

# Executive Summary

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**N**otwithstanding the dramatic growth in private financial flows to developing countries, there is significant untapped potential for greater involvement of the private sector in financing development-oriented investments. Foreign direct investment and private capital flows are highly concentrated geographically: almost half of foreign direct investment goes to the top five destinations (World Bank 2007a).

These flows bypass many high-risk countries, with the exception of some that are directed to extractive industries. Regulatory and contractual risks, particularly in infrastructure, have inhibited investment and threaten the sustainability of economic growth in large portions of the developing world. A core task of the World Bank Group (WBG) is to support the flow of private investment: guarantees have been among the instruments used to achieve this.

This evaluation reviews the WBG's experience with guarantee instruments during 1990–2007.<sup>1</sup> Although these instruments have been an established product line of the WBG for two decades, they have not been rigorously evaluated across the World Bank, International Finance Corporation (IFC), and Multilateral Investment Guarantee Agency (MIGA).

The study asks three main questions: (1) Should the WBG be in the guarantee business? (2) Have guarantee instruments in the three WBG institutions been used to their potential as reflected in WBG expectations and perceived demand? (3) Is the WBG appropriately organized to deliver its range of guarantee products in an effective and efficient manner?

The answer provided by the evaluation to the first question is yes. Guarantees have been effective in promoting key WBG strategic objec-

tives, particularly in facilitating the flow of investment to high-risk sectors and countries. The additionality—or unique contribution of these guarantee instruments—has derived from the WBG's relationship with host countries, its capacity to absorb risks that the private sector is unwilling or unable to bear, and its focus on the objectives of poverty reduction and sustainable development. Guarantee instruments remain important for the WBG's priorities.

The answer to the other two questions is essentially no, especially regarding the delivery of products for political risk mitigation (PRM). The use of guarantee products in each of the three institutions has fallen short of reasonable expectations because of external and internal factors. Considering external factors, demand projections appear to have been overly optimistic. This is particularly true in infrastructure, where the rapid growth of the mid-1990s has not been sustained. In addition, the supply of risk mitigation offerings by other private sector providers in emerging markets has also grown in both products and markets.

The internal factors for the negative answers include (1) competition among institutions for the same clients and of the kind that often imposes additional transaction costs on clients and adds reputational risks to the Bank; (2) weaknesses in the marketing of WBG guarantees and PRM products that limit client awareness and choice; (3) a

range of supply-driven policy and mandate restrictions that inhibit the deployment of WBG guarantee instruments in response to evolving client needs; (4) limited internal awareness, skills, or incentives in the World Bank and IFC to use guarantee instruments in relevant situations; and (5) inconsistent pricing of the Bank Group PRM products, which runs the risk of creating market distortions and product differentiation among WBG instruments based on price. These suggest opportunities to productively expand the use of guarantees.

To overcome the current limitations of the delivery system of WBG guarantees and PRM instruments and to enhance their use and development potential, the evaluation recommends that WBG senior management take a strategic approach and decide whether to maintain the existing organizational structure, while addressing some of its important problems, or to develop and propose an alternative organizational structure to the Board.

Under any scenario, WBG senior management needs to take actions to introduce greater flexibility in the use of guarantee instruments in response to dynamic country and client needs and market developments by taking several actions: (1) revising existing policies and regulations on guarantees to minimize supply-driven product restrictions and allow product differentiation on the basis of value added; (2) ensuring that adequate incentives exist for staff to offer the full array of WBG guarantees and PRM products to private sector clients; (3) establishing more systematic links between advisory services and the deployment of Bank Group PRM instruments and other products, particularly in infrastructure; (4) following a consistent approach to pricing of PRM across its guarantee instruments to avoid potential distortions; and (5) strengthening internal awareness of the guarantee instruments and the skills for their use and reducing transaction costs where possible, keeping in mind the importance of maintaining adequate processes and regulations for risk management and safeguards.

If a new organizational structure is developed and proposed, this evaluation recommends that

WBG senior management consider at least three alternative perspectives for organizational realignment: the client perspective, the country perspective, and the product perspective. If the current organizational structure is maintained, the study recommends that the management of each individual WBG institution enhance the delivery of its own guarantee/insurance products by implementing specific measures designed to improve policies and procedures, eliminate disincentives, increase flexibility, and strengthen skills for the deployment of the products.

### **Should the World Bank Group Be in the Guarantee Business?**

**Guarantee instruments have been largely effective in supporting WBG strategic objectives.** Across the WBG, guarantees have effectively promoted private investment. Since 1990, MIGA has issued 897 guarantees for a total of \$16.7 billion. Its guarantees supported investment flows across a broad range of high-risk sectors and countries and for small and medium-size investments.

The World Bank has issued 25 guarantees for \$3 billion. Although limited in number, its Partial Risk Guarantees have facilitated the flow of investment in large infrastructure projects in high-risk countries, particularly by enhancing the credibility of untested regulatory regimes. The International Bank for Reconstruction and Development's Partial Credit Guarantees have been used to introduce well-performing countries to markets or to regain access following crises.

IFC has approved 196 guarantee operations for \$2.8 billion, including through its Global Trade Finance Program. More than 30 percent of its guarantees have been used to support trade and investment flows in Africa. They have also enhanced access to financing for micro, small, and medium-size enterprises in low-income countries.

Guarantees account for 1.6 percent of the International Bank for Reconstruction and Development's loan portfolio and 6 percent of IFC's. That compares with 2 to 4 percent of the portfolios in other multilaterals examined in this study.

**The WBG's additionality in risk mitigation derives from its relationship with governments and its contribution to broader development objectives.** Each institution has issued a substantial proportion of its guarantees in high-risk countries: 45 percent in MIGA, 46 percent in IFC, and 48 percent in the World Bank.

The WBG's additionality in mitigating risk is largely derived from its special relationship with governments, which enables it to absorb higher risks than private sector providers can take on. MIGA remains the largest multilateral provider of traditional political risk insurance in the world and has filled a gap in the market by providing longer-term insurance in higher-risk countries. World Bank guarantees have helped further both policy reforms and the environment for private investment. IFC guarantees have supported financial innovation and capital market development by introducing new financial instruments to new classes of investors. More than half of IFC's commitments under the Global Trade Finance Program were in Africa, which has helped address a gap in the market for trade finance.

### **Have WBG Guarantees Been Used to Potential as Reflected in WBG Expectations and Perceived Demand?**

**Whereas guarantee instruments remain an important tool for supporting WBG strategic priorities, the use of the instruments has fallen short of WBG expectations to varying degrees.** Several factors contribute to the perception that there is significant unmet demand for WBG guarantee instruments: (1) Political risk is consistently ranked as a main constraint to the flow of foreign direct investment to developing countries; (2) regulatory and contractual risks are perceived as the main reason for the growing investment gaps in infrastructure; and (3) abundant liquidity in emerging markets calls not for external funding but for enhancements that can help deepen the market, extend maturities, lower spreads, and redirect resources to underserved market segments and new areas unfamiliar to financiers in emerging markets.

A large number of developing countries and sectors do not receive enough funding because of perceptions of high risks that the private sector is unable to mitigate. In light of significant potential demand, and given the importance of the instrument for the WBG's strategic priorities, various strategies and policies have anticipated a significant increase in the deployment of guarantees. Relative to these expectations and to perceived demand, the use of WBG guarantees has been modest.

**Some external factors explain limited deployment.** The WBG has had overly optimistic expectations, particularly in the case of public-private partnerships across a range of infrastructure sectors based on rapid growth in the mid-1990s. These have not been realized in part because of perceived high regulatory and contractual risks. Some studies indicate that 65 percent of investors self-insure rather than taking third-party insurance, suggesting a more limited effective demand. Private sector providers of risk mitigation products have expanded their coverage in terms of both products and markets. Liquid markets in the 2000s have reduced the demand for sovereign Partial Credit Guarantees.

**Internal factors have also constrained the deployment of instruments.** MIGA's Convention and Operational Regulations limit its adaptability to new market trends. MIGA has also not been sufficiently aggressive in innovating within the flexibility allowed by current policies. Internal constraints to the deployment of Bank guarantees include the application of standards designed for public sector operations to private sector projects; a depletion of skills; and lack of both internal and external promotion of the instrument. IFC has tended to apply a traditional project financier's approach to guarantee-type instruments. It has taken an overly conservative stance toward risk-sharing facilities, which has constrained their utilization.

Although some progress has been made in innovation, there has been limited replication and scaling up. Processing requirements in terms of safeguards and risk management in each of the

three institutions have added value and must be maintained and strengthened. But inefficiencies that encumber processes need to be improved upon.

### **Is the Bank Group Appropriately Organized to Deliver the Range of Guarantee Products?**

**There is an overlap in the provision of PRM products within the WBG.** The WBG's guarantee instruments were designed to be complementary, not competitive. However, a range of both guarantee and nonguarantee products overlap in the provision of PRM for private sector clients, and this overlap has tended to expand over time.

Flexibility of policies and innovation in guarantee and nonguarantee products have expanded the scope for competition. In addition, several nonguarantee IFC products offer PRM to the market. IFC's lending and equity investments carry a degree of implicit political risk cover, and its B-loan program can mitigate transfer and convertibility risk through the umbrella of IFC's preferred creditor status. The PRM products of the three WBG institutions serve the same broad group of clients, and there is evidence that these overlaps have caused confusion among clients and internal competition of the kind that often imposes additional transaction costs on clients and adds reputational risks to the Bank.

**At the same time, each institution's products carry distinct attributes that help define market niches.** The package of services accompanying Bank/International Development Association (IDA) Partial Risk Guarantees makes them appropriate in situations of large, complex public-private partnerships in untested regulatory environments and difficult business climates. IFC's PRM can be packaged with a full set of financial services and combined with commercial risk cover. MIGA products can offer flexible, self-standing political risk coverage that is least disruptive of the project financial structuring process and that can match the need for longer-term cover and reach smaller investors. Thus relationships of both substitutability and complemen-

tarity exist among the WBG PRM instruments, which implies that there are opportunities for cooperation and a need for coordination.

The three WBG institutions have cooperated on guarantee projects in several instances, but such cooperation has often been associated with high transaction costs. In selected cases, the three WBG institutions have cooperated on the same projects, particularly large, complex projects in IDA countries. At the same time, this cooperation has often been associated with higher transaction costs, for both the institutions and the clients. In one project, the participation of the Bank, MIGA, and a third multilateral insurance provider required the project sponsor to enter into three contractual agreements, each with different structures, coverage, and mechanics.

The IDA-IFC program to enhance small and medium-size enterprise access to finance in Africa, although achieving development outcomes, has been difficult to replicate, because it has been difficult to mobilize IDA resources for first loss provisions. The need to fit these operations into existing IDA operations has also been a limitation, and different procurement and conflict of interest policies within the WBG have added to transaction costs.

The establishment of the joint IFC-Bank Subnational Finance Department has institutionalized synergies between IFC and the Bank in subnational finance. However, it has been difficult to come up with mechanisms to reward Bank staff for contributions to an IFC project. And despite attempts to resolve the pledge of shares and sharing of arbitral awards issues related to the allocation of collateral assets between lenders and insurers, they continue to hinder direct IFC-MIGA cooperation.

**Mechanisms to enhance coordination across the WBG have had varying degrees of effectiveness.** More systematic consultations between MIGA and Bank country and sector departments have helped ensure that MIGA-supported projects are consistent with the Bank

Group’s strategy in a country. But the principles that govern the relationship between MIGA and IFC products have been unclear. The “hierarchy of instrument” principle—which dictates that Bank products be deployed last—has provided some guidance, but implementation has been difficult. A Group-wide Guarantee Review Committee had limited success in harmonizing approaches and added to transaction costs. Its functions have now been transferred to the Operations Committee of the Bank. In some cases, informal information sharing about business opportunities has been effective in leading to actual guarantee projects.

**There is limited coordination within the WBG in developing new products and at the business development stage.** Lack of staff incentives, inadequate skills, and poor familiarity with the products of the other institutions have prevented better exploitation of downstream synergies in marketing WBG products. Significant potential exists for more systematic links between Bank-IFC advisory services and the use of WBG risk mitigation instruments, particularly in infrastructure, keeping in mind the need to manage potential conflict of interest issues. The Bank and MIGA apply different approaches to pricing of political risk in their products for private sector clients, which limits the effectiveness of coordination through the market. Products are not offered as a single menu of options to prospective private sector clients. In sum, opportunities exist for improvement, and maintaining the status quo should not be an option.

## Recommendations

**To overcome the current limitations of the delivery system of WBG guarantees and PRM instruments and to enhance their use and development potential, the Independent Evaluation Group recommends the following to WBG senior management:**

1. **Take a strategic approach and make a decision whether to maintain the existing organizational structure while addressing some of the important problems, or develop and propose an alternative organizational structure to the Board.**
2. **Under any scenario, take action to introduce greater flexibility in the use of guarantee instruments in response to dynamic country and client needs and market developments by—**
  - Revising existing policies and regulations on guarantees to minimize supply-driven product restrictions where most needed and to allow product differentiation on the basis of value added
  - Ensuring that adequate incentives exist for staff to offer the full array of WBG guarantees and PRM products to private sector clients within a single menu of options
  - Establishing more systematic links between advisory services and the deployment of PRM instruments and other products, particularly in infrastructure
  - Following a consistent approach to pricing of PRM across its guarantee instruments to avoid potential distortions
  - Strengthening internal awareness of the guarantee instruments and the incentives and skills for their use and reducing transaction costs where possible, keeping in mind the importance of maintaining adequate processes and regulations for risk management.
3. **If a new organizational structure is developed and proposed, consider at least three alternative perspectives for organizational realignment: the client perspective, the country perspective, and the product perspective.**
  - Under the client approach, all products for private sector clients, including guarantees and PRM instruments, would be offered through a single window.
  - Under the country approach, the deployment of WBG guarantee and PRM products would be made according to country needs, under a management arrangement common for all three institutions.

- Under the product approach, the bulk of guarantee/insurance products would be managed under one institutional roof.
- 4. If the current organizational structure is maintained, direct the management of each individual WBG institution to enhance the delivery of its own guarantee/insurance products by taking actions to improve policies and procedures, eliminate disincentives, increase flexibility, and strengthen skills for the deployment of the products.**