Blended Finance Taskforce calls to scale up the issuance and use of development guarantees

Background note for Taskforce Working Group

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Development guarantees are arguably one of the most catalytic instruments in the blended finance toolkit. They have the power to mobilise largescale private sector investment for sustainable infrastructure and other high-impact sectors. With overseas development assistance (ODA) having stagnated in recent years,[1] issuing development guarantees can be a powerful use of scarce public resources to achieve impact targets and catalyse commercial investment in emerging markets.

Despite their potential for outsized impact, the data suggests that development guarantees are not being deployed at the level that one might expect. Guarantees represented only 4% (US$1.5 billion) of the total multilateral development bank (MDB) climate finance commitments in 2017.[2] Of over 200 blended finance transactions on Convergence's database, only 8% of the deals employed guarantees or insurance, compared to nearly 50% involving grants.[3] Data for the Green Climate Fund (GCF) suggests that guarantees represent only 3% of its current committed portfolio.[4]

Building on the work of many of our partners (including the Milken Institute, the OECD, the GIIN, Sida and USAID) this note sets out some of the challenges which prevent the scale up of development guarantees including:

1. **Standardisation:** Would a standardised development guarantee template be useful for investors? Are existing "harmonisation" efforts progressing and involving the investor community enough?
2. **Regulations:** Basel for banks or Solvency for insurance players as a disincentive to investing in emerging markets. What can we do that isn't already being done? (e.g. call to action for regulators to grant an exception on liquidity classifications for guarantees with a development component)
3. **Guarantee funds:** Third-party guarantee vehicles can act to overcome some of the common hurdles and can achieve significant private capital mobilisation. Can the Taskforce and partners help to drive forwards proposals?

Box 1. Working definition of "development guarantee"
Varying definitions of the term "guarantee" is used in the financial industry. These range from narrower technical definitions to broader definitions that encompass various types of credit enhancement. In simple terms, a guarantee entails a legal agreement in which a third party to a financial transaction promises to repay the investor or lender in the event that the investee or borrower is unable to do so. The contract specifies the conditions that trigger a payment and the amount to be paid.
In this note, a "**development guarantee**" refers to guarantee instruments issued by multilateral and bilateral development banks (MDBs and DFIs, including MIGA), national development agencies (e.g. USAID and Sida), climate funds (e.g. GCF) or philanthropies (e.g. the MacArthur Foundation).

The **OECD definition** for a development guarantee is a guarantee which is "extended with the promotion of the economic development and welfare of developing countries as the main objective (i.e. with a development motive)."

1 Net ODA by OECD DAC members for 2017 stood at $147bn, representing 0.3% of total GNI and down 0.6% year on year vs 2016 (up 1.1% excluding in-country refugee spending). Read more here.
2 MDB Joint Climate Finance Report for 2017 (no breakdown per instrument in MDB/DFI Joint Mobilisation Report). Read more here.
3 Convergence/Blended Finance Taskforce, "Key considerations for mobilising institutional capital through blended finance" (link to working papers).
4 Green Climate Fund, Portfolio Dashboard, retrieved August 2018 here.

4. **Incentives:** Can incentives be improved to encourage the use of development guarantees vis-à-vis other instruments? (e.g. around modernisation of ODA counting for donors and scorecards for development banks)

5. **Measuring mobilisation and default rates:** Can we improve the data measuring mobilisation of guarantees and availability of default/claim loss ratios? Is there a trade-off between making development guarantees more easily enforceable and liquid versus lengthy "workouts" with development partners?

6. **Balance sheet and budget optimisation:** Current accounting treatment of guarantees by national treasuries, development banks and rating agencies can for some create disincentives for their broader use. Should accounting treatment be more aligned between institutions?

The Taskforce wants to bring together practitioners and thought leaders across the investor and development finance community to explore actionable steps to address some of these challenges.
It will host a series of roundtables (the first to be held on the 30th of August) to identify how the Taskforce, and other key partners, can most effectively help drive progress and scale up of the use of blended finance instruments such as development guarantees. During this first call we will focus on the first **three** items discussed herein.
We welcome any suggestions by email on further "guarantee" topics which the Taskforce should prioritise during these roundtables. We also welcome comments from those who are unable to join the first call and suggestions for additional participants.

ALIGNMENT WITH PRIVATE INVESTOR REQUIREMENTS

1) Standardisation of development guarantee templates

The Taskforce considers development guarantees to be one of the most powerful capital mobilisation tools in the blended finance toolbox. It has called for the standardisation of guarantee instruments as a priority in order to reduce transaction costs for the private sector, increase transparency and enable risk-sharing between development banks and development agencies more easily. Today most blended finance transactions still have to be individually tailored, posing a barrier to investors with limited resources, time, and expertise.

While continuing to carefully consider specific underlying project risks, having standardised guarantee templates that strive to be compatible with Basel III/IV and Solvency II (and with reality-based assignment and claim provisions) could substantially increase the number and type of institutional investors eligible to take part in transactions with a guarantee component. Standardising development guarantees could also reduce investor uncertainty – building familiarity with the process itself, leading to more issuances and uses.

Some work has already been done in this space. A GIIN working group focused on guarantees in the US impact investing market emphasised that practitioners should consider ways to standardise guarantees; and they have developed a set of resources intended to streamline the structuring and negotiation process undertaken by investors and investees entering into guaranteed-back investments.[5]

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[5] GIIN working group, "Scaling the Use of Guarantees in U.S. Community Investing", 2017. Read more here. Running from August 2016 through May 2017, the Guarantees Working Group engaged in a series of activities intended to scale the use of guarantees in the impact the U.S. community investing market.

Others such as USAID, have published a series of knowledge sharing tools including compilation of their standard contract terms for credit guarantees (see **Box 2**[6]).

Q: Should the Taskforce's partners push forwards with a standardised development guarantee template, which aims to be as compatible as possible with bank and insurance regulations?

Q: There are a number of working groups seeking to streamline instruments across institutions (e.g. MDB working group to harmonise instruments). Is there sufficient participation from the private sector investor community in these activities ensuring that they speak to private sector needs?

Box 2. Spotlight: USAID's Credit Guarantee Standard Contract Terms

- Backed in full by U.S. Treasury
- 50% *pari passu* guarantee on loan principal
- Flexibility on local and/or foreign currency
- Guarantee of realised losses, requiring the following claim procedure: i) wait 90 days after the final letter of demand is sent to the borrower; ii) certify that reasonable collection efforts have been pursued; iii) write off the loan or take a minimum 20% provision if a legal impediment exists to writing off the loan
- Fees: (i) origination fee – one-time, up-front fee based on facility size; (ii) utilisation fee – semi-annual fee based on value of loans placed under the guarantee.

2) Development guarantee compatibility with investor regulations

Certain financial regulations can operate to disincentivise private sector participation in emerging markets and the scale up of development guarantee programs. Particularly relevant are the revised regulations after the 2008 financial crisis like Basel III / IV (for international banks) and Solvency II (for insurance firms) promoted by international bodies such as the EU, G20, the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS).

The proposed Basel **banking** reforms entails (i) tightening of the large exposure rule (issue for large infra projects), (ii) higher capital requirements for infrastructure projects (increases cost), and (iii) stricter liquidity requirements (forcing banks to match long term lending and funding which is hard to fulfil in many emerging markets).[7] According to analysis by the Milken Institute, development guarantees generally do not score high on the Basel III banking guidelines for liquidity (will not qualify as high-quality liquid assets, 'HQLA') because they are not sufficiently tradable or transferable. Although guarantees typically do include assignment and transfer rights, the process usually requires guarantor approval of the potential assignee – which is though hard to overcome due to MDBs and DFIs "know your customer" requirements. Some guarantors have structured their agreements to allow banks to get capital relief, but its challenging to address the liquidity rules (read more re alignment with Basel banking regulation in Milken/OECD's 2018 paper).[8]

On the **insurance** side, the EU's Solvency II directive on liquidity and capital adequacy requirements limit insurers' ability to enter into long-term plays in less liquid assets which as a result can limit the catalytic impact of a development guarantees for long-term insurance investors (Solvency II currently undergoing its first review process).

Q: Should the Taskforce and partners push on regulators for exceptions to Basel banking liquidity classifications for guarantees with a development component, or a climate objective

[6] USAID. 'Development Credit Authority: Putting local wealth to work.' Read more here.
[7] CGDev, "Basel III & Unintended Consequences for Emerging Markets and Developing Economies - Part 4: Challenges on Infrastructure and SME Lending", 2018. Read more here / Rabobank and FMO, "The unintended consequences of Basel IV on developing countries", 2017. Read more here.
[8] Milken Institute and OECD, "Guaranteeing the Goals: Adapting Public Sector Guarantees to Unlock Blended Financing for the SDGs", 2018. Read more here.

more specifically? Or can the issuers overcome the requirements by structuring guarantees in accordance with regulations?

Q: Is there appetite from investors and Taskforce partners to build on the Milken Institute's exercise and expand the review of development guarantees to achieve compatibility with insurance regulations?

3) Create guarantee funds

A number of actors, including the Milken Institute and the Blended Finance Taskforce, have called for more third-party or centralised guarantee vehicles. These vehicles would be designed to aggregate support from development banks, donors and philanthropies towards sustainable and green infrastructure, leveraging up its own balance sheet and bringing in revenues by issuing guarantees with an appropriate fee structure (to some extent similar to how MIGA is optimising its balance sheet). Third party guarantee funds could achieve significant private capital mobilisation impact and address a number of the typical issues with development guarantees, provided they are operated in alignment with the needs of private investors – and relevant financial regulations.

Establishing such a (funded) guarantee vehicle could also allow donors to disburse DAC-recognised ODA funding in coordination with other donors under current rules (e.g. the **African Guarantee Fund** for SMEs which is backed by Denmark, Spain, France, the Nordic Development Fund and the AfDB. Another example is **GuarantCo's** local currency support for infrastructure backed by the UK, Australia, Netherlands, Sweden and Switzerland).[9]

Q: How can the Taskforce and its partners help to drive forwards proposals to create guarantee funds?

INCENTIVES

4) Getting guarantees to count as ODA for donors

Under current rules, development guarantees do not readily qualify towards DAC member countries' annual targets to deploy 0.7% of GNI towards ODA. Depending on the pressure to meet targets, national agencies could be dissuaded (or is unable to) issue guarantees preferring more traditional grant programs that are unambiguously ODA eligible.[10] Outliers here are Sida (the Swedish International Development Cooperation Agency), which has invested heavily in their guarantee portfolio over the past ten years (see **Box 3**)[11].

The treatment of guarantees and other "private sector instruments" (PSI) under ODA rules have been subject to revision for a number of years, including a new parallel tracking of "total official support for sustainable development" (TOSSD).

[9] DANIDA, "Private Capital for Sustainable Development", 2016. Read more here.
[10] Seven countries deployed more than the 0.7% target in 2017. Read more here. / OECD, "Guarantees for Development", 2013. Read more here.
[11] Sida, "Guarantee Portfolio 2017",

Modernisation of ODA and PSI was again on the agenda at the high-level DAC meeting in October 2017, but we understand the DAC members are yet to reach final agreement on the new approach. It is expected that the new approach will count for development guarantees, but subject to a number of rules and thresholds around concessionality and additionality.[12]

Q: Can the Taskforce and its partners assist in this process?

Q: Is there enough private sector involvement in these conversations?

Box 3. Spotlight: Sida's Guarantee Portfolio
As of 2017, Sida had agreed upon guarantees of aggregate SEK 7bn ($770m) of their total guarantee frame of SEK 12bn ($1.36bn). In total, the agency calculates they have mobilised nearly SEK 19bn ($2.6bn), a mobilisation ratio of 3,7:1, and that it has facilitated SEK 37bn in available lending at a cost of SEK 250m (along with co-guarantors). More than 40% of the guarantees have been issued for infrastructure projects (including for IFC's MCPP infra programme), with the remainder primarily going towards MSME lending (26%), energy projects (14%) healthcare (9%).
The Sida guarantee program mobilises guarantees for development projects in partnership with a number of stakeholders and has an overall loss rate of 0.07% to date. With more than SEK 4bn in the pipeline to be agreed in 2018, Sida is continuing to scale up their guarantee portfolio in the future.

5) High ambition MDB and DFI scorecards to incentivise the use of catalytic instruments

Generally speaking, we understand that most of the MDBs and DFIs still use / work with internal incentive structures – both formal and informal – that place a higher value on an organisation's annual investment and loan commitments ("volume targets") than on total external capital mobilisation. This is also driven by MDB/DFI business models. The Blended Finance Taskforce encourages the development bank community to adjust scorecards and other incentive systems in ways which will be conducive to scaling up the use of instruments such as guarantees which have the ability to increase private capital mobilisation.

Q: What are the "lessons learned" and good examples when it comes to incentivising guarantees and other catalytic instruments vis-à-vis other direct investments or loans?

DATA / BALANCE SHEET OPTIMISATION

6) What do low claim ratios and default rates tell us?

The reported default rates for development guarantees are quite low. One example is USAID's credit guarantee program – with a default rate of 2.4% across 74 countries between 1999 and 2017.[13] Similarly, MIGA's political risk insurance (guarantee) program has very low claim loss ratios over the years. MIGA has had no claims on its sovereign and SOE focused credit enhancement products to date.

The data and default rates still don't give us the full picture in terms of how frequent the development guarantees could (at least in theory) have been called upon – and when they have instead acted as a forcing mechanism for a re-structuring and re-negotiation of terms. For example, MIGA emphasises that "the collaboration with the World Bank Group as pre-claims issues arise has been critical to its low claim loss ratio".[14]

[12] Development Initiatives, "ODA modernisation an update following the October 2017 HLM", 2017. Read more here or watch useful webinar here.
[13] USAID DCA. Read more here.
[14] MIGA, "Strategy and Business Outlook 2018-2020". Read more here.

Using development guarantees, and the presence of MDBs, DFIs and development agencies, as a tool for re-negotiation speaks to the powerful nature of having international financial institutions as parties to a transaction through a guarantee. However, the work-out process suggests that we need to be somewhat careful about drawing simple conclusions about the "actual versus perceived risk" based on default rates or low claim rates of guarantees only.

Q: To what extent do lengthy "work-outs" and low default rates deter the private sector from using development guarantees from development banks and agencies today due to perceived (or real) lack of liquidity and slow enforceability?

Q: On the other hand, could a push for making development guarantees more "on demand" with faster claim procedures jeopardise the benefits of having development actors negotiating at the table?

7) Challenges of measuring mobilisation and effectiveness of guarantees

A key metric used to measure the effectiveness of development guarantees is how much private capital the instrument "mobilised". However, capturing this accurately is quite difficult due to the current lack of data and standardised reporting on development guarantees. The joint MDB report on climate finance does offer some insight into the use of development guarantees across their operations (e.g. it accounted for 4% of their total reported climate finance in 2017). However, the report does not report on the "mobilisation effectiveness" of development guarantees vis-à-vis other instruments. The OECD's reporting is better here as it offers a mobilisation breakdown per instrument. It suggests that guarantees are the most effective mobilisation instrument (accounting for around 45% of private capital mobilised compared to 5% of the committed), however it is arguably on the high side as it credits the "full loan value" to the issued guarantee.[15]

Another metric to measure the mobilisation impact of a development guarantee is the "available lending" approach. This method captures the total amount of possible lending that is generated by a guarantee arrangement made with local implementing partners. For example, USAID's issuance of 542 guarantees – mainly to local banks or non-bank financial institutions – has resulted in more than 250,000 loans from those institutions to SMEs in-country that might not have otherwise received capital.[16]

Q: Do we need a more consistent approach to measure the leverage effect of guarantees across institutions? Can we accelerate the release more granular mobilisation data per instrument (e.g. from the MDBs)?

8) How effective are development guarantees for balance sheet/budget optimisation

The Taskforce recognises that the current accounting treatment of guarantees by national treasuries, development banks and rating agencies can create a disincentive for their broader use. For example, the use of a *guarantee* for a private sector loan and a *direct* private sector loan may have the same balance sheet impact.

Some bilateral donors can transfer the face value of the exposure to their respective treasury departments and only set aside resources for expected losses, so guarantees and equivalent

[15] Reference guide MDB vs OECD mobilisation data. Read more here.
[16] USAID DCA. Read more here.

products can act as a budget leveraging tool.[17] For example, USAID records an obligation for subsidy cost for its loan guarantees which is based on the net present value of the estimated net cash outflows to be paid by the program as a result of the loan guarantees, except for administrative costs, less the net present value of all cash inflows to be generated from those guarantees.[18]

For organisations that do not benefit from budget or balance sheet leverage, guarantees and equivalent products still offer the opportunity for enhanced leverage of their operational and staffing resources because of the ability to shift much of the transaction structuring, arranging, and ongoing investment monitoring responsibilities to private sector partners.

Q: Is there a need to change the provisioning rules and accounting treatment of guarantees to stimulate more widespread use?

Q: Is there any role for the OECD and others to encourage donor countries to review their accounting treatment (and leverage the potential) of guarantees? Would more knowledge sharing across development agencies be beneficial?

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[17] Milken Institute and OECD, "Guaranteeing the Goals: Adapting Public Sector Guarantees to Unlock Blended Financing for the SDGs", 2018. Read more here.

[18] USAID Audit Report 2017. Read more here.