MOBILIZING PRIVATE FINANCE WITH IBRD/IDA GUARANTEES TO BRIDGE THE INFRASTRUCTURE FUNDING GAP

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Executive Summary

Despite increasing private investments, public funding still accounts for the largest share of infrastructure finance in developing countries. Public funding is not sufficient, though, to close the gap between infrastructure needs and available funds. The World Bank is improving its products and revising its business processes in order to mobilize more private capital and close the funding gaps that impede so many developing economies.

Public-private partnerships (PPPs) offer alternatives to attract new sources of private financing and management while maintaining a public presence in ownership and strategic policy-setting. These partnerships can leverage public funds and offer advantages of contracting with well-qualified private enterprises to manage and deliver infrastructure services. They are not panaceas and they require clear goals and objectives, good public leadership, and strong government institutional capacities for effective implementation. Experience has demonstrated that the best way to attract more private capital into infrastructure is to provide a sustainable and credible policy and regulatory framework. Risk allocation – balanced in line with rewards – between the public and private partners is key to the success of these partnerships. The provision of new risk mitigation instruments and the deepening of local capital markets also contribute to the sustainability of PPPs.[2]

Where markets and institutions are not sufficiently developed to attract private participation, innovative risk mitigation instruments and applications can help to bridge the infrastructure funding gap. The World Bank provides practical tools to help address

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[1] The Department is an anchor unit for the World Bank's Sustainable Development Network. It provides global support across sectors (i.e., energy, water, transport, telecoms) in the areas of economics and finance to governments and private clients. This note builds on previous research and papers done by the FEU Department and by other World Bank Infrastructure Units. Particular contributions to the note were provided by Dhruva Sahai (FEU), Maria Clemencia Sierra Penas (IFC) and Ellis J. Juan (Manager, FEU), with comments received from Miguuel Navarro-Martin (Banking, Capital Markets and Engineering), Kyoichi Shimazaki, Tomoko Matsukawa, Andres Londono and Scott Sinclair (FEU). This volume is a product of the staff of the International Bank for Reconstruction and Development/ The World Bank. The findings, interpretations, and conclusions expressed in this paper do not necessarily reflect the views of the Executive Directors of The World Bank or the governments they represent. The World Bank does not guarantee the accuracy of the data included in this work. The boundaries, colors, denominations, and other information shown on any map in this work do not imply any judgment on the part of The World Bank concerning the legal status of any territory or the endorsement or acceptance of such boundaries.The author can be contacted on jdelmon@worldbank.org.

[2] Delmon, J and E. Juan, Euromoney Infrastructure Finance Book 2007, Chapter 10: The Role of Development Banks in Infrastructure Finance, World Bank Views.

specific market and policy risks and leverage larger amounts of private- sector investment. This paper describes the guarantees that the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) use to catalyze private finance for infrastructure. It seeks to demystify these products: partial risk guarantees (PRGs) and partial credit guarantees (PCGs), and help the reader to make a better assessment of when a guarantee would be a useful addition to a project and which product would be the most appropriate. Further information on these guarantee products can be found on www.worldbank.org/guarantees.

If clients lack an investment-grade credit rating, they are often denied access to tools for addressing this vulnerability, or pay prohibitively high prices. For many governments, this challenge is further compounded by weak currencies, underdeveloped local financial markets, and lack of institutional capacity to manage financial risks. To assist clients in managing currency risk, interest rate risk, commodity price risk, liquidity risk (cash flow and rollover), and credit risk, the World Bank offers a menu of products and services that leverage the institution's AAA-rated balance sheet, providing clients with effective risk management tools at very competitive prices to help reduce financial vulnerability and achieve a more desirable cost/risk structure to maximize the developmental impact of specific projects. For additional information on the IBRD/IDA Banking Products visit: treasury@worldbank.org

Section 1 provides background on guarantees and their development within the WBG. Section 2 discusses the WBG's constituent institutions and how they shape their guarantees. Section 3 describes in more detail the guarantees offered by the IBRD/IDA, while Section 4 addresses the extent to which those guarantees can cover key project risks.

1. Background

Developing countries invest on average $300 billion per year (about 5 percent of their GDP) to build, upgrade and maintain their core infrastructure sectors. Of this, 75-80 percent is estimated to come from the public sector, with the rest from the private sector, including foreign investors and creditors.[3] Recent years have witnessed infrastructure's shrinking share of many countries' investment budget, and capital flows have been on a downward trend since the Asian crisis of 1997-98. Linking infrastructure development more effectively with private finance markets would help to leverage and mobilize more capital.

Developing countries are also investing significant resources and government attention to reform their infrastructure sectors and improve the efficiency of infrastructure

[3] Dailami, M; July 2003; Re-engaging in Infrastructure – A Finance Perspective; International Finance Team, Development Prospects Group.

procurement and management, often through private participation. Private investors considering such participation will analyze the risks involved (such as political and market risks) when deciding whether to invest and how much return they will need on that investment to justify taking those risks. Where the main conditions for infrastructure finance are not sufficiently developed to attract private participation at an affordable cost, guarantees can catalyze private capital flows and reduce the cost of private capital to bridge the infrastructure funding gap.

WBG has been catalytic in leveraging financing from private markets with its risk mitigation instruments. Its guarantees can open new financing sources, reduce costs of capital, and extend maturities by providing coverage for risks that the market is unable or unwilling to bear. WBG's participation as guarantor can support transparency and improve market confidence, but cannot make fundamentally unviable projects, viable.

2. The World Bank Group

The WBG is made up of five affiliates:

i. **The World Bank** is composed of the **International Bank for Reconstruction and Development (IBRD),** and the **International Development Association (IDA).** Both institutions support economic development and poverty reduction by catalyzing public and private capital and by supporting sovereign governments. The World Bank aims to help its client countries mobilize resources and attract private financing by offering traditional and innovative financial instruments, such as different lending products, risk mitigation arrangements, guarantees, sub-national financing solutions, and output-based aid products. The World Bank offers PRGs and PCGs.

ii. The **International Finance Corporation (IFC**) promotes economic development by encouraging the growth of productive private enterprises in developing member countries. IFC's investments in emerging-market companies and financial institutions create jobs, build economies, and reduce poverty. IFC's role is to bridge the credit gap between its clients and the market, by offering private clients access to financial products which they may not have on a direct basis due to credit or country risk. The IFC offers PCGs.

iii. The **Multilateral Investment Guaranty Agency (MIGA**) promotes the flow of foreign direct investments by providing three services: political risk insurance for foreign investments, technical assistance to improve investment climates and promote investment opportunities, and dispute mediation to remove investment obstacles. MIGA offers political risk insurance.

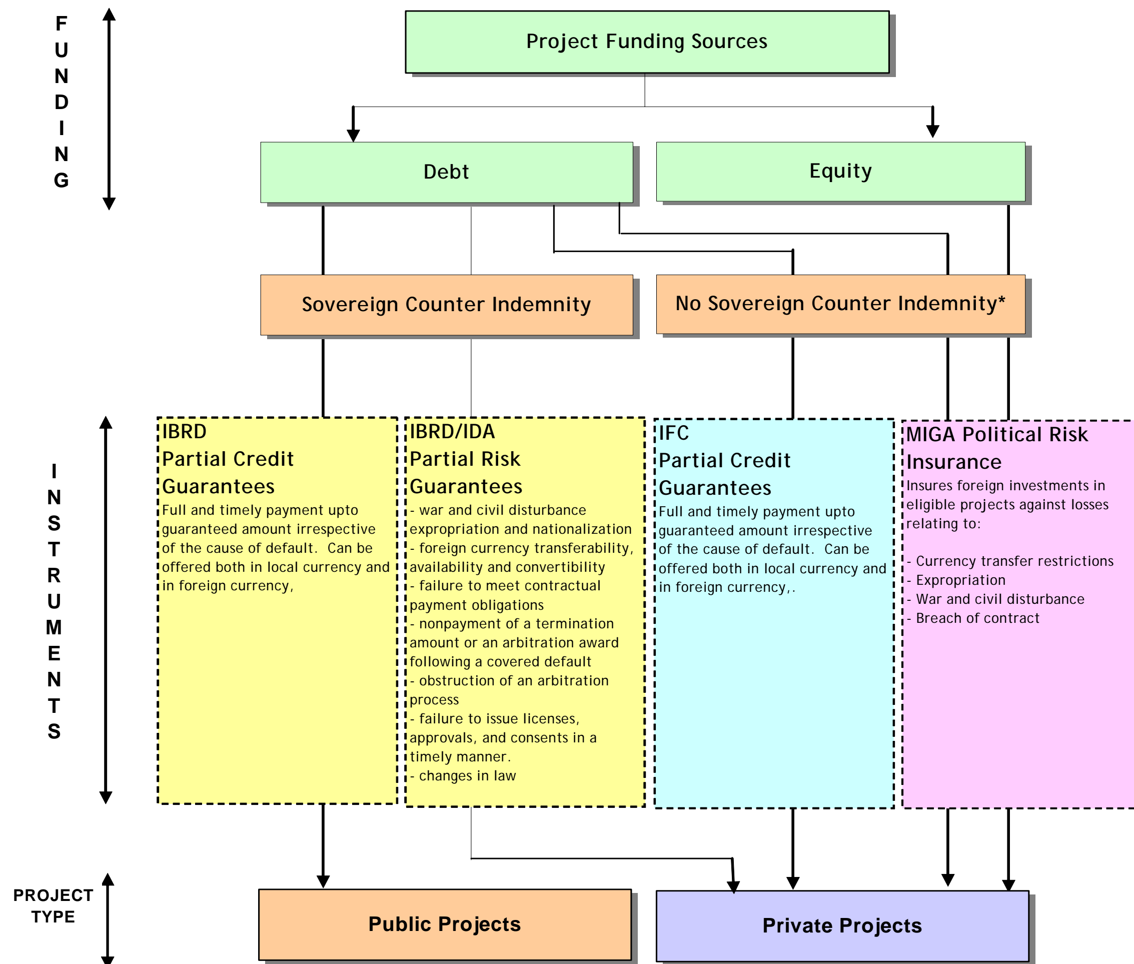
iv. **International Centre for the Settlement of Investment Disputes (ICSID)** provides facilities for the conciliation and arbitration of disputes between member countries

and investors who qualify as nationals of other member countries, with the objective of improving the flow of private capital to developing countries.

Figure 2.1: The World Bank Group

The unique nature of WBG institutions allows them to bundle lending, guarantees, technical assistance, policy dialogue, and knowledge dissemination to promote sectoral reforms and private participation in infrastructure. The institutions are mutually supportive in their mission of global poverty reduction. For instance, the World Bank provides sovereign loans (through IBRD), or concessional credits and grants (through IDA) to developing countries for infrastructure, health, education and other purposes. IFC and MIGA offer market-based financial products primarily for private projects, while ICSID provides a well-regarded dispute resolution facility. The basic characteristics of the WBG guarantees is set out in Figure 2.2.

Figure: 2.2 WBG Product at a Mix and Coverage Options*



3. IBRD/IDA Products

3.1 Characteristics of IBRD/IDA Products

The IBRD and IDA offer two types of guarantees:

- **Partial Risk Guarantees** (PRGs) cover private lenders and investors against debt service default caused by the risk of the government and its agencies or entities failing to perform their contractual obligations with respect to a private investor or lender in private sector projects.
    - ***Enclave Guarantees*** cover projects located in IDA countries but whose purpose is export to IBRD countries. For example, a gas

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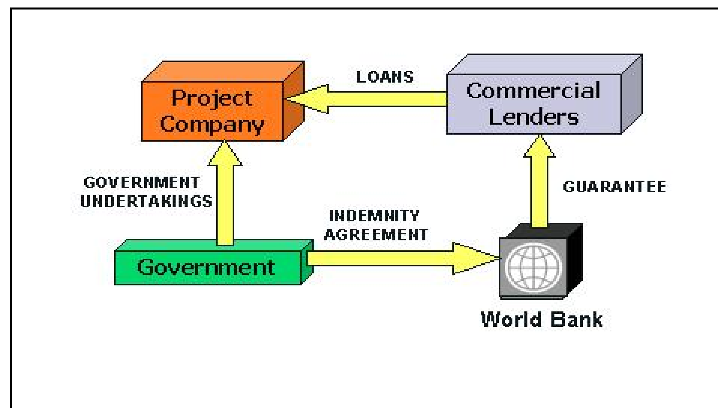
* The MIGA Convention requires that the host member country approve any guarantee operation and provides MIGA with certain rights to recover amounts paid out.

pipeline was built from Mozambique to South Africa, whose purpose was the export of gas to South Africa. An IBRD PRG was provided for the project lenders with a counter-guarantee from Mozambique (an IDA country).

- **Partial Credit Guarantees** (PCGs) cover private lenders against debt service default typically by public sector borrowers. PCGs cover only a portion of debt service i.e. the principal and/or interest payments. PCGs typically provide public sector borrowers with better access to the bank and capital markets by extending maturities and improving borrowing terms.

    - ***Policy Based Guarantees*** (PBGs) help to improve sovereign governments' access to capital markets and support social, institutional, and structural policies and reforms. As a variation of PCGs which are used for investment projects, PBGs are offered for fiscal support under Development Policy Lending (DPL) frameworks to countries with a strong track record of performance.

Figure 3.1 : Sample IBRD-IDA PRG Structure

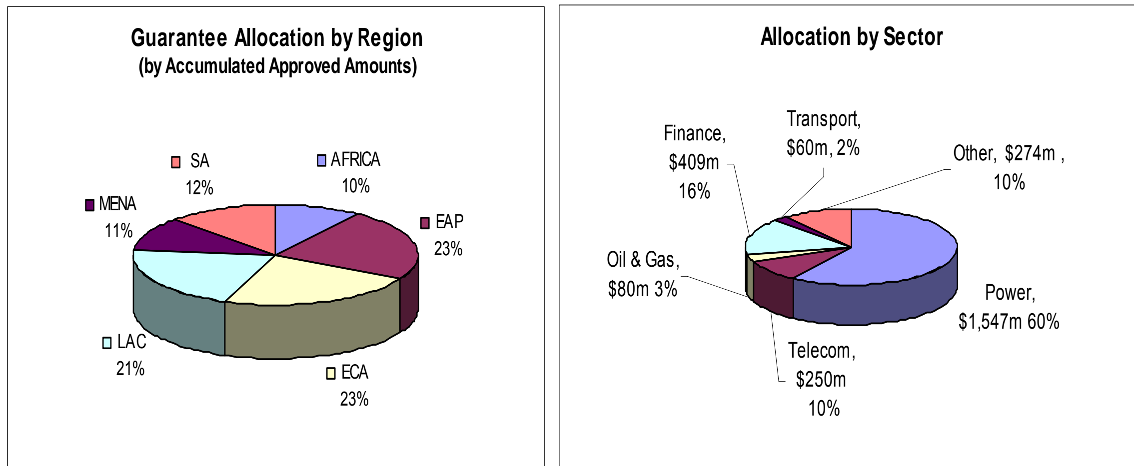


Source: FEU, World Bank (2005)

By end of FY06[4], 31 Guarantee operations had been approved, with an estimated US$ 10.2 billion of private capital mobilized, and a total approved amount of about US$ 2.5 billion. These include 8 partial credit, 19 partial risk and 2 policy-based guarantees. The Bank's portfolio of 31 Guarantees is spread through six regions, with AFR (Sub Saharan Africa) and EAP (East Asia and Pacific) leading with nine and seven operations respectively followed by ECA (Europe and Central Asia) with four operations. The highest Bank exposure is however concentrated in the EAP and ECA regions. In terms of sector composition, the power sector was the largest recipient of IBRD-IDA guarantees at US$ 1.5 bn.

[4] June 31, 2006

Figure 3.2 IBRD-IDA Guarantee Allocation by Region and by Sector



IBRD offers PRGs and PCGs, and requires a counter-guarantee from the sovereign government. IDA offers PRGs only and does not, by its Articles, have to obtain a government counter-guarantee. This said, the World Bank Board in authorizing IDA PRGs took the policy decision to require a counter-guarantee from the sovereign. This policy, in theory, could be adjusted by decision of the World Bank Board where the logic of requiring a counter-guarantee is outweighed by the benefit to be provided to the client country in the event that no counter-guarantee is required.

The pricing for IBRD PRGs, IBRD PCGs and IDA PRGs for financial year 2007 is set out in Tables 3.3 – 3.5.

Box 1: IDA PCGs

IDA does not offer PCGs, under the premise that IDA countries are not credit-worthy and therefore IDA should not be providing such guarantees for public borrowing.

This logic does not hold true for certain more creditworthy IDA countries (possibly on the verge of graduating to IBRD) who, due to the current buoyant financial markets, are in a position to borrow directly from the international capital markets with yields sufficiently low to justify a decision to pursue such commercial debt.

Such is currently the case in a number IDA countries, including in Sub-Saharan Africa where one such country is planning to issue bonds in the amount of $500 million. In such cases, the development opportunities for IDA of being supportive to client countries borrowing for the first time on the international markets could justify a change of policy to permit IDA PCGs.

Table 3.3: IBRD PRG pricing (in basis points) for FY07

	Fee Type	Fee charged to the borrower[2]
Upfront charges	Initiation Fee	15 bp on the guaranteed amount or USD 100,000 (whichever is higher)
	Processing Fee[1]	Up to 50 bp of the guaranteed amount
Recurring charges	Guarantee Fee (on the maximum aggregate disbursed and outstanding guaranteed debt)	55 bp per annum
	Standby Fee (on the maximum guaranteed debt committed but undisbursed)	25 bp per annum

bp is basis point or .01%.
Source: FEU, World Bank

1. Determined on a case by case basis. Exceptional projects can be charged over 50 bps of the guaranteed amount.
2. Fee charges net of applicable waiver. For example, a front-end fee of 25 bp is normally charged, but has been waived by the IBRD for FY07.

Table 3.4: IBRD PCG pricing (in basis points) for FY07

	Fee Type	Fee charged to the borrower[1]
Recurring charges[2]	Guarantee Fee (on the present value of the guarantee exposure)	50 bp per annum
	Standby Fee (charged on the undisbursed portion of the guarantee exposure)	25 bp per annum

bp is basis point or .01%.
Source: FEU, World Bank

1. Fee charges net of applicable waiver.
2. Charged upfront on a present value basis.

Table 3.5: IDA PRG pricing (in basis points) for FY07

	Fee Type	Fee charged to the borrower
Upfront charges	Initiation Fee[1]	15 bp on the guaranteed amount or USD 100,000 (whichever is higher)
	Processing Fee[1,2]	Up to 50 bp of the guaranteed amount
Recurring charges	Guarantee Fee (on the maximum aggregate disbursed and outstanding guaranteed debt)	75 bp per annum
	Standby Fee[3] (on the maximum guaranteed debt committed but undisbursed)	20 bp per annum

bp is basis point or .01%.
Source: FEU, World Bank

1. For all private sector borrowers, i.e. only applicable to PRGs.
2. Determined on a case by case basis. Exceptional projects can be charged over 50 bps of the guaranteed amount.
3. For guarantees approved in FY07.

It should be noted that 75 percent of the guarantee commitment amount is added to the Country Assistance Program for the recipient country (reducing to 25% the impact of the guarantee on the relevant country allocation); the procurement guidelines of "economy and efficiency" apply for goods and services financed under IBRD-IDA guarantees; and the host government's indemnity of the World Bank does not increase the government's liabilities in accounting terms when the government is already directly obligated to the private sector for the same liabilities.

3.2 PARTIAL RISK GUARANTEES (PRGs)

PRGs primarily cover commercial lenders against debt service default caused by the risk of a government or its agencies/ entities failing to perform on their obligations to a private project, including:

1. Standard political risk, such as:
   - war and civil disturbance;
   - expropriation and nationalization; and
   - foreign currency availability and convertibility.

2. Contractual and regulatory risks, such as:

- failure to meet contractual payment obligations;
- nonpayment of a termination amount or an arbitration award following a covered default;
- obstruction of an arbitration process;
- failure to issue licenses, approvals, and consents in a timely manner; and
- changes in law.

PRG for Romania Electricity Distribution Privatization

The Government of Romania (GOR) initiated its privatization effort in the power sector by launching the tender for the majority shareholding of two of its eight regional electricity distribution companies (Discoms), Banat and Dobrogea. Given the untested performance of the sector regulator, GOR used a World Bank PRG to mitigate regulatory risk perceived by Enel Spa of Italy, the winning bidder. The 5.5 year € 60 million (capped) PRG provides a guarantee for loss of regulated revenues resulting from non-compliance by the regulator and/or change or repeal by GOR of the regulatory framework relating to:

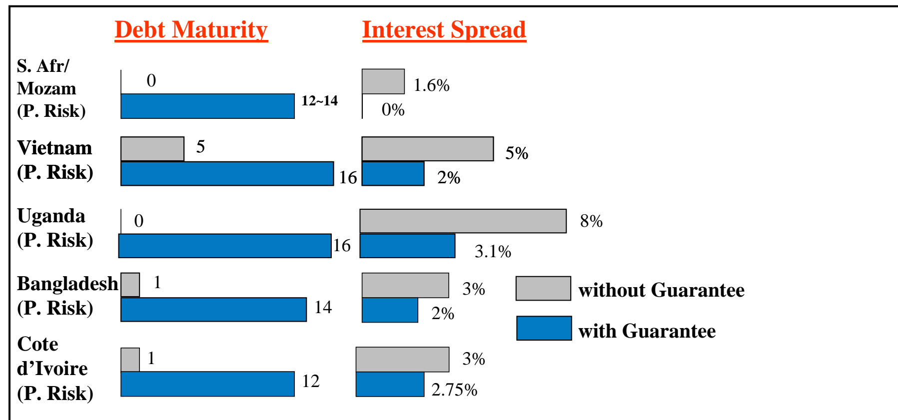
- distribution tariff formula
- full pass through of the electricity costs
- pass through of PRG-related costs

Regulatory framework: Distribution revenues regulated by the National Energy Regulatory Authority are based on a Price Cap/Price Basket based on a guaranteed return, a pre-agreed weighted average cost of capital, performance incentives, and full pass through of electricity costs.

The Letter of Guarantee: GOR opened a Letter of Guarantee (L/G) issued by Citibank Romania in favor of the two privatized Discoms. If the Event of Default is not remedied within the cure periods, the Discoms would be entitled to draw under the L/G. Following the drawing, the Ministry of Public Finance would be obligated to repay Citibank for the amounts drawn plus accrued interest within a period of 12 months. In the event of nonpayment by the Ministry of Public Finance, Citibank Romania would have the right to call on the PRG.

The experience with PRGs suggests that PRGs help to significantly improve the borrowing terms for emerging market infrastructure projects (see Figure 3.3 below). PRGs have leveraged significant amounts of private capital. The US$ 1.6 bn in PRG coverage (as of Jan. 2005) has mobilized US$ 7.2 bn of private capital thus representing a leverage ratio of 4.5:1.

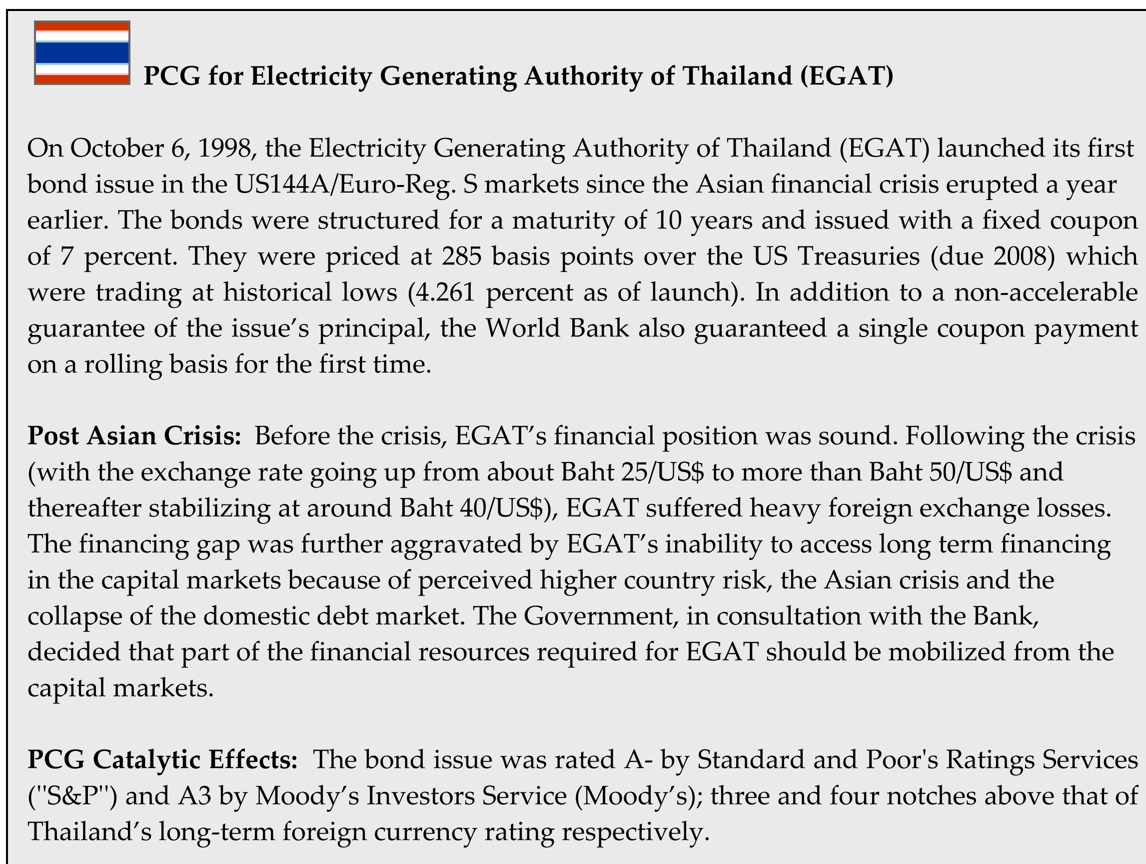
Figure 3.3: PRG Benefits



Source: FEU, World Bank

3.3 PARTIAL CREDIT GUARANTEES (PCGs)

IBRD PCGs cover private lenders and bondholders against all risks during a specified period of the financing term. The main objective of PCGs is to lengthen the maturity of the private debt financing beyond that available in private markets by covering a part of debt service obligations for private loans or bonds. PCGs are generally provided for public projects. The longer maturity and lower borrowing costs substantially improve the terms of commercial debt, leading to lower tariffs for consumers.



PCG for Electricity Generating Authority of Thailand (EGAT)

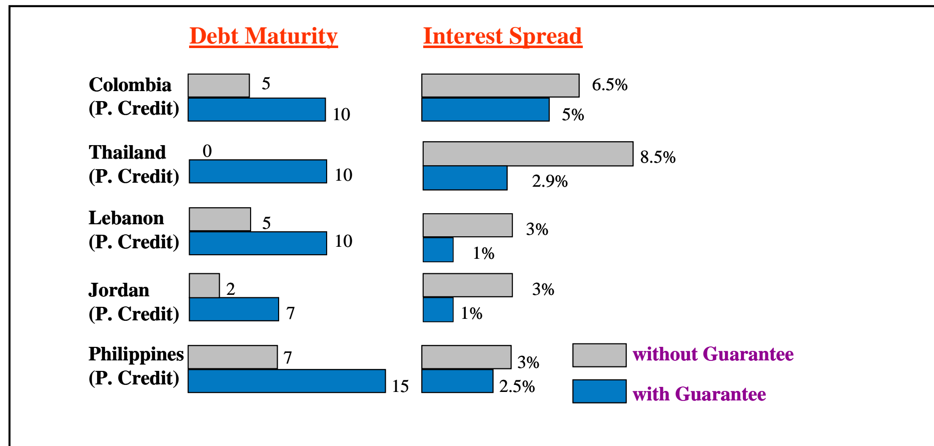
On October 6, 1998, the Electricity Generating Authority of Thailand (EGAT) launched its first bond issue in the US144A/Euro-Reg. S markets since the Asian financial crisis erupted a year earlier. The bonds were structured for a maturity of 10 years and issued with a fixed coupon of 7 percent. They were priced at 285 basis points over the US Treasuries (due 2008) which were trading at historical lows (4.261 percent as of launch). In addition to a non-accelerable guarantee of the issue's principal, the World Bank also guaranteed a single coupon payment on a rolling basis for the first time.

Post Asian Crisis: Before the crisis, EGAT's financial position was sound. Following the crisis (with the exchange rate going up from about Baht 25/US$ to more than Baht 50/US$ and thereafter stabilizing at around Baht 40/US$), EGAT suffered heavy foreign exchange losses. The financing gap was further aggravated by EGAT's inability to access long term financing in the capital markets because of perceived higher country risk, the Asian crisis and the collapse of the domestic debt market. The Government, in consultation with the Bank, decided that part of the financial resources required for EGAT should be mobilized from the capital markets.

PCG Catalytic Effects: The bond issue was rated A- by Standard and Poor's Ratings Services ("S&P") and A3 by Moody's Investors Service (Moody's); three and four notches above that of Thailand's long-term foreign currency rating respectively.

PCGs are flexible instruments, allowing various structures for meeting client needs such as covering bullet principal repayment, later maturities, rolling and non-reinstatable rolling guarantees, and others. PCGs are available only for countries eligible for loans from IBRD. The US$ 925 mn in IBRD PCGs have mobilized US$ 11.3 bn in private capital thus providing a leverage of 12:1. The following are examples of significant improvement in borrowing terms for public borrowers by using PCGs:

Figure 3.4: PCG Benefits



Source: FEU, World Bank

3.4 Benefits of IBRD/IDA Products

The following summarizes the principal benefits of IBRD/IDA guarantees.

For governments, guarantees:

- ***catalyze private financing*** in infrastructure by insulating potential investors from risks that may not be financeable or may result in untenable project costs;
- ***allow lower risk weighting*** for the associated loan thereby reducing the cost of the loan and releasing capacity from financial markets to provide capital for additional projects;
- ***provide access to capital markets*** at competitive terms and encourage co-financing by lowering the cost of borrowing and extending maturities;
- ***reduce the cost of private participation*** by reducing investors' risk, and thereby reduce tariff increases, release value within the associated utility for further investment, increased concession fees and reduce the possibility of project failure;
- ***wholesaling*** enables the Government to offer WBG standards of appraisal,

quality, risk evaluation, supervision and compliance with safeguards for their guarantee program;

- ***support sector reform,*** World Bank support for reform processes can be combined with a guarantee to support project viability, invigorate early stage of reform, and mitigate reversibility risk;

- ***aid crisis management*** enabling crisis stricken countries (possibly suffering temporarily from a degradation of their credit rating) to borrow in global capital markets while also offering opportunities to private insurers to insure/co-insure projects in these countries by mitigating sovereign risk; and

- ***support emerging markets*** by providing cover to emerging market treasury and other public bond issues.

For the private sector, guarantees:

- ***mitigate some risks of lending and investment***, including sovereign/political risks that the private sector does not control, allowing investment in economies where the private sector may not otherwise (due to external or internal controls) be permitted to invest;

- ***improve a project's financial viability, sustainability and bankability***, enabling private-sector investors to access sources of financing, including the capital markets, for projects that might not otherwise attract financing and at a reduced cost of capital. This increases financial viability, bankability and potentially rates of return and decreases the risk of default. For example, WBG guaranteed projects can pierce the sovereign ceiling by achieving a credit rating superior to that of the sovereign thereby lowering the cost of capital;

- ***benefit from Bank Group safeguards***, providing the private investor with additional mitigation of risks such as environmental impact and corrupt practices through robust procurement and safeguard processes;

- ***mitigate risk of breach*** an explicit counter-guarantee is desirable to limit the risk of breach and ensure that the consequence of a breach is felt by the sovereign Government, who is likely to have influence over the responsible public entity;

- ***mitigate regulatory risk***, for example, PRGs can back government tariff and regulatory undertakings; while in the transport sector guarantees can reaffirm governments' minimum revenue/traffic commitments to mobilize private finance; and

- ***reinforce government undertakings*** to a private entity, help attract better bids,

and allow investors to assume increased investment commitments.

4. What investors want to be protected from

Risk is uncertainty, or the perception of uncertainty. The government may seek to reduce those investor risks and thereby attract more private capital, at a lower cost. Risk mitigation instruments allow investors to be compensated in the case of certain adverse events, thereby reducing their risks and, consequently project costs.

Certain risks tend to raise particular concerns for potential private sector investors. Key risk issues can be categorized as: political, breach of contract by government entity, market risk, and default risk. These risks are discussed in more detail below. Figures 4.1 and 4.2 show the relationship between certain of these risks and project costs and revenues. Figures 4.3 and 4.4 provide an overview of the investment cycle, putting project costs and revenues in context.

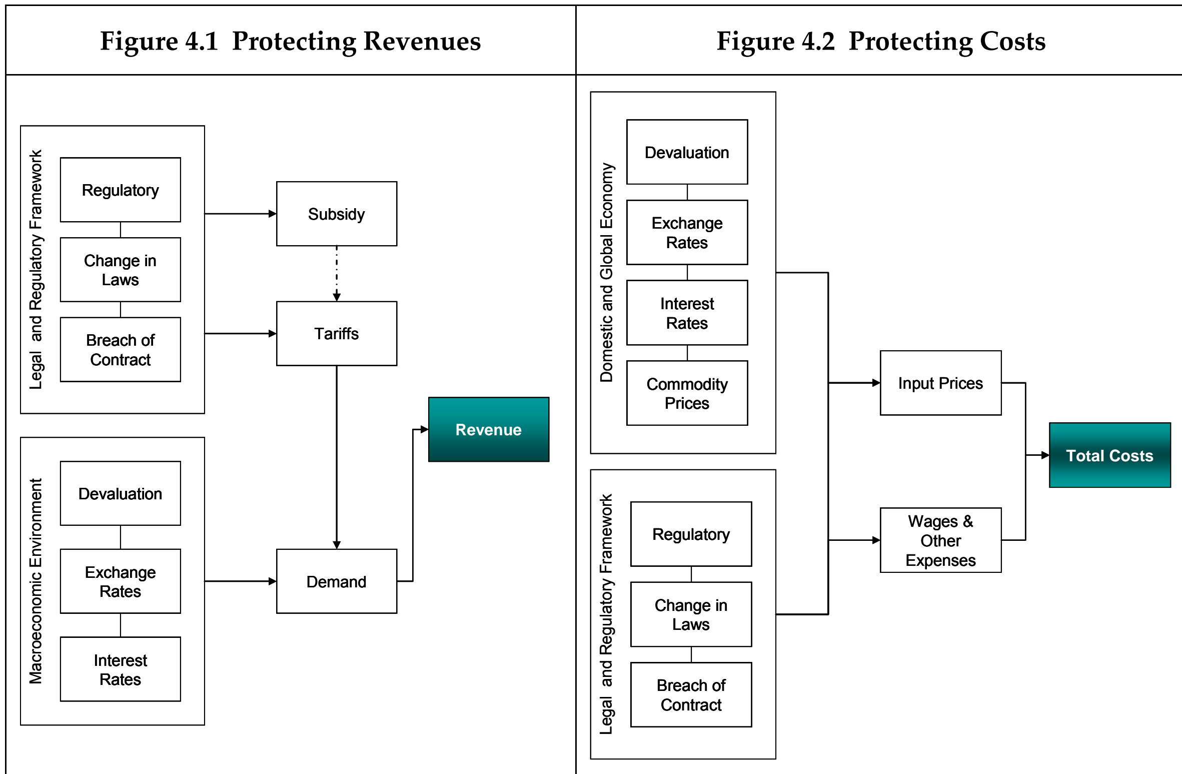


Figure 4.1 Protecting Revenues

Figure 4.2 Protecting Costs

4.1 Political risk

Under a broad definition, political risks are those which arise from the potential impact of governmental, legislative, judicial and political acts. It is difficult to avoid some overlap with other types of risks since political influence can be so pervasive, particularly in emerging markets where institutions and policies may be evolving. The following describes the type of political risks that preoccupy investors.

- ***Convertibility and transferability*** – monetary regulation can limit the extent to which local currency (capital, interest, principal, profits, royalties, or other monetary benefits) can be converted to foreign currency and to which local and foreign currency can be transferred out of the country. These restrictions cause significant problems for foreign investors and lenders who will want to have access to distributions and debt service in foreign currencies and to service their debt abroad. *IBRD/IDA PRGs can cover convertibility and transferability.*

- ***Devaluation*** – certain countries govern conversion of the local currency into foreign currency by legally or administratively fixing the rate or terms of exchange. For example, the exchange rate of the Hong Kong dollar is tied to the US dollar. Revaluation occurs when the government or the relevant regulator decides to modify the exchange rate. Though it may be influenced by macro and micro-economics, revaluation is a political decision. If the currency is not tied to a foreign currency or a basket of currencies, then any change in the relative value of that currency will be the subject of exchange rate risk, discussed below in 5.3. *This risk could be covered by IBRD/IDA PRG as a failure to pay contractual payment to the extent the risk is covered by a contractual obligation of a government entity.*

- ***Expropriation, confiscation and nationalization*** – the government of a country may decide to alter the way assets are owned or managed. An act of the government may therefore reduce or eliminate ownership of, control over, or rights in an asset. Privatization is where the government decides that assets owned and managed by the public sector would be better owned or managed privately and transfers rights to the private sector. Where the government decides that assets currently owned by or under management of the private sector would be better managed by the public sector it can nationalize those assets by confiscating or expropriating them. Most countries have the right to expropriate any asset located in their jurisdictions, subject to restrictions and processes. Most countries (and international law) require the government to pay compensation for the seized assets, but issues arise as to what constitutes fair compensation and how long it takes to get it. *IBRD/IDA PRGs can cover expropriation as a failure to pay contractual payment to the extent the risk is covered by a contractual obligation of a government entity.*

- ***Political violence (including war and civil disturbance)*** – political decisions may result in destruction, disappearance, or physical damage to assets caused by politically motivated acts, be they further to formal declarations of war or acts of civil disobedience. *IBRD/IDA PRGs can cover political violence as a failure to pay contractual payment to the extent the risk is covered by a contractual obligation of a government entity.*

- ***Failure to provide or revocation of licenses, approvals and consents*** – investments in infrastructure require a number of permissions from political entities from different levels of government, involving often heavily decentralized decision processes. *This risk could be covered by IBRD/IDA PRG as a failure to pay contractual payment to the extent the risk is covered by a contractual obligation of a government entity.*

- ***Regulatory decisions*** – secondary legislative powers are delegated to regulatory bodies. Risks arise in relation to the discretion granted to regulators (often subject to political influence) over issues key to the investment, in particular pricing (such as tariffs or tolls) standards of performance and who is entitled to receive services. It should be noted that currency risk as defined above is a regulatory risk, which is normally treated separately by guarantees. *This risk could be covered by IBRD/IDA PRG as a failure to pay contractual payment to the extent the risk is covered by a contractual obligation of a government entity.*

- ***Change in law or tax*** – legislative powers may be used to change laws or pass new laws inconsistent with the arrangements on which the investor is relying for his return on investment. *This risk could be covered by IBRD/IDA PRG as a failure to pay contractual payment to the extent the risk is covered by a contractual obligation of a government entity.*

4.2 Breach of Contract by Government entity

Though likely associated directly or indirectly with a political decision, breach or repudiation of contract by a government entity can result from a number of influences, and often by neglect or lack of resources. The types of contractual breaches that raise particular concerns include:

- ***Non-payment*** of amounts due under contract, including fees for services, tariff shortfall compensation, damages, penalties, termination amounts, subsidies, and compensation for change in law or failure to provide licenses, approvals or permits.

- ***Frustration of contractual arbitration processes***.

- ***Non-payment of contractual arbitration award***.

Breach of contract by a Government entity raises particular concerns in Public Private Partnership projects, where the private investor will rely on the Government for the project revenue stream, or to supplement payments made by consumers. *IBRD/IDA PRGs can cover breach by a government entity of a contractual obligation.*

4.3 Market risk

Other risks relate to macro-economic and market influences that create uncertainties around the financial fundamentals of the project. These are not under the direct control of any of the parties and are therefore difficult to manage.

- ***Foreign exchange rate*** – where the local currency floats freely against other currencies, the currency markets define the relative value of the local currency. Foreign exchange rate risk arises where the local currency's value decreases relative to the currency of investment or debt, which then increases the cost of debt in local currency and decreases the return on investment in the currency of investment. *This risk could be covered by IBRD/IDA PRG as a failure to pay contractual payment to the extent the risk is covered by a contractual obligation of a government entity.*

- ***Commodity price*** – project profitability may rely on the price of a given commodity, for example a coal fired power plant will rely on the price of coal. Commodity price risk arises if the actual price of the commodity could change in a way that is contrary to the interests of the investors. Commodity prices are usually set by the regional or international market, and but may be under direct control of the government. *This risk could be covered by IBRD/IDA PRG as a failure to pay contractual payment to the extent the risk is covered by a contractual obligation of a government entity.*

- ***Interest rate changes*** – projects financed with variable rate debt are subject to the risk that the interest rate charged (based on the market cost of money) will increase more than anticipated, increasing the cost of debt and reducing return on investment. Given the volatility of interest rates, most privately financed infrastructure projects seek fixed rate lending. *IBRD PCGs can cover fixed or floating rate based debt service requirements.*

- ***Access to financing*** – infrastructure requires large, long-term investments, usually 10 to 20 years. It may be difficult to access large amounts of long tenor debt in some financial markets. Project sponsors looking to finance an infrastructure project will bear the risk of the liquidity and depth of relevant financial markets. Where the local financial markets are insufficiently liquid or

deep, the sponsor will borrow abroad, with the associated cost and currency mismatch risks. *IBRD PCGs can be used to extend debt tenor by covering debt service requirements for long term instruments.*

- ***Demand*** – a variety of market influences affect demand for the product or service produced by the project, including demographic changes, competition and changing technology. Where demand falls, revenues may not reach anticipated levels and profits may suffer. *This risk could be covered by IBRD/IDA PRG as a failure to pay contractual payment to the extent the risk is covered by a contractual obligation of a government entity.*

4.4 Default risk

Underlying many of the risks discussed above are lenders' concerns that the borrower will default on its payments of principal and/or interest (Figures 4.3 and 4.4 show the investment cycle that supports debt service payments). Default risk is also based on qualitative assessments of the borrower's credit risk such as perceptions of quality of management, market position of the borrower and the effectiveness of governance mechanisms. *IBRD PCGs can cover default risk for public borrowing and IBRD/IDA PRGs can mitigate default risk for private projects.*

Figure 4.3 Investment Cycle

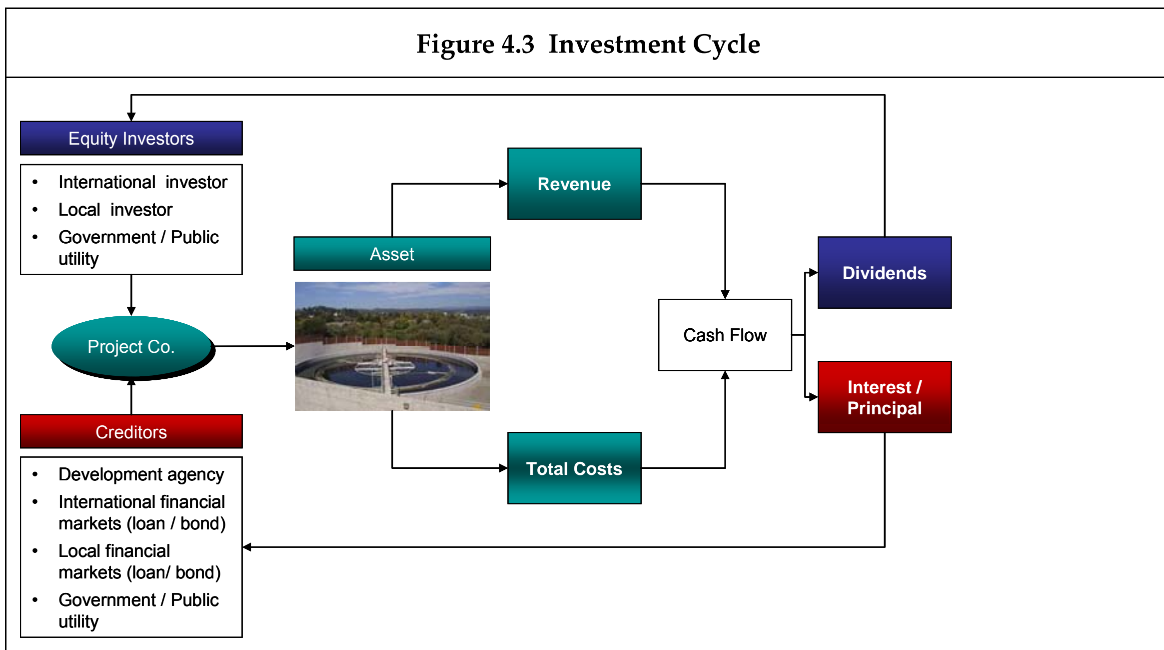
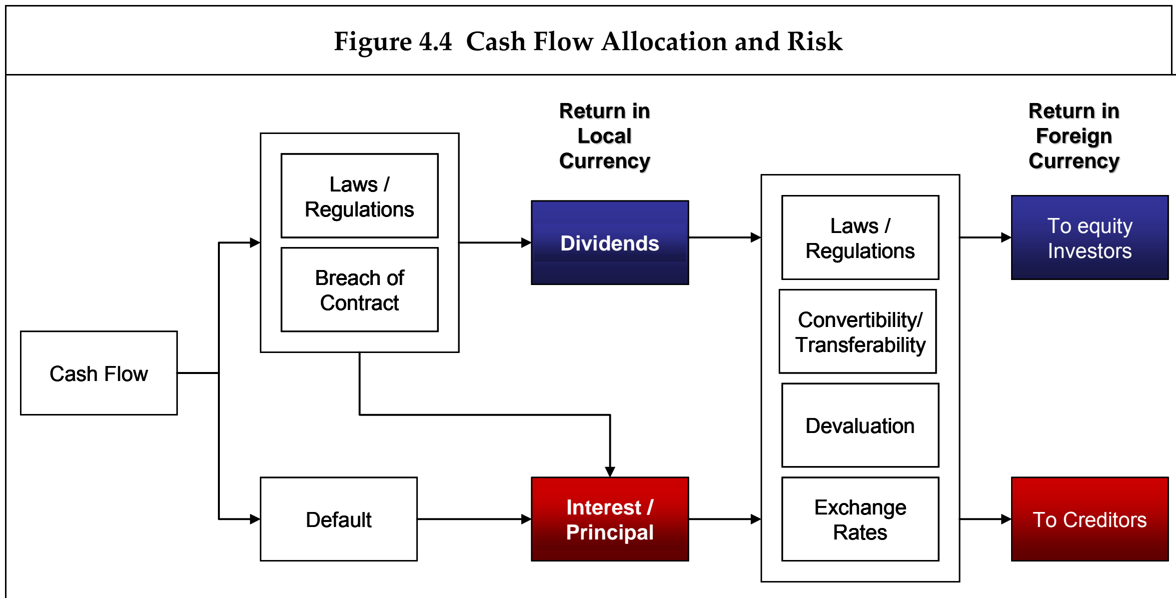


Figure 4.4 Cash Flow Allocation and Risk



5. Conclusion

The IBRD/IDA guarantee products provide options for managing and mitigating the key risks that constrain private sector investment; and thereby mobilize the private capital needed to close the infrastructure funding gaps that impede so many developing economies. These guarantees are designed to be flexible, responsive to client needs and focused on market requirements. For further assistance when considering the application of IBRD/IDA guarantees, please contact:

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