

# Viewpoint

The World Bank

May 1996

Note No. 79

## Mitigating Project Risks—World Bank Support for Government Guarantees

*Philippe Benoit*

### Project risks and risk mitigation

Private investors try to mitigate the risks facing a proposed project before they invest. Foreign investors in developing countries are often concerned about two kinds of risk in particular. The first is political risk—risk relating to political acts of government and to the general country context, including war, expropriation, and restrictions on repatriation of earnings. The second kind of risk, referred to here as “parastatal risk,” relates to the performance of parastatal companies and includes such risks as failure of the government-owned power company to supply electricity to a project.

To mitigate project risks, investors generally require guarantees from the project sponsors. For protection specifically against political risks, investors often procure insurance or guarantees from specialized institutions, such as export credit agencies or private political risk insurers. Another source of political risk insurance for foreign investment in developing countries is the Multilateral Investment Guarantee Agency (MIGA), a specialized organization in the World Bank Group.

In addition, foreign investors in developing countries often approach host governments for guarantees, particularly for political and parastatal risks. Host governments structure these guarantees in a variety of ways. They may issue guarantees directly to investors. Or they may establish a special facility to do so, such as a facility to issue guarantees for export financing. In both these approaches, investors rely on the host government to finance payments under the guarantee. But in some projects, governments have a third party, such

as an offshore bank, issue the guarantee (for example, a letter of credit). Under this structure, often used to provide coverage to foreign investors concerned about timely payment from a host government guarantor, the investors look to the third-party guarantor for payment, and the third party relies on the host government for reimbursement.

### World Bank support for guarantees

The World Bank has employed two distinct financial vehicles to support developing country governments that decide to provide guarantees to attract private investment: issuing guarantees to investors and making loans to host governments to fund guarantees.<sup>1</sup>

#### World Bank guarantees

The International Bank for Reconstruction and Development (IBRD), one of the World Bank's two constituent organizations, has established a guarantee program to issue guarantees to lenders covering either all or a part of their loan against certain specified risks (partial risk guarantees), or certain specified payments under their loan against all risks (partial credit guarantees). The Bank's other constituent organization, the International Development Association (IDA), which lends at concessional rates, has never issued guarantees and has no guarantee program in place.

When the IBRD issues its guarantee, it receives a counterguarantee from the host country, under which the country remains financially responsible for any payments that the IBRD makes to lenders (figure 1). The IBRD has issued guarantees for several large infrastructure





FIGURE 1 IBRD GUARANTEE

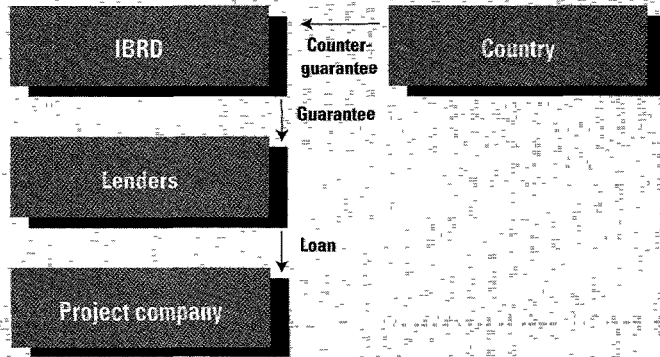


FIGURE 2 WORLD BANK-FINANCED THIRD-PARTY GUARANTEE

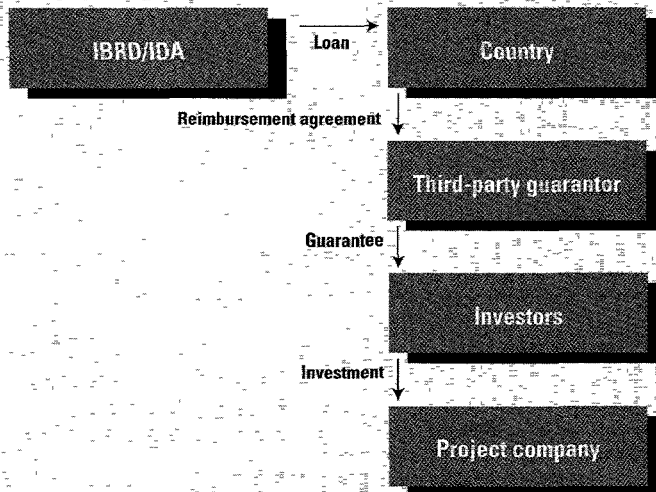
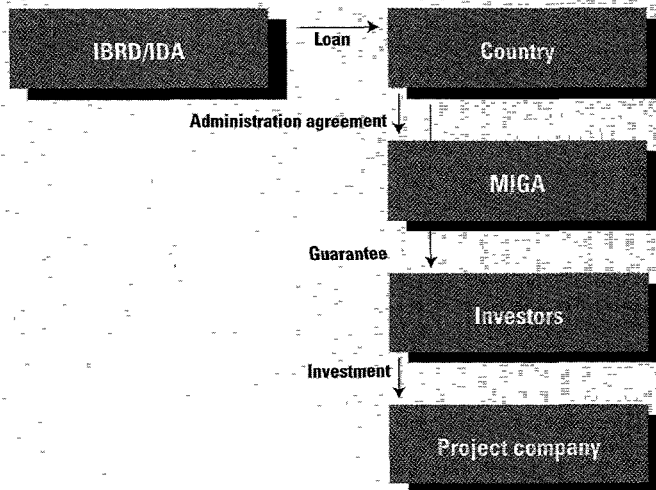


FIGURE 3 WORLD BANK-FINANCED AND MIGA-ADMINISTERED GUARANTEE



projects For example, in the 1994 Pakistan Hub River Power Project, the IBRD issued a partial risk guarantee protecting lenders against debt service defaults resulting from a breach by the Pakistan government of its undertakings to the project company These undertakings relate to parastatal performance and certain political risks (such as currency transfer). Projects involving the partial credit guarantee include the 1994 China Yangzhou Thermal Power Project and the 1994 Philippines Leyte-Luzon Geothermal Project; in both cases, the IBRD guarantee covered long-term maturities.<sup>2</sup>

**World Bank financing of government guarantees**

The World Bank can also support host government guarantees by providing loans to finance them The host country provides investors with a guarantee, the World Bank provides a loan to the country, and the country draws down the loan if and as required to finance payments due to the investors under the guarantee. Such World Bank loans could be provided to finance a wide range of government guarantee structures, including the third-party guarantee structure (figure 2).

The World Bank has provided loans to fund guarantees and other forms of coverage in only a few projects to date. One such project, the 1995 Moldova Pre-Export Guarantee Facility Project, involves both a government guarantee facility and a third-party guarantor. Moldova established a guarantee facility to cover foreign supplier credit provided to its exporters against specified political risks In parallel, an offshore bank (the agent bank), acting as a third-party guarantor on behalf of Moldova, issued standby letters of credit to the foreign creditors, backstopping the government facility's guarantees The agent bank could draw down the IBRD loan to fund payments to be made under its letters of credit to the foreign creditors. In a second project, the 1994 Argentina Capital Market Development Project, the government created a backstop facility to purchase eligible commercial bank bonds from banks otherwise unable to place them because of specified market disruptions.

---

The IBRD provided a loan to Argentina to fund eventual payments from the facility.

### **Integrating Bank and MIGA support**

The World Bank and MIGA are exploring an integrated approach to supporting host governments of developing countries in providing political risk coverage for foreign investments where insurers are unwilling to issue insurance funded from their own resources (figure 3)

Under this approach

- The World Bank would provide a loan to the host country.
- The country would use the loan to provide designated investors with coverage against specified political risks
- The country would have MIGA administer the coverage.
- Both the investors and the country would rely on MIGA to evaluate and process any investor claims
- As administrator, MIGA would pay investors' claims, using the proceeds from the country's Bank loan
- The country would be obligated to repay to the Bank all amounts withdrawn under the loan—but the loan would be drawn down only if and as required to pay valid claims.

This approach is being considered for a power project whose foreign sponsors are concerned about their ability to convert local currency earnings into foreign exchange. The host government has requested an IDA loan to finance currency transfer coverage for these investors, to be administered by MIGA.

### **The implications of Bank support**

World Bank support for guarantees presents several advantages:

- The IBRD, under its guarantee program, serves as an independent offshore guarantor with strong financial standing—to which lenders can turn to for payment regardless of the host government's actions or financial weaknesses.
- The World Bank's involvement in a transaction can mitigate political risks in two ways

First, the World Bank has greater leverage than most commercial banks and other private investors over developing country governments—in large part because of its financial, contractual, and cooperative relationships with these countries, as well as its multilateral character. It can use this leverage to discourage unreasonable government actions that would threaten the success of a project. Second, a payment by the World Bank always entails a corresponding obligation from the host government—under the counterguarantee for an IBRD guarantee, and under the loan itself for a loan financing a guarantee. This obligation creates a financial disincentive for a government to take actions that would trigger payments to the investors.

- Guarantees and loans to finance guarantees allow host governments to shed project risks that they would assume under a traditional World Bank loan. Under traditional debt financing, the country must repay the World Bank loan even if the project fails, regardless of the reason. Under guarantees, the Bank makes payments, which triggers the government's financial liability, only for specified risks. These instruments thus provide governments with a straightforward mechanism for shedding project risks, particularly commercial ones, by leaving the exposure for them with private investors.
- Guarantees also provide a mechanism for governments in transnational projects, such as the construction of a pipeline between two countries, to allocate political risks between the host countries. In such a project, each host government could provide lenders with a guarantee covering the political risks relating to its country. The lenders would be covered against all political risks, while each government's liability to the lenders would be limited to the political risks its country poses.
- The World Bank can provide developing countries with the financial resources (typically in foreign exchange) to fund payments to investors or to a third-party guarantor.
- Guarantees often allow a project to obtain lending on relatively favorable terms by protecting lenders and mitigating political and parastatal risks. This can lead to a lower



interest rate or extend the maturity of the loans, as has been the case with the IBRD partial credit guarantees. But guarantees can also add to the transaction costs. There typically are guarantee fees, and legal expenses may be higher if the guarantee makes the transaction much more complex.

- Obtaining the services of a third-party guarantor can be costly for governments of developing countries that do not enjoy a strong credit rating. Commercial institutions may require the government to provide escrow accounts and other costly security arrangements to back the government's reimbursement obligation. But the World Bank, because of its development character and leverage in securing reimbursement by member country governments, can fulfill the role of third-party guarantor at a relatively low cost to the government.

An integrated World Bank–MIGA approach would present several additional advantages. It would permit a developing country government to finance political risk coverage for investors in order to secure their participation in priority development projects. It would give these governments access to MIGA's expertise in designing and administering political risk insurance. And it would provide investors with an offshore, independent third party to administer the coverage. The result of this integration of the Bank and MIGA would be a structure that makes the most of the comparative advantages of each institution.

But World Bank support for government guarantees can raise concerns in certain circumstances. Guarantees are generally inefficient instruments where there is a strong likelihood that the risks guaranteed against will occur. In these cases, efforts should focus on reducing the risks to a reasonable level. Furthermore, the availability of guarantees might encourage investors to seek broader protection from host governments than they would otherwise require. And while guarantees provide protection to specific investors in specific transactions, they are no substitute for substantive regula-

tory reforms—which reduce the cost to governments of attracting private investment and eventually obviate the need for host government guarantees.

### Use of guarantees

Whether the World Bank should provide an IBRD guarantee or a loan financing a government guarantee for a proposed project depends on the assessment of the project and the costs and benefits of such Bank support. The Bank assesses the project's development impact, the investor's need for the guarantee, the nature of the risks to be covered, the government's actions to mitigate those risks, the cost of such coverage to the government, and the benefits to the country from the investor's involvement in the project. Another factor considered by the Bank is the ability of the government and the investors to obtain alternatives to Bank support. These include MIGA insurance and risk mitigation provided by the International Finance Corporation (IFC), another member of the World Bank Group.<sup>3</sup>

To date, the World Bank has issued few IBRD guarantees and loans to finance government guarantees. Their use has been hampered in part by their newness. As government officials, the private sector, and Bank staff become more comfortable with these instruments, and as the emphasis on private sector investment in projects increases, the number of projects in which these instruments play a part will likely grow.

The Note series is an open forum intended to encourage dissemination of and debate on ideas, innovations, and best practices for expanding the private sector. The views published are those of the authors and should not be attributed to the World Bank or any of its affiliated organizations. Nor do any of the conclusions represent official policy of the World Bank or of its Executive Directors or the countries they represent.

Comments are welcome. Please call the FPD Note line to leave a message (202-458-1111) or contact Suzanne Smith, editor, Room 68105, The World Bank, 1818 H Street, NW, Washington, D.C. 20433, or Internet address [ssmith7@worldbank.org](mailto:ssmith7@worldbank.org)

♻️ Printed on recycled paper

<sup>1</sup> For a fuller discussion, see Philippe Benoit, *Project Finance at the World Bank*, World Bank Technical Paper 312 (Washington, D.C., 1996).

<sup>2</sup> For a fuller description of IBRD guarantees, see the World Bank's *Guarantees and the Project Finance and Guarantees* series, published by the World Bank's Cofinancing and Project Finance Department.

<sup>3</sup> For example, the IFC offers a loan syndication program that provides commercial lenders with the protection of its lender-of-record umbrella. For a fuller description of MIGA and the IFC, see their 1995 annual reports.

*Philippe Benoit, Senior Private Sector Development Specialist, Private Sector Development Department (email: [pbenoit@worldbank.org](mailto:pbenoit@worldbank.org))*