves from donor resources, using unallocated programming capacity or tapping into the resources currently dedicated to fund other instruments.

7.10 **Other Considerations regarding risk**. Guarantees may offer new opportunities for risk management for the Bank. For example, guarantees that cover events, such as commodity price movements or weather events, that are not sovereign risks per se, could offer potential benefits from risk pooling and risk reduction[71]. Management will continue analyzing these topics and submit to the Board specific proposals, if merited.

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[70] Given the large variety and complexity of potential guarantee structures, the ALCO will review and approve new guarantee structures, based on operational and risk management considerations.

[71] Pooling certain risks may be advantageous for the Bank as, for example, some countries may be negatively affected if commodity prices rise while others are affected if they fall. Also, there may be correlations between the risks the Bank faces

7.11 **Future enhancements and adjustments.** Notwithstanding Management's view of the developmental role of this product, it is possible that demand for SCG guarantees may be limited, given the comprehensive range of policy requirements being proposed, which includes safeguards, procurement, macroeconomic conditions, scoring and pricing among others. In such case, Management would consider presenting to the Board policy adjustments and enhancements based on lessons learned once experience is gained in the implementation of this proposed policy.

VIII. CONCLUSIONS AND RECOMMENDATIONS

8.1 Based on the PFGI's aspects presented in Chapter III through VII, Management recommends that a new flexible and consolidated policy framework for SCG Guarantees be implemented to broaden the range of financial products the Bank can offer to its borrowers and allow for more flexibility and clarity with respect to the Bank's policy framework for sovereign guarantees.

8.2 On the basis of the analysis presented and the proposals contained in this document, Management recommends that the Board of Executive Directors approve the following recommendations:

Recommendation I: To establish the Proposed Policy for a Flexible Guarantee Instrument, in accordance with the criteria set forth in Chapters III and IV of this document.

Recommendation II: That the following policies be superseded by the PFGI only for purposes of SCG Guarantees: GN-1858-2, GN-2365-6 and GN-2311.

as hedging for commodity, disaster or other risks in a country may reduce the risks of the entire Bank portfolio in that country. These considerations may then have beneficial effects on scoring for liquidity and borrowing capacity.

ANNEXES