Public guarantees

Guarantees can mobilize and leverage commercial financing by mitigating and/or protecting risks (such as political, regulatory, and foreign-exchange risk), notably commercial default or political risks. This note focuses on public guarantees, where a government or an international donor agrees to bear some downside risk, typically by assuming a borrower's debt obligation in the event of a default.

Key words: Risk mitigation, credit guarantee, loan guarantee, partial risk, all-risk, political risk, commercial risk, credit risk

How does it work?

A guarantee is a promise by a guarantor to a beneficiary (or beneficiaries) that, in the event of a specified default by an obligor, the guarantor will pay the beneficiary a specified amount. Typically, guarantees cover lenders or bond investors against payment defaults by a borrower. Although similar to insurance, a guarantee does not entitle the issuer to review a claim before it is paid; rather, the payment is triggered by specified events.

Guarantee schemes can make lending possible (or more attractive) by virtue of sharing risks and freeing financial institutions' balance sheets. Public guarantee schemes often aim to catalyse lending to priority sectors or classes of borrowers, such as Small and Medium Enterprises (SMEs), low-income households (e.g. for mortgages) or "green" investments (e.g. energy-efficient equipment). They can become a substitute for the collateral that businesses would have otherwise needed in order to access commercial lending and thus expand available credit.

State-supported guarantee funds emerged in Europe in the aftermath of the Second World War, where they contributed to reconstruction efforts. In developed countries, many state schemes are still in operation today, despite the growing offer from the private sector. Governments also offer guarantees (as well as insurance) through export credit agencies to promote exports, including pre- and post-shipment guarantees and advance payment guarantees covering non-payment risk. Since the 1980s, guarantees have become an effective development cooperation instrument. Most Multilateral Development Banks (MDBs) offer guarantee schemes to developing countries. Their high credit rating and low risk-weighting under international capital adequacy rules enable them to deliver highly-rated guarantees at low cost.

Developing countries have also established their own domestic guarantee schemes, traditionally in the agriculture sector. For example, Nigeria offers credit guarantees for agriculture and Small and Medium Enterprises (SMEs), e.g. the Nigeria Agricultural Credit Guarantee Scheme Fund (ACGSF) and the Nigeria Incentive-Based Risk Sharing Scheme for Agricultural Lending. The ACGSF guarantees credit facilities extended to farmers by banks up to 75 per cent of the amount in default net of recoveries. The China Utility-Based Energy Efficiency Finance Program (CHUEE) has promoted energy-efficient and renewable-energy investment by offering a partial loan guarantee where the International Finance Corporation covered 75 per cent of the risk for the first 10 per cent of participating banks' losses related to the specified loans, and 40 per cent of the remaining 90 per cent of losses. Banks participating in the CHUEE programme have provided loans to 178 energy-efficient and renewable-energy projects, demonstrating the viability of the initiative.

A few private monoline insurers (which exclusively guarantee financial products) such as Ambac and the Municipal Bond Insurance Association have also issued "wrap" guarantees (see below) for debt instruments in selected developing countries, such as asset-backed securities and bonds issued by infrastructure project companies; however, they have largely withdrawn from this business in the wake of the 2008 financial crisis.

The guarantee contract specifies the terms and conditions of the guarantee. Key elements include the *extent of loss coverage, the types of risks* covered, what *financial instruments* are covered, and the *guarantee fee*:

- The *extent of loss coverage* may be for the full amount of the potential loss (unlimited) or partial (limited). Partial credit guarantees cover a specified portion of the debt service, regardless of the cause. Full Credit (or "wrap") guarantees cover timely payment of scheduled principal and interest to creditors for the entire obligation in the event of a default. Their primary use is to achieve a higher credit rating on bonds, in order to lower borrowing costs and/or meet the investment requirements of capital market investors. Otherwise, unlimited guarantees from public entities are rare, as they tend to create perverse incentives.

Summary

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English (817.2 kB)

Financial Results

Generate revenues

Realign expenditures

Instruments Used

Risk Management

Market

Sources of Finance

PRIVATE

- *Risk coverage* may cover all risks—protecting lenders against default regardless of the cause—or partial risk—covering defaults arising from specified events such as non-payment under an offtake contract (e.g. power purchase agreement). Guarantees may cover a range of risks including commercial risk (i.e. the risk of default on debt service payment obligations) and political risk (i.e. the risk of losses caused by failure of government to meet specific performance obligations, such as change of laws and regulations, expropriation, non-convertibility and transferability of currency, and war and civil disturbance).

- The *financial instruments* covered can range from *individual* instruments (e.g. a bond issue), to a *portfolio* of investments (e.g. a bank's credit facility for SMEs or microfinance, or a portfolio of consumer loans to finance energy-efficient equipment), to a *class* of investments meeting certain requirements (e.g. home mortgages, car loans, credit card receivables). For example, guarantees have been used to encourage banks to "downscale" into microfinance or small business lending, by providing partial guarantees for credit provided to targeted groups. Examples range from the US Small Business Administration (SBA) Section 7(a) Loan Guaranty Program, which guarantees 75 to 85 per cent of loans to small businesses, to the Ghana ARIZ guarantee mechanism, under which Agence Française de Développement guarantees local-currency commercial-bank loans to SMEs and microfinance institutions.
- The *guarantee fee* is levied by the guarantor, and may be: a one-time or annual fee, or a blend of both; a percentage of the underlying loan amount; and/or a percentage of the guaranteed portion of the loan. The level of the fee typically depends on the creditworthiness of the creditor, but some public guarantee schemes offer preferential or concessional terms for targeted classes of borrowers.

Guarantees can be grouped into two main classes: **project-based** guarantees and **policy-based** guarantees.

- *Project-based guarantees* cover losses related to the viability of a specific project or a debt issue. Their aim is to improve access to lending and make its terms more attractive (e.g. longer maturities, less collateral, and lower interest rates). There are two main types of project-based guarantees.
  - *Credit or loan guarantees* provide credit risk mitigation to commercial lenders covering debt service defaults, regardless of the cause. The guarantee can substitute for part of the collateral requirement, thus facilitating access to finance. They can cover a range of instruments (e.g. loans, overdraft, leases, bills of exchange, corporate bonds, notes and transaction liabilities).
  - *Payment guarantees* provide risk mitigation with respect to payment default on non-loan-related obligations by government. These may include payment obligations arising from contracts, law or regulation, such as payments under an offtake agreement (see *Case Study*: MIGA).

- *Policy-based guarantees* guarantee a portion of government debt service for a specified commercial debt instrument against all risks, thus improving the government's access to capital markets. They can be used for any commercial debt instruments offered by any private institution to the eligible government, including foreign currency debt. The borrowing government may use the proceeds of the guaranteed debt for any budgetary purposes. They may be self-standing or part of a larger package of financial support—typically including development policy lending in support of a set of agreed reforms. Eligible countries have a strong track record of performance with a satisfactory social, structural and macroeconomic policy framework and a coherent strategy for gaining (or regaining) access to international financial markets. For example, Colombia issued US$1 billion of 10-year notes in May 2001, backed by a US$159 million World Bank policy-based guarantee. It provided a rolling guarantee on the first two semi-annual scheduled payments of principal and interest, so that after each debt service payment, the guarantee rolled forward to the next scheduled payment.

Elements of both classes of guarantees can be combined in a single instrument. For example, the African Development Bank extended a policy-based partial credit guarantee to the Seychelles in the context of a financial reform programme and debt restructuring. The guarantee covered US$10 million in interest payments on 16-year bonds with a face value of US$169 million, alongside a Euro15 million budget support loan. Under the restructuring, Paris Club creditors agreed to exchange over US$300 million of existing debt for the 16-year bonds, resulting in a 45 per cent reduction in the Seychelles' nominal debt, and clearing its arrears.

Stakeholders

- *Provider/Issuer/Guarantor/Surety:* The party that offers the guarantee and pays in the event of a default. They can be governments, government agencies, bilateral and MDBs or private financial institutions.
- *Beneficiary/Creditor/Obligee:* The party entitled to payment if the guarantee is triggered. The beneficiary may be the signer/purchaser of a guarantee contract with the provider, or a third party. The beneficiary is typically a lender or bond investor concerned with the credit risk of the borrower, and wanting coverage against debt service default losses. It may also be a trade creditor—a participant in a value chain as a buyer or seller, importer or exporter, say, of agricultural commodities covered under a special-purpose Credit Guarantee Scheme or an export promotion programme. Equity investors may also seek guarantees to protect their own investment, for example, against government non-performance.
- *Principal/Obligor:* the party whose performance is secured through the guarantee. They may be part of the

PUBLIC

NATIONAL

INTERNATIONAL

Related SDG

Related Sector

ENERGY

MANUFACTURING

AGRICULTURE

FINANCE

TRANSPORTATION

guarantee structure (e.g. an offtaker for a power project, or a sovereign that provides a counter-guarantee) or even a project participant, but they are not a party to the guarantee itself. * Promoter: in the case of microcredit and SME guarantee mechanisms, there may be entities that initiate the microcredit mechanisms or support a program promoting specific activities (e.g. the Global Alliance for Clean Cookstoves).

Potential in monetary terms (revenues, realignment or savings)

Two key objectives of guarantees are to mobilize financing that would not otherwise be forthcoming, and to lower financing costs. It has been argued that guarantees can catalyse private financing many times the value of the guarantee; this is difficult to verify, however, because projects with guarantees also typically involve a suite of other credit enhancements and risk-mitigation tools that work together to mobilize capital. The size of guarantee schemes also varies widely from a few million to several billion US$.

When is it feasible?

Legal and/or other feasibility requirements

In most, if not all, developed economies, private and public guarantors coexist in financial markets. Some products (e.g. export credit) are also offered to individuals and firms in developing countries, typically with a counter-guarantee from the host-country government. Developing-country governments and companies can also access public guarantee programs offered by MDBs.

The establishment of a domestic public guarantee programme might require the enactment of legislation, establishing and funding the guarantor, and developing financial and operational policies and procedures, including, notably, risk management for new entities. The establishment and operational policies of the public guarantor must be given legal force. For example, Korea's Credit Guarantee Fund Act (1974) provided the legal basis for the establishment of the Korea Credit Guarantee Fund (KODIT), which extends credit guarantees to SMEs. Establishing a mechanism within an existing agency may be the simplest approach, assuming the agency has the legal capacity to offer guarantees. If established as a standalone entity, it must establish a credit rating sufficient to meet the investment criteria of its target investors, or secure a guarantee from a highly-rated entity. Government funds are generally required not only for initial capital and start-up costs, but typically for a share of ongoing costs as well, particularly in the event of high levels of losses.

There are three main institutional delivery models for guarantee programmes:

- through *standalone financial institutions*, such as Japan's 51 Credit Guarantee Corporations, which are subsidized and reinsured by government agencies (the Organization for Small and Medium-Sized Enterprises and the Japan Finance Corporation, respectively), and Colombia's Fondo Nacional de Garantia (FNG), a state- and privately-held fund with independent legal status;
- within a *government agency*, such as the United States' Small Business Administration (which offers SME loan guarantees alongside other financial and advisory services) and the Canada Small Business Financing Program (a loan loss-sharing programme for government and private sector lenders managed by Industry Canada); or
- through a *special-purpose government-supported guarantee fund*, such as the Korea Credit Guarantee Fund and the US Federal National Mortgage Association (also "Fannie Mae", a Government-sponsored enterprise and a publicly-traded company).

Minimum investment required and running costs

Public credit guarantee schemes require substantial initial investment related to establishment and capitalization of the guarantee fund, and might require further transfers in the event of systemic losses. Capitalization costs are proportional to the guarantor's cost of capital, its capital-adequacy requirements, and other statutory requirements, notably its maximum ratio of guarantees to capital. The Republic of South Korea, for example, provided US$10 billion in initial capitalization for its Credit Guarantee Fund. The Fund's aggregate amount of outstanding guarantees is limited to 20 times its capital, although the actual ratio of guarantees to capital is usually less than half the statutory level (as of the end of 2012, the ratio was 7.5 times). The recently-established Credit Guarantee Investment Facility (see above) was capitalized at US$700 million by its shareholders in 2012; its Capital Adequacy Measurement Guidelines enable it to provide guarantees of 2.5 times its capital. These ratios are within the range identified by the OECD for a sample of European guarantee agencies of 0.9 to 34.6, depending on whether the guarantor is subject to Basel III capital-adequacy requirements, the riskiness of the portfolio, and how much government support (explicit or implied) can be counted on in the event of a crisis.

The net annual losses on guarantee operations are the total amount of pay-outs to lenders minus the proceeds from recovery. Suppose that over time it is learned that annual net losses on guarantee operations are 1.5 percent of the average outstanding guarantee amount per year. This figure has to be added to the cost of funds and the operational costs of the guarantee fund, since all three cost factors have to be adequately covered by the income from fees and investments. Net losses in efficient guarantee funds are below 2% of the average outstanding guarantee amount per year. If the rate appears to be less, the guarantee fund might be too conservative. If it goes over 3 percent, remedial action must be taken, since word can spread amongst the client groups and the fund will be depleted fast.

Administrative costs may be substantial about 3.5 per cent of guarantee fund assets in Japan (JPY1.0-1.8 trillion a year) and 7 per cent in Korea. These costs can be recovered through guarantee fees paid by applicants or financial intermediaries participating in the scheme. In most guarantee funds, the guarantee fee is set as a percentage of the guaranteed loan amount and it is charged annually. In most countries the fee is around 2 per cent of the guaranteed loan amount per annum. For example, the BBMKB Guarantee Scheme in the Netherlands charges a flat rate of 3 per cent over the guaranteed loan amount. The Korea Credit Guarantee Fund also offers a 0.5 per cent discount on guarantee fees for SMEs, and preferential terms (e.g. 100 per cent coverage) for targeted sectors, including small businesses, "green growth" industries and high-tech companies. SME loan guarantee fees range from 0.5 per cent to 2.0 per cent depending on credit rating. While guarantee funds should ensure their business continuity and operate according to cost-effectiveness criteria they might not need to pursue financial sustainability if they produce positive social or environmental impacts. For example, Italy's state-funded guarantee scheme for SMEs offers up to 80 per cent coverage and waives loan guarantee fees in "less developed areas;" elsewhere it offers up to 60 per cent coverage and charges annual loan fees of 0.25 per cent for micro enterprises, 0.5 per cent for small enterprises, and 1.0 per cent for medium firms and consortia of SMEs.

In what context/when it is more appropriate?

Public guarantee programmes can be useful in addressing market failures, for example:

- In the presence of borrowers with insufficient collateral or credit quality to qualify for commercial finance, e.g. first-time home buyers, farmers and small businesses.
- To promote liquidity in financial markets, for example housing. Fannie Mae, for example, guarantees mortgage-backed securities, enabling mortgage originators to sell mortgages to free up capital. Similarly, in Mexico, several guarantors offer partial credit guarantees in the mortgage market, including the Sociedad Hipotecaria Federal, the International Finance Corporation and the Netherlands Development Finance Company.
- In the presence of high political risk, public guarantees can unblock private investment by protecting against risks of expropriation and failure of government to meet specific performance obligations. Typical uses include large infrastructure projects involving high sunk costs, long payback periods, and/or offtake contracts with government entities.

What are the main pros and cons, risks and challenges?

Pros

Guarantees can mobilize financing and lower borrowing costs, benefiting both obligors and governments:

Benefits to principals/obligors:

- Guarantees can help borrowers secure financing, or improve the terms of financing (e.g. lower interest rates, longer maturities);
- Reduce losses to beneficiaries (usually creditors) in the event of a default;
- Support the long-term financial stability of the project;
- Enhance the credit quality of the borrower/project. Benefits to governments: * Require less funding than loan programmes, unless called; * Facilitate government access to commercial funding; * Leverage multilateral and bilateral support for a member country's fiscal and macroeconomic framework.

Cons

For sponsoring governments:

- Guarantee schemes require funding for initial capitalization; in addition, they may require operational subsidies. Japan, for example, has funded annual deficits of its guarantee corporation in the range of JPY200-600 billion. Subsidies may be phased out, however, if the institutions become established and access commercial funding sources.
- Systemic financial crises affecting the guaranteed sector may require emergency government support—even if the guarantor is a standalone entity. For example, during the US subprime mortgage crisis (2008-15), the federal government provided US$116 billion in support to Fannie Mae, even though the government had no formal obligation.

For the guarantor/issuer:

- Guarantees represent a contingent liability to the issuer, with significant negative potential impact on its financial viability and its credit rating. Sustainability of debt remains a critical element of sound macroeconomic management in developing countries, particularly in those most vulnerable to external shocks.

- Adverse selection: Lenders have an incentive to select loans at the lower end of their credit assessments for guarantee programmes. As a result, the programmes may be supporting projects that are more likely to default than non-guaranteed projects.
- Moral hazard: By protecting lenders against losses, guarantees may encourage them to reduce their enforcement of lending criteria, supervision and loan repayment, which can lead to higher default rates. Moral hazard can be reduced by ensuring that coverage levels are low enough and collateral is high enough to incentivize both lenders and creditors to perform. For example, partial risk coverage (e.g. 80 per cent coverage) provides more incentives than unlimited coverage in order to limit defaults.

Risks

Risk is at the core of guarantees: their fundamental premise is to transfer risk to a party better positioned to assume it, thereby enabling an underlying business transaction or financing to go forward. The main objective of public guarantees is to encourage creditors to extend credit to targeted borrowers, who the creditors may normally consider too risky. Notwithstanding the above, the risk transfer inherent in guarantees itself creates new risks, including:

- Losses in guarantee programmes can be a burden on government budgets; high levels of exposure can affect the guarantor's creditworthiness.
- Public guarantee programmes are generally not as well equipped to assess risk as the creditors; this increases the risk of regulatory capture (i.e. creditors taking advantage of the guarantee fund's limitations on supervision).
- The potential for political interference in managing and allocating funds, and the difficulty that managers have in minimizing this interference given that they typically rely on government for financial and other support.
- Narrow targeting of guarantee funds on specific classes of borrowers (sectors, geographic areas, loan sizes etc.) may increase risk due to concentration/lack of portfolio diversification.
- Adverse selection and moral hazard, as indicated above.

How can the design be ameliorated to improve the social/environmental impact?

Given that their purpose is to catalyse funding for designated sectors and/or populations that are deemed government priorities (e.g. housing, SMEs and energy-efficient equipment), public guarantees often seek ¾ but in itself by any means do not assure ¾ the achievement of social/environmental benefits. To promote the realization of these public outcomes, the mandate for a public-guarantee scheme should narrowly target investments that can deliver these benefits, for example through strict eligibility criteria, transparent standards, and other limits on the size of the loan being guaranteed and how the proceeds may be used. Guarantee programmes targeting energy-efficient investment, for example, require the equipment to meet certain specifications set by a regulatory authority. Similarly, housing loan guarantee programmes may target certain types of housing or set a ceiling on loan size in order to target lower-income households, or may be structured to support certain populations, e.g. veterans or small business owners. The guarantee scheme needs also to provide evidence over additionality, i.e. that the number of borrowers that are provided with formal credit increases as a consequence of the guarantee fund.

Guarantees can also be used to expand funding for social/environmental investments. For example, in a two-phase financing, the Inter-American Development Bank extended a US$50 million credit line to two Mexican energy service companies, which they used to extend loans for energy-efficient equipment. In the second phase, these loan receivables are securitized through the issuance of green bonds in the local debt capital markets. The bond is backed by US$19 million guarantee from the Clean Technology Fund. The credit enhancement provided by the guarantee will improve the credit quality of the green bonds. Selling off loan receivables (in exchange for the bond proceeds) will enable the companies to extend financing to more customers. Another example is the Alliance for a Green Revolution, whose guarantee scheme helps to extend accessibility to low-cost credit for smallholder farmers through the establishment of "loan guarantee funds" to leverage commercial lending. The programme also combines financial products with offering literacy training for its clients.

Guarantees cannot overcome problems inherent to the un-creditworthiness of a borrower or financial entity. Bilateral donors and MDBs can close the gap and offer guarantees for developmental purposes. These challenges are acute in the poorest and most vulnerable countries, where guarantees need to be complemented by broader capacity development programmes for financial institutions on risk management and clients, for example, SMEs, on financial literacy.

As stated above, guarantee schemes have historically been a target for corruption and mismanagement. Additional measures should be put in place to assure the transparency and independence of public guarantee trusts or funds. If mismanaged, these facilities can produce long-lasting repercussions in a country's balance sheet, reducing further its political and fiscal space for development.

Guidelines and Case Studies

Detailed guidance

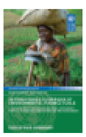
- SME and Entrepreneurship Financing: The Role of Credit Guarantee Schemes and Mutual Guarantee Societies
- Guarantee funds for small enterprises. A manual for guarantee fund managers – ILO
- Credit Guarantee Schemes for SME lending in Central, Eastern and South-Eastern Europe
- Government Guarantees: Allocating and Valuing Risk in Privately Financed Infrastructure Projects
- Review of Risk Mitigation Instruments for Infrastructure Financing and Recent Trends
- Credit guarantee systems for agriculture and rural enterprise development - FAO
- Guarantees for Development

Case studies

- Microcredit Guarantee Funds in the Mediterranean: A Comparative Analysis
- Loan Guarantee Fund: Korea Credit Guarantee Fund and The Services of Korea Credit Guarantee Fund
- Nigeria Agricultural Credit Guarantee Scheme Fund
- Guarantees for SMEs by the European Investment Bank
- Ghana Sankofa Gas Guarantee (additional information)
- Seychelles Policy Based Partial Credit Guarantee

Our work

International Guidebook of Environmental Finance Tools null



Sustainable Development Goals

Environmental finance

Our Perspective

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We should reach a consensus on the fact that macroeconomic policies in low-income economies need to also jettison the conventional wisdom of undue restrictiveness.