Guarantees & risk mitigation instruments

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Recap: risks of water sector

1. Generic risks
   - Political
   - Credit
   - Exchange rate
   - Commercial

2. Specific & disproportionate risks of water
   - Project profile
   - Rate of return
   - Sub-sovereign
   - Contractual & regulatory
Purpose of guarantees

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

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

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

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

Types
- Political: MIGA, other IFIs (through B loans), bilateral official agencies, private companies. A large, well established and active market, with supply well matched to demand.
- Credit: Partial Credit Guarantees by IFC & other IFIs; bilateral donor Partial Loan Guarantees; insurance policies of private Monoline companies.
- Foreign exchange: in practice, not widely available from either private or official agencies (n.b. OPIC, & Camdessus proposal). Local currency guarantees have a similar effect.
### Examples of impact

<table>
<thead>
<tr>
<th>Impact of Partial Credit Guarantee on loan terms</th>
<th>Without guarantee</th>
<th>With guarantee</th>
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</thead>
<tbody>
<tr>
<td>Philippines</td>
<td>3% 7 years</td>
<td>2.5% 15 years</td>
</tr>
<tr>
<td>Uganda</td>
<td>8% n.a.</td>
<td>3.1% 16 years</td>
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<tr>
<td>Bangladesh</td>
<td>3% 1 year</td>
<td>2% 13 years</td>
</tr>
<tr>
<td>Ivory Coast</td>
<td>3% 1 year</td>
<td>2.75% 12 years</td>
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<tr>
<td>China: maturity</td>
<td>7 yr</td>
<td>15 yr</td>
</tr>
<tr>
<td>Pakistan: maturity</td>
<td>3 yr</td>
<td>15 yr</td>
</tr>
<tr>
<td>Jordan: maturity</td>
<td>2 yr</td>
<td>7 yr</td>
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Other risk sharing methods

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

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