Guarantees for development

By Raundi Halvorson-Quevedo and Mariana Mirabile, Development Co-operation Directorate

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Why look at guarantees?

Guarantees – a type of "insurance policy" protecting banks and investors from the risks of non-payment – have been a mainstay of financial markets all over the world for many years. They play an important role in helping the private sector make investments that promote growth and create jobs. Could official guarantees play more of a role in mobilising finance for development?

"Developmental guarantees" – a special category of official guarantees backing projects that promote the development and welfare of developing countries – could provide the measure of security needed to bring on board more private risk capital. But unfortunately, not much is known about them – there is no international statistical standard or data collection that could provide information about the magnitude and scope of their use in developing countries.

Part of the reason for the lack of information is that guarantees are "unmaterialised" financial flows: as "contingent liabilities"[1], they are registered in the financial statements of the institutions issuing them but they do not actually give rise to official financial flows until a default occurs. Thus, while the OECD Development Assistance Committee (DAC) runs a comprehensive statistical system on financial flows, guarantees in themselves do not appear in it.

Nevertheless the DAC is now exploring the scope for a new data base that could help the development co-operation community understand where resources are being mobilised by guarantees, what types of guarantee instruments are being used, and whether additional resources are being catalysed by these flows. This in turn could inform financing policies, such as how development finance might best be allocated, e.g. grants to the poorest countries versus market-related instruments (such as developmental guarantees) for better-off countries.

As a first step, the DAC has undertaken a first-ever survey of the guarantee portfolios of a range of bilateral aid agencies, development finance institutions (DFIs) and international financial institutions (IFIs)[2]. The results of the survey – and reflections it prompted on related statistical measuring issues – are summarised below.

[1] A contingent liability is an obligation to cover payment that depends on the outcome of a future event: thus, the timing and the amount of any payment cannot be known when the contingent liability is assumed.

[2] The survey is at http://www.oecd.org/dac/stats/guaranteesfordevelopment.htm. DFIs are specialised financial intermediaries designed to work with, and offer tailored products and services to, the private sector in developing countries.

What are guarantees and how can they spur development?

A guarantee, in the sense of the survey, is a promise of indemnification up to a specified amount in the case of default or non-performance of an asset, e.g. a failure to meet loan repayments or to redeem bonds, or expropriation of an equity stake. Guarantees typically cover political and/or commercial (e.g. credit, regulatory/contractual) risks that investors are unwilling or unable to bear. Guarantors assess risks and use a range of tools including reinsurance, co-guarantees, or reserve assets to transfer, diversify or cover them. The survey focused on guarantees issued by public institutions to cover private investors. Guarantees issued by donor governments to reduce the funding costs of their own DFIs were excluded[3].

Developmental guarantees are a valuable instrument for mobilising private resources – be they from private companies, banks, individuals, NGOs, self-help groups, investment funds, etc. For a fraction of the potential cost of the risk exposure undertaken, considerable liquid resources can be deployed for investments to improve economic and social conditions in developing countries. And they can be used in a myriad of ways, such as i) backstopping financing for large-scale, multi-year infrastructure projects, ii) lengthening the maturities of loans to small enterprises, iii) refinancing municipal utilities, iv) enabling local banks to enter new markets such as mortgage or microenterprise lending, or v) deepening capital markets by facilitating local-currency bond issues. In a larger sense, developmental guarantees are uniquely suited to facilitate investment flows to developing countries and high-risk sectors – and they thus mobilise additional resources beyond what financial markets would normally provide. Boxes 1 and 2 describe the operations of two different developmental guarantee funds.

Box 1. Overview of a bilateral credit guarantee programme

Since its inception in 1999, USAID's Development Credit Authority (DCA) has issued guarantees that have mobilised up to USD 2.7 billion in credit to entrepreneurs in 70 developing countries. With historically low default rates, USAID has paid out only USD 9.1 million in claims across the entire portfolio while collecting USD 11 million from banks in fees.

In 2012, DCA worked with 45 financial institutions in 23 countries to unlock up to USD 525 million in private capital for underserved entrepreneurs in developing countries (more than half in Sub-Saharan Africa). Highlights from DCA's FY12 portfolio include:

- USAID partnered with Acumen Fund, a non-profit global venture fund, to facilitate the flow of up to $15 million in debt capital to social enterprises providing critical goods and services in Africa and South Asia.
- USAID partially backed private loans made to smallholder farmer organisations, including those with contracts from the World Food Programme "Purchase for Progress" initiative: qualifying organisations will be able to use forward delivery contracts to obtain local, private financing.
- New guarantees mobilised $30 million in Haiti for private lending toward housing, construction, and small businesses impacted by the 2010 earthquake.
- A new credit guarantee allowed Root Capital to disburse more than USD 50 million in loans, reaching more than one million small-scale farmers over the next five years.

Source: USAID

[3] This is because the DAC statistical system measures flows as closely as possible to actual cross-border transfers. Transactions within the official sector of the donor country are ignored, in favour of counting the final transaction with the developing country – in this case, the DFI's loan or investment that was facilitated by an official guarantee.

Box 2. GuarantCo: facilitating local currency finance and deeper capital markets

GuarantCo is a special guarantee facility established in 2006 under the aegis of the Partnership for Infrastructure Development (PIDG), a multi-donor organisation working to mobilise private sector investment in infrastructure in the developing world. GuarantCo provides local currency guarantees to infrastructure projects in low-income countries to mitigate credit risks for local banks, thereby promoting domestic infrastructure financing and capital market development. The cumulative value of GuarantCo's financial commitments as of end-2012 was US$ 230.3 million (18 projects).

GuarantCo has supported investment in the industrial, telecommunications and transport sectors, each of which accounts for approximately 25% of its outstanding portfolio. Half of its guarantee operations have been targeted at crucial infrastructure investments in fragile states. Recent activities include a credit enhancement for a municipal bond issue in Kenya, a guarantee for a public-private partnership hospital in Egypt, and partial guarantees for a river hydropower project in Nepal, a slum redevelopment project in India and a greenfield agro-energy project in Tanzania.

Source: Guarantco

Survey results: a "snapshot" of the size and spread of developmental guarantees

The survey questionnaire was sent to institutions with a development mandate, e.g. DFIs and aid agencies in 24 DAC countries and 17 international financial institutions (IFIs). The survey covered over 1,000 long-term guarantees issued by 14 countries and organisations over the period 2009-11[4]. It aimed to provide basic information on the magnitude, geographic spread and characteristics of developmental guarantees, and to assess measurement and leveraging issues.

Highlights from survey findings include:

- Guarantees for development supported a total of USD 15.3 billion from private sector actors for investments in the developing world from 2009 to 2011: volumes doubled from USD 3.2 billion to USD 6.4 billion over the period. Nevertheless, they were a marginal component of development finance when compared to ODA for the years in question, e.g. net ODA in 2011 was USD 134 billion – more than 20 times the volume of risks covered by developmental guarantees.

- Most of the private capital mobilised by the guarantees was sourced from banks, investment funds, or companies domiciled in OECD economies.

- The largest country issuers of guarantees were the United States, France and Austria. The largest multilateral issuers were the World Bank Group, the Islamic Development Bank, and the Private Infrastructure Development Group.

- The region benefiting the most from guarantees was Africa, followed by Asia and Eastern Europe (41, 24 and 22 per cent of the total amount mobilised, respectively): contracts issued in Africa were significantly smaller but much more numerous than those issued in other regions.

- Forty percent of the amount mobilised by guarantees was targeted to banking and financial services, backstopping lines of credit for small- and micro-enterprises, mortgage finance, rural credit co-operatives, small farmers associations, industrial refinancing, etc.

[4] Information on guarantees issued to both public and private investors, was collected, but due to the small number of public guarantees, the analysis focused only on private guarantees.

- More than half of the resources mobilised were guaranteed by IFIs – likely due to their: i) strong treasury and co-financing operations, ii) leading role in infrastructure/big ticket investments, and iii) comparatively larger average guarantee exposures (particularly regarding political risk guarantees given the Multilateral Investment Guarantee Agency). Of the 15 IFIs responding to the survey, all but four issue guarantees[5].

- Only eight of the 20 bilateral DFIs and agencies participating in the survey are issuing guarantees (although two more envisage doing so soon), in part due to the fact that guarantees cannot be scored as ODA.

Policy conclusions/implications:

- *More use could be made of guarantees as a mechanism for mobilising private resources for financing development, particularly by DAC member DFIs. This may require measures to: i) enlighten decision-makers and institutional leadership about the positive cost-benefit performance of guarantees as a development finance tool, ii) permit bilateral DFIs to offer financial products <u>beyond</u> those that can be scored as ODA, iii) develop new DAC statistical measures that encompass – and thus value – guarantees, and/or iv) enable DFIs to expand their guarantee portfolio by increasing their equity stakes or capital reserves.*

- *The bulk of survey guarantees supported investments in the productive sectors: financial services, infrastructure and industry combined accounted for more than 70% of the resources mobilised.*

- *Most of the guarantees (85% by value) backed capital that was not mobilised in the countries where it was deployed. Arguably there is scope for making greater use of developmental guarantees to tap local savings and develop domestic capital markets in the developing countries where these guarantees are being used.*

- *Most developmental guarantees surveyed covered risks in middle-income countries – where conditions are well-suited for the use of market-based instruments to mobilise private capital.*

Advancing international thinking on measuring guarantees: what is meant by mobilisation and leveraging – and how might statistical systems best capture the catalytic impact of guarantees?

The survey permitted a reflection on how to best measure the extent to which guarantees catalyse resources for investing in development.

At present there is no internationally agreed concept, definition or methodology for measuring the amount of resources mobilised by guarantees. This creates challenges when it comes to statistical analyses, particularly – given the importance of ensuring comparability and the risks of double-counting – where statistics are aggregated across multiple institutions. An agreed methodology could also help incentivise greater use of guarantees.

[5] Two IFIs envisage issuing guarantees in the future.

The reflection took up in turn: i) a methodology for quantifying resources mobilised by a guarantee and ii) how best to measure its catalytic, or leveraging effect. This required consideration of how to establish causality (whether the project would have taken place without the guarantee), how to avoid double-counting and how to capture the probability of default.

Measuring the catalytic impact of guarantees – the mobilisation concept

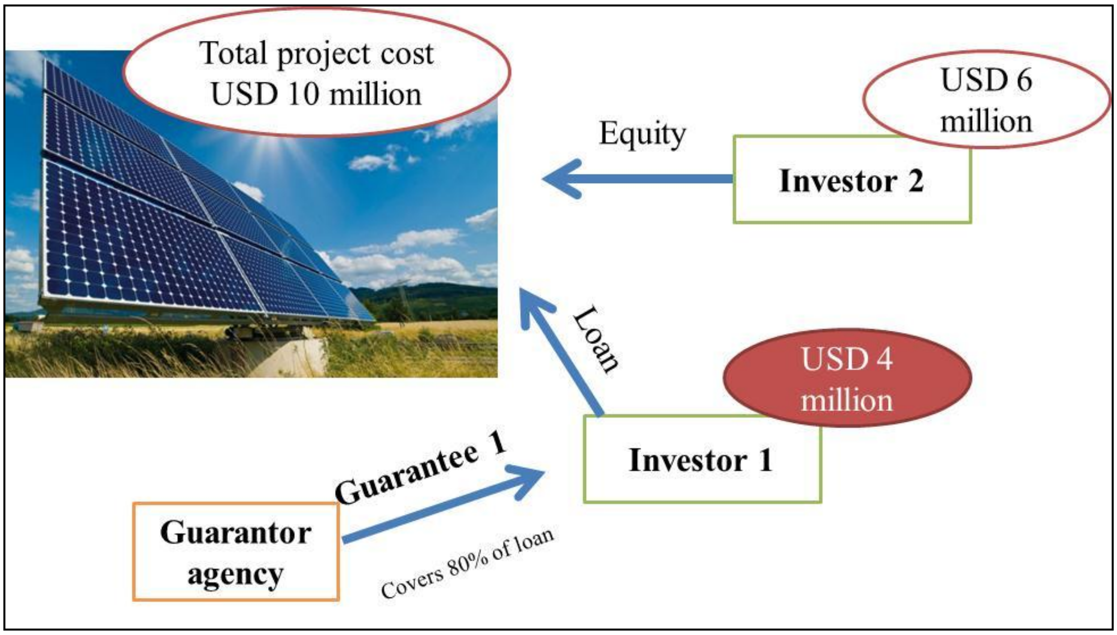
The survey assessed two different approaches to measuring the amount of resources mobilised by a guarantee: i) using the ***total value of the project*** with which the guarantee was associated or ii) using the ***total amount of resources*** (e.g. loan, equity) ***mobilised*** by a specific guarantee.

The analysis identified two problems with the "total value of the project" approach:

- Where a guarantee covered only a small share of the total project cost, it would be difficult to assert that it played a crucial role in the decision to make the investment. Accordingly, measuring the amount of resources mobilised in terms of "total project amount" would overstate the effect.

- If two different guarantees covering different elements of a financing package were both reported in the data, then the "total value of project" would be counted twice.

On the other hand, causality can realistically be assumed between a guarantee and the loan or investment it covers, particularly where the guarantee covers a large share of the loan – and this was the approach taken in the survey, e.g. the amount mobilised was defined as the amount of the instrument (loan, equity) to which the guarantee related.



The diagram above illustrates a simple guarantee operation, where a project totalling USD 10 million is funded by an equity stake from Investor 1 (totalling USD 6 million) and a loan from Investor 2 (totalling USD 4 million), with the loan being guaranteed by Guarantor X. According to the survey, therefore, the amount mobilised by Guarantor X in this case was USD 4 million.

Policy conclusion/implication:

- *The best approach for quantifying the resources mobilised by a guarantee is to use the value of the resources backed by the guarantee. In future, if statistical information on guarantees is gathered, this methodology would measure the resources directly mobilised by a guarantee and available for investment – information that is of great interest to the developing countries involved.*

Measuring the catalytic impact of guarantees – the leveraging concept

The survey also looked at how to assess the catalytic effect of guarantees – their ability to leverage resources.

Leverage is most often expressed as a ratio: it compares the amount of resources deployed by the donor agency (donor effort) with the amount of resources made available as a consequence (the result of the donor effort).

There is, however, a fundamental problem in measuring the first term in the ratio – the donor effort. This can only be approximated after assessing the ***probability of default***, since the donor effort is the probability of default, multiplied by the amount covered by the guarantee, minus any premium paid to purchase the guarantee. To take a simplified example, if there is a 30% probability that a guaranteed loan of USD 100 million will not be repaid, but the price of guarantee is only USD 10 million, then the donor effort is 0.3*100 – 10 = USD 20 million.
The real challenge lies in measuring the probability of default: this involves such a large number of risk factors (e.g. commercial, project, political, governance, foreign exchange, etc.) that it would in practice not be worthwhile to attempt to introduce a standard methodology.

Policy conclusion/implication:

- *The leverage ratio is not a good instrument for tracking and comparing country performance in mobilising resources through guarantees because of the difficulty in assessing and capturing the probability of default – necessary for correctly quantifying the donor effort. The difficulties include extensive data demands and problems for finding a common methodology that could apply across different institutions and programmes.*

Next steps

The post-2015 development agenda will call for a financing strategy that includes a wide range of available sources of finance and draws in new actors and instruments. The DAC is exploring how, as a consequence, external development finance could best be measured, incentivised and tracked. This involves coming up with new statistical measures and data presentations against which efforts and initiatives can be assessed – and which will encourage development co-operation actors to provide resources using different instruments and arrangements. Developmental guarantees should be part of the statistical picture of development finance.

In future the DAC will:

- Consider introducing a methodology for measuring and monitoring developmental guarantees, and assess the scope for building a data base for information, analysis and comparison across institutions. An important issue in this consideration will be the extent to which information can be made publicly available, including at the level of individual projects.
- Explore the scope for including guarantees in a new measure, wider than ODA, of external development resources related to official support, as a contribution to global monitoring of development finance in the post-2015 era.

The full length paper, Guarantees for Development, is available through this page:
http://www.oecd.org/dac/stats/guaranteesfordevelopment.htm