RESEARCH NOTE: GUARANTEES

Guarantees for Sustainable Development – Achieving 10x Mobilisation

October 2023

SUMMARY

- **G7 and G20 leaders have called for the mobilisation of trillions of dollars of private capital to finance sustainable development, green infrastructure, and the energy transition in emerging market and developing economies (EMDEs).**
- **By reducing risk and transforming sub-investment-grade assets into investment-grade securities, guarantees can offer best-in-class mobilisation rates, outperforming other financial instruments by up to 5-6 times[1].**
- **Yet, guarantees remain underutilised in developing economies – the very markets where they could add the most value due to a lack of collateral and acute risk misperceptions among investors.**
- **Development finance actors are especially well-placed to expand the provision of guarantees. In addition to de-risking directly, donors and development finance investors can provide seed equity to establish dedicated guarantee platforms offering requisite specialisation and funding flexibility.**
- **Deploying guarantees to *demonstrate* the commercial viability of new asset classes offers the potential for genuinely scalable private capital mobilisation. When demonstration effects take hold and risk perceptions improve, scarce guarantee capacity can be recycled to catalyse new issuers.**

CONTEXT

Credit guarantee schemes reduce funding costs and offer best-in-class mobilisation but remain underutilised

G7 and G20 leaders have called for the mobilisation of trillions of dollars of private capital to finance sustainable development, green infrastructure and the energy transition in EMDEs. The Organisation for Economic Cooperation & Development (OECD) estimates[2] that at current investment levels, another US $3.7 trillion in funding will be needed every year to meet the United Nations's Sustainable Development Goals (SDGs) by 2030. This funding gap cannot be filled without involving commercial capital. However, mobilising private investment requires concrete and innovative financial solutions.

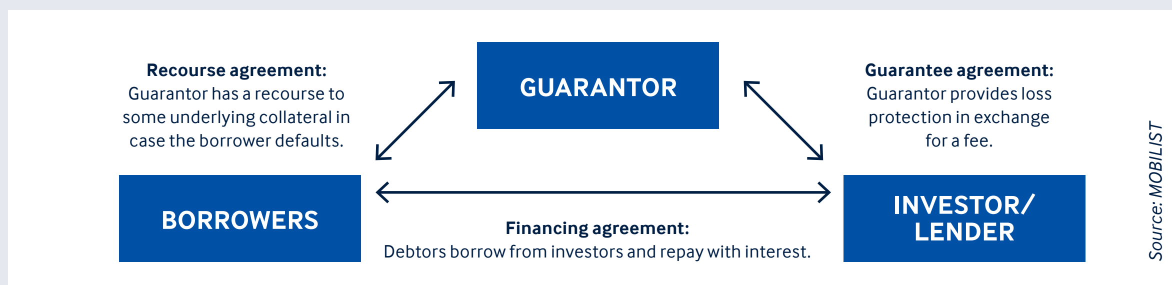
1 Blended Finance Taskforce: Better Guarantees, Better Finance (2023) p. 5

2 OECD: Global Outlook on Financing for Sustainable Development 2021: A New Way to Invest for People and Planet

BOX 1 – UNDERSTANDING GUARANTEE SCHEMES

Typically, there are three parties in any guarantee scheme: borrowers, guarantors, and lenders or investors. Each party has clearly defined rights and responsibilities (see Figure 1).

Figure 1 – Guarantee Schemes



Guarantee schemes can play a critical role in unlocking private capital at scale, especially when collateral is scarce[3] and risk misperceptions are acute[4]. Guarantee schemes transfer risks[5] that investors usually face to a third party (see Box 1). Guarantees provide a valuable bridge for EMDE borrowers to reach maturity and establish a track record to enable them to graduate to borrowing without credit enhancement. By reducing capital costs and enhancing funding flexibility[6], guarantees can generate a range of economic benefits for EMDE issuers and markets, enabling larger investments and accelerated growth.

Guarantees are a cost-efficient method to improve the creditworthiness of EMDE businesses. Guarantor fees are relatively low compared to the elevated borrowing costs these companies face. Guarantors *"generally charge anywhere between 0.5% to 1% of the amount that they guarantee,"*[7] which is low when compared to the average funding cost gain of ca. 2-3%. This cost gain is most notable when credit ratings improve to investment grade.[8]

The main risks associated with guarantee schemes are moral hazard and a lack of diversification. Once debt is underwritten by a third-party guarantor, the investor or lender may feel less pressure to complete an in-depth due diligence process. On the other hand, the borrower may take on more risk than is appropriate. These risks are particularly high in contexts of inadequate regulation and corporate governance that fail to protect against conflict of interest, negligence, fraud, and excessive leverage. Weak regulation also increases costs and uncertainty over collateral recovery in default.

Guaranteed assets also need to be diversified at scale. The leading monoline insurance companies were hit hard during the Global Financial Crisis because they held a large number of correlated exposures (mortgage-backed securities), which all lost value at once. If there is even a single default during the build-up of a guarantee structure, it can meaningfully impact the capital base. This raises the risk of a downgrade and affects the potential for private capital mobilisation. To protect against such an event, guarantee schemes must have enough scale to build an uncorrelated, diversified asset base.

Guarantee structures have great potential for private capital mobilisation. As the Blended Finance Taskforce explains: *"Guarantees show the highest mobilisation ratios, on average mobilising $1.5 of private capital for every dollar of multilateral development bank (MDB) capital and outperforming the average mobilisation ratio of loans and equities by 6 times"*[9] (see Figure 2). Export guarantees are one of the best demonstrations of this potential. These guarantees enable billions of dollars in trade with EMDEs while placing relatively little burden on government budgets.[10] Superior mobilisation ratios mean that guarantee structures punch well above their weight as a proportion of private finance mobilised globally. This is especially the case among funders in the United States, France, and Sweden (see Figure 3, based on OECD definitions and data).

Unlike direct lending, guarantees are particularly efficient in mobilising private capital because they reduce the risk facing commercial lenders and investors and impact regulatory capital provisions for EMDE assets. Under Basel III rules,[11] the risk weight

3 Source: Menkhoff, Neuberger, Rungruxsirivorn: Collateral and its Substitutes in Emerging Markets' Lending (Journal of Banking and Finance, Sep 2011)

4 See Moody's (2023): Default and recovery rates for sustainable project finance bank loans, 1983-2020

5 Given the most common risks in EMDEs there are three broad types of guarantees in development finance: credit, political risk and currency guarantees. Source: Blended Finance Taskforce: Better Guarantees, Better Finance (2023)

6 Source: https://kpmg.com/ch/de/blogs/home/posts/2021/09/financial-guarantees-in-focus.html

7 Source: https://www.managementstudyguide.com/pros-and-cons-of-bank-guarantees.htm

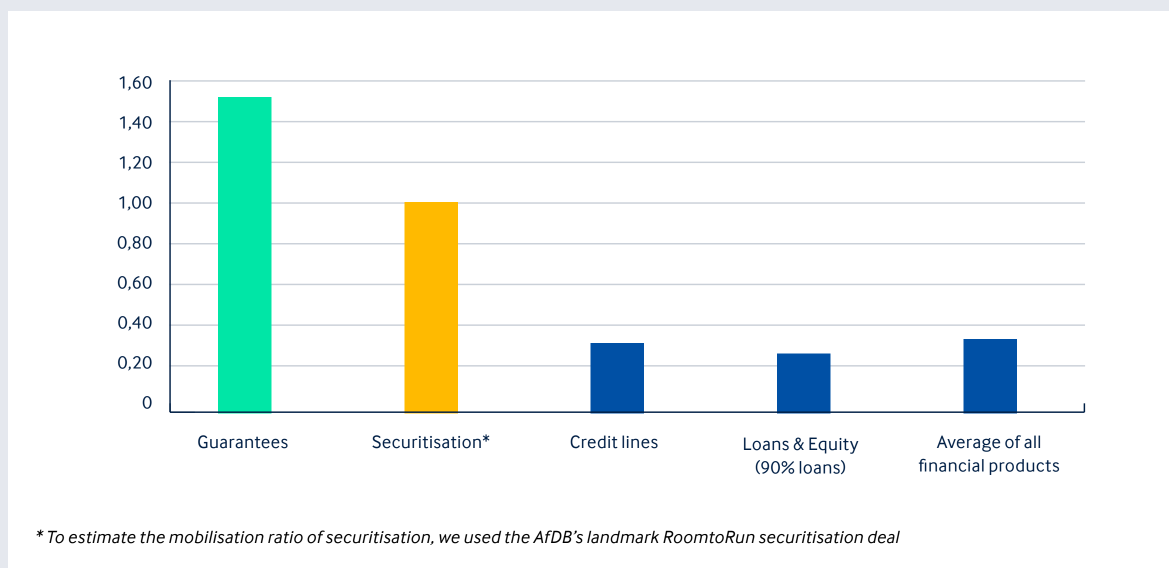
8 Source: Montana Department of Revenue: High Yield Study (based on corporate bond yields in 2021)

9 Blended Finance Taskforce: Better Guarantees, Better Finance (2023) p. 17

10 Inga Heiland and Erdal Yalcin: Export market risk and the role of state credit guarantees (International Economics and Economic Policy 2021) p. 26

11 Basel Committee on Banking Supervision: High-level summary of Basel III reforms (Dec 2017)

Figure 2 – Mobilisation ratios of financial instruments (2016-2020 MDB aggregate data)[12]



** To estimate the mobilisation ratio of securitisation, we used the AfDB's landmark RoomtoRun securitisation deal*

for financial instruments rated between AAA and AA- is 20%, compared to 100% for instruments rated between BB+ and B-. This means that if a guarantee allows an issuer to secure an upgrade from BB+ to AA, the reserve capital that a financial institution needs to hold against this asset falls five times. In this way, using guarantees to enhance an asset's credit rating could potentially free up significant extra capital for new investment.

Guarantees of listed products can also help mitigate information asymmetries, bringing EMDE assets to market that can help correct investors' risk misperceptions. For example, Moody's research shows that EMDE project default rates are not dissimilar to those of developed economies.[14] In fact, *"expected loss provisions of guarantees are typically higher than actual claims by a factor between 7 and 20."*[15] Therefore, carefully considered guarantees can reduce unjustified interest rate premiums and deliver market returns, as *"guarantees can help address the information asymmetry, reducing uncertainty and enabling more accurate estimations of risks in future projects."*[16] The unparalleled transparency of public markets accelerates the transmission of price signals and risk information. As a result, allocator misperceptions are also mitigated faster. This implies that guarantees are most appropriate when the market is mispricing credit risk, as the above evidence on EMDE project finance suggests.

Yet, guarantees remain underutilised as a financial solution for private capital mobilisation. In the analysis underpinning Figure 2,[17] guarantee schemes represent just 4% of total commitments. Although the global financial guarantees market expanded significantly to support the recovery of banks' lending activity after the 2008-09 Global Financial Crisis, it declined again in recent years to below US $40 billion. On average, MDBs only provided EMDEs with US $1.4 billion per year in guarantee cover for climate finance purposes.[18]

One of the main reasons appears to be that development finance actors' business models incentivise staff to focus more on origination and less on private capital mobilisation.[19] Since, from an origination point of view, the accounting treatment of guarantees (rightly or wrongly[20]) is the same as that of loans[21], MDB personnel are not directly incentivised to focus on guarantees. This is despite guarantees' potential for superior transaction-level mobilisation by reducing capital costs for underlying borrowers and investees while transferring risk from commercial investors' balance sheets. Perhaps the key exception is where MDBs recognise that they are not the most efficient funders in the market. For example, guarantees may be more efficient than hard currency borrowing and on-lending by MDBs in the case of local currency bank facilities, where the local bank has access to local currency markets and can itself on-lend in the same currency.

12 Sources: Blended Finance Taskforce: Better Guarantees, Better Finance (2023) p. 17 and https://www.afdb.org/en/news-and-events/african-development-bank-and-partners-innovative-room-2run-securitization-will-be-a-model-for-global-lenders

13 OECD: PRIVATE FINANCE MOBILISED BY OFFICIAL DEVELOPMENT FINANCE INTERVENTIONS: Opportunities and challenges to increase its contribution towards the SDGs in developing countries (Jan 2023)

14 Moody's (2023): Default and recovery rates for sustainable project finance bank loans, 1983-2020

15 Blended Finance Taskforce: Better Guarantees, Better Finance (2023) p. 18

16 Ibid. p. 18

17 Ibid. p. 17

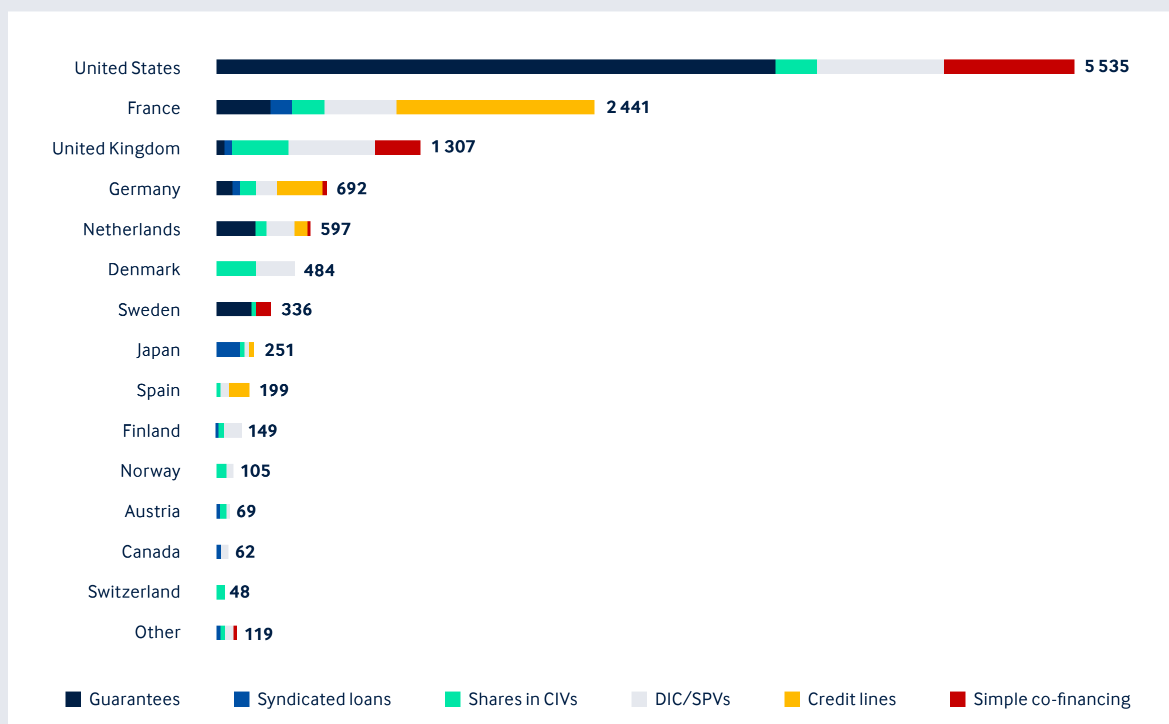
18 Ibid. p. 17

19 As earlier MOBILIST research observes: "Conversations held with DFI teams and management…feedback from private investors, and engagement with DFIs all provide evidence of the same core issue: there is a need for better alignment of DFI incentives and private capital mobilisation objectives." p. 68 Source: Eighteen East/Mobilist/FCDO: The exit-mobilisation opportunity in Africa (March 2021)

20 There are arguments on both sides: the rationale for preferential accounting treatment of guarantees is that MDBs only need the liquidity if the guarantee is called, while lending demands finances to be raised upfront. The counterargument is that ceteris paribus the probability of a guarantee being called is the same as loans defaulting, therefore provisioning must be the same.

21Source: Chris Humphrey and Annalisa Prizzon: Guarantees for development: A review of multilateral development bank operations (Dec 2014)

Figure 3 – Mobilised Private Finance by Bilateral Providers (2018-2020 average in US $m)[13]



POLICY IMPLICATIONS

MDBs and their shareholders are especially well-placed to expand guarantee cover

Development finance actors are especially well-placed to facilitate a renewed expansion of guarantees for sustainable development. This could happen in at least three ways, with momentum building on shareholder guarantees in particular:

1. **Shareholders guaranteeing MDB lending.** The Innovative Finance Facility for Climate in Asia and the Pacific (IF-CAP) guarantee platform[22] developed by the Asian Development Bank (ADB) is a good example. The IF-CAP targets US $3 billion in shareholder guarantees to facilitate up to US $15 billion in new loans for climate projects across Asia and the Pacific[23].

2. **Shareholders directly guaranteeing EMDE bonds and loans.** For example, the US Sovereign Bond Guarantee (SBG) programme has provided targeted cover for US $23.78 billion from 1993 to 2019, often supporting US strategic and foreign policy goals.[24]

3. **MDBs acting as guarantors of EMDE bonds and loans.** For example, major guarantee programmes by the World Bank and the European Fund for Sustainable Development similarly offer 6-8x mobilisation ratios.[25,26] The Roadmap for the Implementation of the Recommendations of the G20 Independent Review of MDBs Capital Adequacy Frameworks recommends additional leveraged guarantee platforms.[27]

22 Ibid. pp. 29-30

23 Source: https://www.adb.org/news/adb-announces-if-cap-new-program-accelerate-billions-climate-change-financing

24 https://www.cgdev.org/sites/default/files/greening-us-sovereign-bond-guarantee-program-proposal-boost-climate-directed-sovereign-paper.pdf

25 Sebnem Erol Madan: Big Risks for Big Rewards: How World Bank guarantees support transformative solutions for complex problems (June 15, 2023)

26 Global Gateway: EU greenlights 40 new guarantee programmes under the European Fund for Sustainable Development plus (Brussels, Dec 2022)

27 G20 Roadmap for the Implementation of the Recommendations of the G20 Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks (July 2023) p. 15

Public-private partnerships are required to expand guarantee cover of this nature. For example, Sunfunder Inc., a specialised private finance intermediary, benefitted from a Swedish International Development Agency (SIDA) loan portfolio guarantee that enabled it to offer loans to solar energy sector companies in sub-Saharan Africa. Vumbuzi Multiplier Impact Fund, launched by SouthBridge Investments, similarly employed a guarantee instrument to mobilise commercial capital for reforestation and land restoration investments in Africa. The AFRI Climate & Transition Fund (ACT), launched by ARM-Harith Infrastructure Investments, finances green- and brownfield clean energy by offering partial credit guarantees alongside technical assistance.

Extensive collaboration with credit rating agencies (CRAs) is also needed to scale guarantee platforms further. As the G20's Implementation Road Map[28] suggests, MDBs should coordinate with CRAs to capture the full mobilisation potential of guarantee structures.

CRAs are generally open to evaluating guarantee schemes. While they insist on certain core principles,[29] MDBs have already studied and incorporated the agencies' rating methodologies (especially in infrastructure guarantees[30]), which should open the possibility of launching new guarantee structures.

This is especially important as rating methodology is intimately related to mobilisation ratios. Since the most significant cost of capital saving is tied to achieving an investment grade rating, it is important to appreciate how rating agencies view the relationship between rating and leverage. For example, one of the key conditions of an investment grade rating by Fitch is that the ratio of outstanding (green) bond portfolio to capital may not exceed 10x in a guarantee structure[31].

Although this caps the mobilisation rate of guarantee products at 10x, it still compares most favourably with the mobilisation ratios of most other investments in MDB portfolios.

Seeding new specialist guarantors to aid EMDE climate adaption

One of the most innovative and scalable guarantee platforms for climate investments is the Green Guarantee Company (GGC)[32]. Recognising that less than 10% of green bond proceeds flowed to emerging markets outside China in 2022.[33] GGC will issue guarantees and provide technical assistance to enable developing country borrowers to raise financing through listed hard currency green bonds and other green instruments. This will include bonds listed on the London Stock Exchange and other exchanges with robust regulatory frameworks.

GGC is the first specialist guarantor for emerging market climate adaptation and mitigation projects.[34] GGC's cover will prioritise green infrastructure, renewable resources, alternative energy, and clean transportation. Guarantees will be prioritised for issuers from ODA-eligible countries in Africa and Asia, including India, Indonesia, Pakistan, Brazil, Bangladesh, Philippines, Egypt, Vietnam, Kenya, and South Africa. These guarantees seek to enable borrowers from developing markets to access capital traditionally destined for investment-grade instruments (see Figure 4). The GGC, with equity participation by MOBILIST, could achieve a 10 times mobilisation ratio by targeting a BBB rating, with a US $100 million guarantee fund potentially able to unlock US $1 billion in green financing from commercial investors.

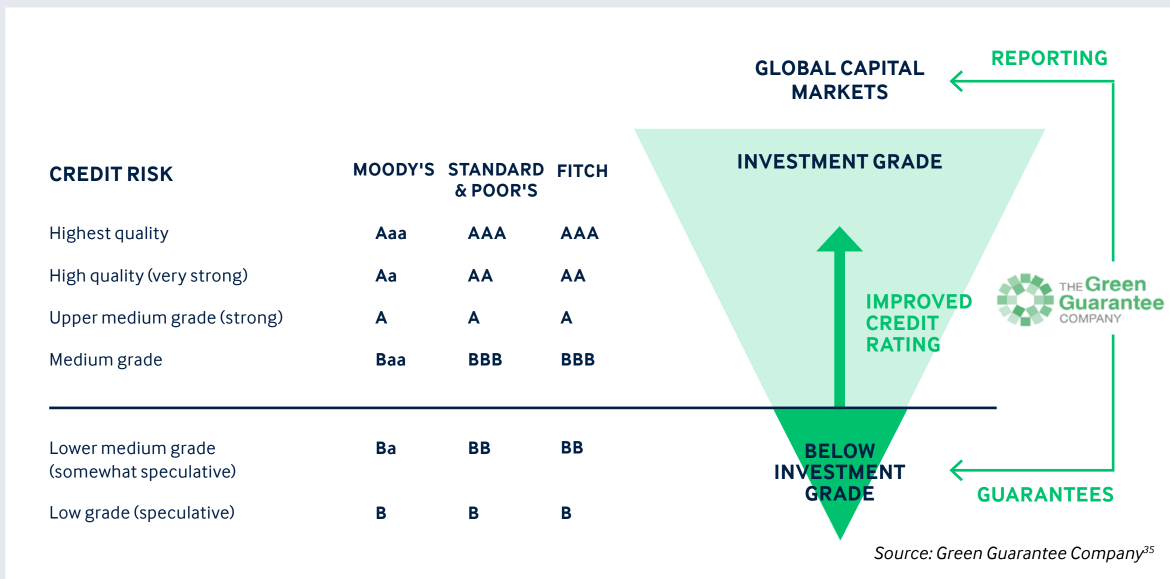
The GGC also offers Technical Assistance (TA) since one of the biggest hurdles of green bond issuance, especially in developing countries, is limited knowledge among issuers of relevant standards. Such technical assistance could reach US $15 million over the next 20 years, of which donor contributions and one-third by the GGC itself cover two-thirds. Technical assistance requirements may decline over time as emerging market issuers familiarise themselves with investors' climate requirements and investors become more familiar with emerging market hard currency green instruments.

MOBILIST's participation in the structure shows the value of official development finance in scaling green guarantees indirectly through seed equity investment in a specialist guarantor company. By providing equity into specialist and commercial guarantee platforms, official development finance actors can mobilise capital and efficiently outsource specialisation in pioneering asset classes – in this case hard currency green instruments. The GGC management team has intimate knowledge of the green finance market, a strong understanding of market segmentation across underlying instruments and associated risk profiles, and a strong track record with complex operational projects across multiple business areas. The team is also experienced in positioning guarantees in the market and development finance landscape and mobilising private capital with public sector capital providers. This skillset positions GGC with a unique, scalable offering in the market.

28 G20 Roadmap for the Implementation of the Recommendations of the G20 Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks (July 2023) p. 4
29 Moody's: Core Principles of Guarantees for Credit Substitution (2010)
30 G20 Introductory Guide to Infrastructure Guarantee Products (jointly prepared by MDBs (2018)
31 Climate Policy Initiative: Green Guarantee Company: Instrumental Analysis (Sep 2022) p. 17
32 Source: https://www.climatepolicyinitiative.org/wp-content/uploads/2022/10/GGC-overview.pdf
33 Ibid.
34 Ibid.

Official sector participation also ensures upfront and ongoing impact monitoring and enforcement, maximising the contribution of mobilised funds to sustainable development in EMDEs. For example, GGC guarantees have the capacity to finance aversion of up to 75 Mt carbon dioxide equivalent over the lifecycle of projects supported during the pilot phase.[36] Public commitment to such an impact ensures that funding raised subsequently by GGC will continue to support results prioritised at inception.

Figure 4 – Investment Grade Guarantees Improve Borrowers' Credit Rating



CREDIT RISK	MOODY'S	STANDARD & POOR'S	FITCH
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (strong)	A	A	A
Medium grade	Baa	BBB	BBB
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B

Source: Green Guarantee Company[35]

The potential future listing of the GGC could also create crucial additional learning for the wider investment community. Though there is no contractual obligation, a stated commitment from GGC shareholders suggests that once the GGC has established a track record, it will also list in the public market. Listing the GGC in public markets could potentially provide:

- Significant new capital to facilitate new guarantee capacity and so private capital mobilisation.
- The necessary liquidity for official seed investors to consider profitable exits, bringing in private capital to unlock development finance that can be recycled into new mobilisation schemes.
- Invaluable demonstration of the viability of green guarantee companies in general, encouraging private capital to establish new commercial guarantee platforms covering EMDE assets without the support of development finance actors.

MOBILIST's participation in this transaction is designed to generate crucial learning for both the development finance and the private investor community. It should not only reduce the information gap between perceived and actual credit default risks in EMDEs. It will also test the superior mobilisation ratios of guarantee schemes and the commercial viability of these structures in the context of hard currency green finance. The potential future listing of the GGC should also inspire the development finance community to find new ways to accelerate capital recycling and further mobilise private investment to finance sustainable development in EMDEs.

MOBILIST hopes that learnings from this transaction will inform the community's efforts to use scarce official development finance in the most catalytic way possible.

35 Source: https://greenguarantee.co/the-problem-we-solve/