

Management Response

Management welcomes the opportunity to provide its revised response to the evaluation of the use of World Bank Group (WBG) guarantee instruments, prepared jointly by the three Independent Evaluation Group (IEG) units of the WBG: IEG–World Bank, IEG–International Finance Corporation (IFC), and IEG–Multilateral Investment Guarantee Agency (MIGA).

Management agrees with IEG’s conclusions that WBG guarantee instruments have evolved over the last 17 years; they now have the ability to provide support to clients across a large and diverse spectrum of investments under a variety of institutional structures, and they have played an important role in mobilizing private capital. Management also agrees with the thrust of several of the recommendations for exploring ways to ensure that guarantees are used as effectively as possible, including improving coordination and marketing. Management notes that these improvements need to be carried out in a manner that ensures that Bank Group risk mitigation instruments complement—not supplant—private sector risk mitigation instruments and provide true additionality.

Management Comments

Management is pleased that the IEG report reflects management’s view that guarantee products have proven to be useful instruments in helping the WBG fulfill its mission. Recent experiences tell us that more could be done to optimize the use of guarantee products to meet WBG clients’ demand.

Building on the strengths of WBG institutions

Although management shares the report’s view that there are opportunities to increase the effectiveness of the WBG guarantee products, it has concerns about the manner by which the evaluation was conducted. Management believes that in an attempt to generate overarching conclusions, the report has “oversynthesized” issues as relevant

to all parts of the WBG, when most are relevant to one, sometimes two, but seldom all three institutions. As a result, management believes the report missed an opportunity to appropriately inform the WBG on how it could build on the strength in the difference in the mandates, client bases, and guarantee products of each institution.

Differences in mandates of MIGA, IFC, and the Bank

Each WBG institution has a mandate that is defined under its charter. According to these mandates, each member of the group serves the needs of its clients. The International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) clients are, first and foremost, member governments. IBRD and IDA guarantees, which require a sovereign counter-guarantee, play a role that is distinctly different from that of MIGA insurance and IFC guarantees. This difference is evident in the structure and use pattern of these products: IFC guarantees do not have a sovereign counter-guarantee and are used chiefly as unfunded loans to support primarily private sector clients; MIGA provides mitigation of political risk for cross-border investments. Bank guarantees are mostly used for complex projects in high-risk situations that require government commitment, with the ongoing Bank engagement with the country and the sector as primary factors in choosing this instrument. In fact, only a small fraction of these guarantee products have a common risk mitigation function. It also points out that multilaterals

that have unified structures have an equal or smaller share of guarantees in their product mix than the WBG does.

Summary of Management Actions

Even prior to the IEG report, management has been working to identify opportunities for increasing synergies in the WBG guarantee products. Subsequent to the Committee on Development Effectiveness discussion of the IEG report in May 2008, management has been engaged in a process of further analysis and has identified two broad areas for improvement: (1) a set of issues specific to each institution and (2) more effective collaboration among the Bank, IFC, and MIGA on joint solutions in support of ultimate clients (essentially governments in the case of the Bank and private sector entities in the case of MIGA and IFC). Management is now working to put these improvements in place.

Institutional issues

MIGA has embarked on a wide-ranging set of initiatives to better serve its clients. The Bank has also launched a focused effort toward realizing the

full potential of IBRD and IDA guarantee products. The effort is aimed at removing constraints to the effective deployment of guarantees, looking at issues of policy, organization, and incentives.

More effective collaboration

At the same time, work is under way on more effective collaboration, notably between MIGA and the Bank and between MIGA and IFC, given the very different nature of Bank and IFC clients. For MIGA and the Bank, the focus is on joint organization and underwriting of large, complex infrastructure projects. For MIGA and IFC, the focus is on working out a claims cooperation framework and on piloting cross-marketing of products and services.

Conclusions

Again, management welcomes this evaluation and finds its analysis useful for ongoing work on improving effectiveness of the use of its guarantee and insurance tools. Management agrees with and is acting on several of IEG's recommendations. Detailed responses to IEG's recommendations are given in the Management Action Record.

Management Action Record	
Recommendations	Management response
<p>To overcome the current limitations of the delivery system of WBG guarantees and political risk mitigation (PRM) instruments and enhance its use and development potential, IEG recommends the following to WBG senior management:</p>	<p>Partially agreed with regard to incentives and staff awareness, as noted below.</p>
<p>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.</p> <p>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—</p> <ul style="list-style-type: none"> • 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 WBG PRM instruments and other products, particularly in infrastructure. 	<p>As noted in the Management Response, the WBG institutions have complementary but differing mandates that are defined under their respective charters. Under these mandates, each member of the group has developed different products serving the different needs of its clients. Management therefore believes that current institutional arrangements are adequate, and issues of coordination and marketing can be addressed without a change in institutional structure.</p> <ul style="list-style-type: none"> • The specific characteristics of each entity's products are governed by the entity's respective charters and policies, based on the clients it serves. Each institution continues to work to eliminate unnecessary restrictions, if any, in the use of its products. Management does not agree that an across-the-board revision covering very different guarantee products offered by the WBG members is needed. More effective coordination would better address these concerns (see below). Management would also like to point out that IFC has no specific policies restricting the offering of partial risk guarantees within its institutional boundaries and calls on MIGA to provide political risk insurance as needed. In accordance with its internal guidelines, IFC does not offer guarantee products that replicate the offerings of MIGA. • Management will assess the feasibility of increased staff incentives in the context of potential benefits. <ul style="list-style-type: none"> IFC is prepared to work with MIGA and the Bank with regard to marketing the various PRM products through IFC's channels with clients. For example, there could be scope to leverage IFC's industry departments' relationships with key global private sector players to offer PRM instruments along with other financing options as appropriate. As the report notes, the newly established Client Relationship Management System could also be a vehicle for coordinated marketing efforts. The incentives for MIGA or Bank staff to utilize these channels could be considered. • The World Bank and MIGA will explore ways to establish more systematic links between advisory services and their PRM instruments. For MIGA, as solely a provider of political risk insurance and with no commercial interest, close collaboration with Bank policy advice is possible and indeed encouraged, as there is full alignment of interests between sound policy advice and such guarantees. <ul style="list-style-type: none"> The infrastructure area is in fact a good example of WBG coordination on advisory and financing services. IFC's investment team, which is separate from the advisory team, can offer a financing package to the winning bidder subject to satisfactory due diligence. Such a package could include WBG guarantee

Management Action Record (continued)	
Recommendations	Management response
<ul style="list-style-type: none"> • 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. 	<p>products as appropriate. Advisory teams working with government clients will, as a matter of course, need to advise a government on the best options for ensuring a successful and competitive bid, for a concession, build-operate-transfer, or other structure. Those options may lead to recommendations that either indications of interest from potential financiers (IFC or others) or of availability of political risk reduction mechanisms (WBG or others) be included in bidding information packages to increase the prospects of the government achieving its objectives. Governments are of course always free to reject such recommendations. Given the possible appearance of conflicts of interest, potential conflicts arising from such recommendations are fully disclosed to clients and mitigating measures as per WBG Conflict of Interest policies are put into effect if the governments choose to follow such recommendations. WBG units may not be able to offer financing or guarantee products if the winning bidder does not turn out to be acceptable to them.</p> <ul style="list-style-type: none"> • Each of the Bank group institutions uses pricing methodology that reflects the unique characteristics of its charter and its clients. Management will provide guidance to staff to ensure the consistency of Bank advice to governments with regard to the “hierarchy of instruments” principle and the fee charged by governments to the private sector to offset the costs associated with issuing a counter-guarantee. Such a fee will be considered the default option and application of the guidance will be monitored through the Finance, Economics, and Urban Development Department (the Sustainable Development Network department that supports the Regions’ guarantee work). • Efforts to increase awareness and ensure adequate skills in different specializations are ongoing. MIGA and the Bank will review their procedures to address any specific issues identified in the report that lead to higher transaction costs. IFC is prepared to provide training to staff on MIGA and/or Bank guarantee products it may be asked to promote. Within IFC guarantee products, IFC’s Investment Guidelines and Practices provide a detailed description of each product with a note to inform IFC Treasury as soon as is practical of plans to offer a guarantee product. Within the Finance/Treasury Vice Presidential Unit, the Structured and Securitized Products Department is the center of knowledge and practice on guarantee products in IFC, providing structuring guidance to investment staff as needed. IFC will continue to cover guarantee products in relevant training modules for staff. IFC is also mainstreaming a range of innovative financing techniques to investment departments to the degree possible.
<p>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.</p> <ul style="list-style-type: none"> • Under the client approach, all products for private sector clients, including guarantees and PRM instruments, would be offered through a single window. 	<p>No changes to the current institutional structure are envisioned.</p>

Management Action Record

Recommendations	Management response
<ul style="list-style-type: none"> 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 the three institutions. Under the product approach, the bulk of guarantee/insurance products would be managed under one institutional roof. 	
<p>4. If the current organizational structure is maintained, direct management of each individual WBG institution to improve the delivery of its own guarantee/insurance products by—</p> <p>MIGA management</p> <ul style="list-style-type: none"> Proposing to MIGA's shareholders amendments to its Convention to remain relevant and meet its market potential. Considering, in the meantime, alleviating several constraints derived from its operational regulations and policies. Increasing its responsiveness to market demand by addressing internal weaknesses that reduce efficiency and slow responsiveness without lowering MIGA's financial, social, or environmental standards. Improving its client relationship management, including aftercare, to enhance the value MIGA adds and increase its client retention. <p>Bank management</p> <ul style="list-style-type: none"> Maintaining and promoting the partial credit guarantee instrument as a potential effective countercyclical tool to leverage government access to commercial funds and extending such access to IDA countries. Creating awareness among Bank staff of the potential use and benefits of partial risk guarantees and building necessary skills. 	<ul style="list-style-type: none"> MIGA agrees on the desirability of amending the Convention to provide greater flexibility in political risk insurance coverage that MIGA would be permitted to provide. However, this would be a major undertaking and would require a strong consensus among shareholders on such amendments, and MIGA would proceed to a formal proposal only with such a consensus. Agreed. An in-depth review is under way to examine what changes might be warranted in the Operational Regulations and Policies but that would still be consistent with the requirements of the MIGA Convention. Agreed. A Business Process Review is under way to examine what measures can be taken to improve operational efficiency and responsiveness. Agreed. The Business Process Review noted above is also addressing client relationship management. Partially agreed at this time. Extending access of the Partial Credit Guarantee instrument to IDA countries would be an option that will be discussed under the IDA Guarantees Review to be presented to the Board by December 2008. Agreed. Banking and Debt Management currently provides training on the political risk guarantee and other IBRD/IDA guarantee instruments for operational staff, and also includes a discussion of the guarantees in its general training for task team leaders. The Finance, Economic, and Urban Department (the Sustainable Development Network department that supports the Regions' guarantee work) will continue to maintain adequate capacity to respond to demand from task teams for specialized guarantee expertise.

Management Action Record (continued)

Recommendations	Management response
<ul style="list-style-type: none"> • Developing a marketing strategy that encompasses both governments and the private sector to better identify situations in which the role of a partial risk guarantee can make a difference. • Streamlining processing steps to reduce both internal disincentives to working on partial risk guarantees and transaction costs for private sector clients while ensuring that crucial measures for social and environmental safeguards and risk management are maintained. <p>IFC management</p> <ul style="list-style-type: none"> • Mainstreaming its guarantee products through its operations departments in the same manner that its equity and loan products are deployed. 	<ul style="list-style-type: none"> • Partially agreed. The potential use of guarantees is most usefully discussed as a part of Country Assistance Strategy preparation, thus making the governments fully aware of the availability of guarantees. Management will work to ensure that the potential use of guarantees is discussed as part of the preparatory Country Assistance Strategy discussions for all countries. In addition, as part of outreach programs for IBRD financial products, Banking and Debt Management routinely includes material on the availability and potential for IBRD guarantees. Management plans to undertake a similar outreach program for IDA guarantees and is exploring various institutional options. • Partially agreed. Management is exploring ways to streamline the processing of guarantees but will not commit before identifying specific measures. Compliance with Bank policies pertaining to environment and social safeguards would not be affected by any changes in policies related to guarantees. • Already the practice. IFC guarantees are essentially unfunded loans, enabling IFC to extend credit to a client, but without the associated funding inherent in a loan. The basics of the appraisal and processing are identical between the two products; however, there are differences in structuring and documentation. Therefore, a member of the Structured and Securitized Products Department joins the investment team to assist with these functions for structured guarantee transactions. IFC has the same relationship with the client whether offering a guarantee or loan, with the same investment staff in IFC involved, regardless of the product offered. In both cases, staff from IFC's Investment Operations do a thorough due diligence up front and perform a monitoring function throughout. The representations, warranties, covenants, and so forth contained in the documents are similar. Therefore, there is not an overall issue regarding the processing of guarantees versus loans. <p>However, there are some broader, related issues with respect to improving processing of innovative financial products at IFC that are important and that management is addressing. IFC has been developing many innovative financial products in recent years, including various types of structured finance, RSFs, local currency facilities, securitizations, and other structures, using many guarantees. An important challenge is to mainstream the use of these products to investment departments as they become established, to reduce processing times and improve efficiency, and to allow groups such as the Structured and Securitized Products Department to remain focused on innovation and product development. This mainstreaming requires training investment department staff and developing replicable financial models and documentation. Management is undertaking this process now, including implementing a new organizational structure for the Structured and Securitized Products Department in which product development is centralized and business development decentralized. This is expected to better facilitate ongoing development of innovative products by a core staff in headquarters, with a focus on mainstreaming these products to field-based investment staff as the products mature.</p>

Management Action Record

Recommendations	Management response
<ul style="list-style-type: none"> • Assessing the extent to which it can bring its guarantee products closer to meeting Basel II and regulatory requirements in general, so that the guarantee beneficiaries can use IFC products more effectively for capital, provisioning, and exposure relief. • Revisiting its approach to RSFs to increase flexibility and improve the attractiveness of the product. • Scaling up successful models in energy efficiency, education, and capital market development based on the use of guarantee structures. 	<ul style="list-style-type: none"> • Not agreed. Because guarantees are simply unfunded loans, to the degree that loans are Basel II efficient, so are guarantees. As there is no underlying discussion in this report on what issues specific to IFC guarantee products pertain to Basel II, IFC cannot assess this recommendation. • Agreed with respect to simplifying the process. IFC's position with respect to first loss in risk-sharing facilities (RSFs) is not about willingness to take risk but about the appropriateness of the project structure. It is well understood in the market at this time that the decoupling of origination and risk is what led to the subprime crisis. Fortunately, IFC understood this risk early on and has insisted that clients who originate loans retain a first-loss position in the portfolio to ensure an alignment of interest. Whether an off-balance sheet securitization or an on-balance sheet RSF, the approach to portfolio risk is the same. <ul style="list-style-type: none"> However, there are some broader issues with respect to the implementation and replication of RSFs in a timely and efficient manner that management is addressing. As management develops more of these structures, it is becoming more efficient with respect to processing and documentation, and management is now working to simplify and standardize these structures to the degree possible. IFC currently has more than 20 RSFs in the pipeline with a medium to high probability of closing, many in IDA countries. In addition, management continues to work with counterparties such as IDA to share in the first loss alongside clients in instances in which such participation enables a deal to happen that otherwise would not. • Agreed on scaling up in these sectors; not agreed on limiting scope to guarantee products. Management agrees that IFC continues to scale up successful models in these areas. However, guarantees are just a subset of the full range of financial products IFC offers, and scaling up is not necessarily dependent on the use of guarantees. As discussed in a recent planning document, IFC is pursuing programmatic approaches as a way to increase the development impact and additionality of operations by extending IFC activities beyond the individual project into a program of projects and advice. A key approach to this is through wholesaling, where IFC is combining its financial sector and industry expertise to enable the wholesaling of IFC financial products for specific industries through local banks. This will allow IFC to reach smaller clients in smaller, harder-to-reach countries, in many cases IDA countries. The education sector is one of the major areas in which this is being done. In energy efficiency, IFC has been a leader in the development of financing programs through financial intermediaries designed to deliver environmental benefits, including clean energy. Management expects to scale up in this area. Finally, a number of capital market projects that include guarantees are being explored that would address such needs as access to housing finance, trade finance, and agribusiness, and which will be facilitated using short-term finance, local currency financing, and risk-sharing products.