

AFRICAN DEVELOPMENT BANK



BANK POLICY ON GUARANTEES

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I. INTRODUCTION

Background

- 1.1.1 At the time of the establishment of the Bank, certain instruments, including guarantees, were identified as the core financial instruments with which the Bank would carry out its function of mobilizing resources for the socio-economic development of its regional members. Accordingly, in Article 14(1)(d) of the Bank Agreement, the Bank is authorized to guarantee loans extended by other institutions. It may also be recalled that on January 12, 2000, the Board of Directors, by Resolution B/BD/2000/01, approved the General Authority on the Bank's Financial Products and Services (Document ADB/BD/WP/99/164) (the "General Authority"), which further confirmed that guarantees are one of the Bank's core financial products.
- 1.1.2 In April 2000, the Board approved a document outlining the interim principles and modalities to guide the issuance of Bank guarantees for a two-year pilot period.¹ This pilot program was capped at a loan equivalent amount of UA 750 million. In connection with the pilot program, Management recommended that at the end of the two-year pilot program the Bank would develop a comprehensive policy on Bank guarantees for Board consideration. In May 2000, when this Board approved the Bank's first guarantee operation, it also requested Management to prepare a policy document outlining the principles and modalities to guide the use of Bank guarantees to mobilize additional financial resources for member countries. This document responds to the Board's request.
- 1.1.3 To date the Bank has approved two guarantee operations, both in 2000. The first was in the amount of Euro 330 million to cover a proposed bond issue by the Development Bank of Southern Africa (DBSA). However, due to changes in its funding needs, DBSA did not utilize this approval, which has since lapsed. The second was for a Euro 13 million equivalent amount for MTN Cameroon, a private Telecommunications company to partially support a local currency syndicated loan. This has been signed and is effective. The experience gained in handling these two transactions has been taken into consideration in preparing this policy paper. The paper has also benefited from a review of the guarantee operations and policies of other Multilateral Development Banks.

1.2 Organization of the Report

This report is organized as follows: Chapter II, establishes the rationale for and role of guarantees in Bank operations, and describes the types of guarantees to be offered and their benefits. Chapter III discusses the operational policy and procedural aspects of guarantees, and Chapter IV the financial policy aspects. Chapter V summarizes the main conclusions and provides recommendations on how to proceed.

¹ "Guiding Principles For Bank Guarantees" document ADB/BD/WP/2000/48.

II. THE ROLE AND STRUCTURE OF BANK GUARANTEES

2.1 Economic rationale

Africa faces daunting development challenges, with close to half of its population living on incomes of less than \$1.00 a day. In response to these challenges, many of the countries in the region have embarked on stabilization and adjustment programs designed to stimulate rapid economic growth and reduce poverty. A key element of these programs is an increased role for private investment, especially in the provision of basic infrastructure. This calls for a significant increase in the flow of private investment to the continent. The African Development Report of 2001, for example, postulates that if the number of Africans living in poverty is to be halved by 2015, annual net capital inflows will need to be about \$20 billion, of which about 70% should be private flows. Thus, there is both a need and an opportunity for the Bank to help mobilize more private capital for RMCs. This calls for increased diversity in the Bank's financing instruments, and more flexibility in their utilization.

2.2 The Role of Guarantees

2.2.1 It is in this context that it is proposed that the Bank utilize its statutory ability to offer Guarantees proactively. This is in line with efforts that have been made since 1997 to expand the range of financial products and services available to Bank clients. Guarantees are financial instruments, which enable the Bank to leverage its creditworthiness to assist eligible borrowers, public and private, to obtain additional financing from the private sector, including through the international capital markets.

2.2.2 By covering risks that the market is not able to bear or adequately evaluate, the Bank's guarantee can attract new sources of financing, reduce financing costs and extend maturities. Principally, the Bank's objective is to cover risks that it is uniquely positioned to bear given its international financial standing, credit experience with African countries and special relationships with governments.

2.3 Types of Guarantees

2.3.1 A guarantee is an undertaking by a third party (guarantor) to fulfill the obligations of a borrower to a lender under a agreement, in the event of non-performance or default by the borrower of its obligations under the agreement. The underlying causes of default are generally defined ex ante as either commercial or political risks. Guarantees with full risk coverage will typically incorporate all commercial and political risks, whilst Guarantees with partial risk coverage will incorporate either commercial or political risks.

Commercial risks typically include volatile market demand for a company's products, and adverse movements in commodity prices, interest rates, foreign exchange rates and similar indices. Political risks encompass risks such as currency transfer, expropriation and similar measures, war and civil disturbance and breach of governmental agreement.

2.4 The Proposed Bank Guarantees

2.4.1 The Bank will provide guarantees that can generally be classified into two (2) categories: Partial Credit Guarantees, and Partial Risk Guarantees.

2.4.2 **Partial Credit Guarantees:** Partial Credit Guarantees (PCGs) cover a portion of scheduled repayments of private loans or bonds against all risks. PCGs could be utilized to support mobilization of private funds for project finance, financial intermediation and policy-based finance.

2.4.2.1 **Project Finance.** PCGs can be used for both public sector and private sector investment projects, especially in infrastructure. These guarantees can be used to encourage the extension of maturity and improvement in market access. The guarantee could cover the principal for bullet maturity bonds, or later maturity principal payments of amortizing syndicated loans. (See MTN example in Box 1)

2.4.2.2 **Financial Intermediation.** Institutions such as Banks can use PCGs to support the mobilization of long-term resources from both international and domestic capital markets. The ADB guarantee can be structured to cover the bullet principal repayment on a bond, or later maturities of a syndicated loan. PCGs for financial intermediaries can also be used from the financial sector development perspective to help deepen domestic money and capital markets. In this context, the Bank can also guarantee short and medium term instruments such as commercial paper issued by both private and public financial institutions. (See DBSA example in Box 1)

2.4.2.3 **Policy Based Finance.** A special example of a PCG is the Policy Based Guarantee (PBG), which can be structured to cover the full risks of portions of sovereign borrowings from private creditors. These guarantees can help improve sovereign's access to capital markets to raise financing in support of agreed structural, institutional and social policy reforms. Given that PBGs are considered as an alternative or supplement to adjustment loans, eligible client countries should have demonstrated a strong track record of performance. (See example of IBRD Argentina PBG in Box 1)

2.4.3 **Partial Risk Guarantees:** Partial Risk Guarantees (PRGs) cover private lenders against the risk of the government, or a government owned agency, failing to perform its obligations vis-à-vis a private project. PRGs can attract commercial financing in project finance transactions, particularly in sectors such as power, water, transport, telecom, oil and gas, and mining, where

project success depends as much on Government undertakings, as on private commercial acumen. In public-private partnerships, PRGs can give assurance to the private partners that government will meet its obligations toward the partnership. These guarantees can cover a variety of government risks, including government contractual payment obligations; availability and convertibility of foreign exchange; changes in law; expropriation and nationalization. The commercial risks under PRGs are fully borne by the private investors. (See example of Azito Power Project in Box 1)

Box 1

A. Description of the MTN Partial Credit Guarantee For Project Finance.

This guarantee covers up to Euro 13 million equivalent of principal payments on a local currency (CFA) syndicated loan raised by MTN Cameroon for a Euro 209 million cellular development project. This was a project financing for the purchase of equipment and the provision of related working capital. The ADB guarantee is shared *pari-passu* by FMO, which issued a guarantee of a similar amount to the company. The guarantee is secured by the project's comprehensive security package.

B. Description of the DBSA Partial Credit Guarantee For Financial Intermediation.

This partial credit risk guarantee was designed to cover a maximum of EUR 330 million of principal and one interest payment on a bond issue. The guarantee was to be denominated in the same currency as the bond issue and was to be limited to a maximum final maturity of 15 years, with an average life of not more than 10 years. The Bank's guarantee was conditional upon the conclusion of a counter-guarantee agreement pursuant to which the Government of South Africa would guarantee the Bank's obligations.

C. Description of the Argentina Partial Credit Policy Based Guarantee

The World Bank guaranteed the payment of the aggregate principal amount due on a scheduled maturity date for a single series of notes at any time, up to a maximum of \$250,000,000. Initially, only Series A notes were guaranteed. If Argentina pays the principal amount of the Series A notes on the scheduled maturity date, the guarantee of the World Bank will automatically roll forward to the principal amount of the new series of notes. If Argentina fails to pay the principal amount of the series then guaranteed by the World Bank, and the World Bank has made a payment under its guarantee, the guarantee will be rolled forward to the next series of notes only if Argentina reimburses the World Bank within 60 days of such payment by the World Bank. Neither the series of notes that is at any time guaranteed by the World Bank nor the World Bank guarantee itself may be accelerated and paid prior to the scheduled maturity of such series under any circumstances.

D. Description of the Azito Partial Risk Guarantee For Project Finance.

The US\$30.2 million commercial loan supported by an IDA Partial Risk Guarantee was syndicated on a *pro rata* basis with an IFC B Loan. The IDA PRG guaranteed commercial lenders against defaults in debt service on a non-accelerated basis resulting from State default on its undertakings under the CA (Concession Agreement) and the CCEM ("Contract Clef en Main"). IDA would make payment to the lenders in accordance with the amortization schedule pre-agreed with them or prepay the loan, at its option, if the default amount was the result of: (i) Payment default of the State under the CA or the CCEM; (ii) Internal *force majeure*; (iii) Change in law causing a material adverse effect on the Company; (iv) Nationalization; (v) Expropriation; (vi) and Changes in the CFA arrangement affecting transferability or convertibility.

2.5 The Benefits and risks of Guarantees

2.5.1 Both the Bank and its borrowers will benefit from the use of Bank guarantees. For the borrowers, the main benefits are:

- The leverage of the Bank's creditworthiness will help attract private financial resources at a reduced cost. For instance, rating agencies have rated bonds guaranteed by a AAA-financial institution, up to three notches above the sovereign ceiling, allowing countries that are close to investment grade to access the investment grade investor class while lowering the cost of funds;
- The enhanced access to financing for projects/programs which, in the absence of the guarantee, would have been too risky to qualify for private sector funding;
- The opportunity to establish credibility in capital markets and to have a direct interaction with private lenders.

2.5.2 From the Bank's perspective, a guarantee will:

- Broaden the scope of its development activities by enabling it to leverage its financial strength to help regional member countries attract more private financial resources;
- Permit the Bank to align its financing instruments fully with those of the other MDB's.

2.5.3 The risks associated with guarantees are generally similar to those associated with loans. Consequently, guarantee risks, such as credit, liquidity, and currency risks, will be mitigated with the same measures and instruments as Bank loans.

2.6 Demand For Guarantees

2.6.1 Although the Bank has approved only two guarantees there is potential for more active use of the instrument, and more demand is likely to be generated when it is actively marketed. Based on recent inquiries and discussions with potential clients, it is estimated that, on average, about two to three guarantees can be concluded per year for two types of transactions.

2.6.2 First is for private infrastructure projects for which large amounts of debt financing of long maturities is required. Typically, projects in the telecommunications and power sectors, because they generate their revenues in local currency, often find it attractive to mobilize local currency debt funding. Sponsors of these projects and their financial advisors have however had difficulties in structuring financing plans with the appropriate amounts of long maturity local funding. Indications are that they would be quite keen to utilize an ADB guarantee in these situations to support the mobilization of the needed long term local funding. For instance the Private Sector Department is currently in discussions on two projects, one in telecom and the other in power, that have expressed an interest in such a guarantee.

- 2.6.3** The second area is in support of resource mobilization by financial intermediaries. In the past the Bank has provided lines of credit in foreign currencies to DFIs. However, as the range of financial intermediaries the Bank supports gets diversified to include private commercial banks and merchant banks, the traditional line of credit may no longer be the most appropriate instruments for these newer types of client. Already, some of the financial institutions in discussions with the Private Sector Department have expressed an interest in raising funds through the issue of local debt instruments guaranteed by the Bank. For those financial intermediaries active in financing SMEs, this approach, in lieu of direct local currency borrowing from the Bank, is currently the most feasible way of providing Bank support.
- 2.6.4** With respect to demand for policy-based guarantees, there are no active inquiries at this time. The proposal to offer this instrument should therefore be seen in the context of its potential use, on a fairly limited basis, in the middle-income countries. As indicated in the proposals to enhance Bank operations in these countries, Bank guarantees can be used to support their borrowing in the international capital markets. This could be done either as part of structural adjustment type loans, or other types of balance of payments or budgetary support financing.
- 2.6.5** Overall it should be noted that even with more active marketing of guarantees, the core financial instrument of the Bank would remain the loan product. The experience to date of the World Bank Group and the Asian Development Bank with their Guarantee Programs indicate that their respective total exposures from Guarantees does not exceed 2% of their outstanding loan portfolios.

III OPERATIONAL POLICY ASPECTS

3.1 Country Eligibility and Country Strategies

3.1.1 Although guarantees to be issued by the Bank will be contingent liabilities, in the event that they are called, they will create the same repayment obligations to the Bank as a disbursed loan. Therefore, it is intended that in using this instrument, the same country creditworthy and eligibility criteria that applies to loans be followed.

3.1.2 In this connection, the projects and programs to be supported by guarantees must be consistent with the Bank's country strategy. Country Strategy Papers (CSP) will be required to assess the use of guarantees as part of the Bank's array of instruments of potential intervention in providing assistance to a country. In addition to a government's efforts to utilize current resources as efficiently as possible, it is important that the minimum credit enhancement required to mobilize additional private financing be provided. The CSP would therefore identify potential sectors that could benefit from guarantees as well as assess the contingent value of guarantees, which the Bank could provide to the borrower in support of new investments.

3.2 Project/Sector Eligibility

Any project eligible for ADB financing (whether public or private sector) will be eligible for a Bank guarantee. Therefore, the eligibility criteria for guarantees will be similar to the current one for loans. For Policy Based Guarantees (PBG), the eligibility would be governed by the same policies and practices as Policy Based Loans (PBL). In practice, the Bank will only engage in PBG when a co-financing and partnership exist with the World Bank and the International Monetary Fund (IMF).

3.3 Linkage with Bank Lending

Guarantees, as complementary instruments to loan products, are intended to broaden the range of the Bank's instruments of intermediation on behalf of its borrowing member countries. A Bank guarantee can be used in conjunction with a loan, or as a stand-alone instrument. In any case, guarantee operations will be conducted in accordance with the Bank's normal project processing procedures.

3.4 Implementation Strategy

To ensure that guarantees achieve their full potential as a Bank financing instrument, a proactive strategy to mainstream their use in Bank operations will be developed and implemented. This strategy will include active marketing to both external and internal constituencies. A specific guarantee product brochure will be prepared which will outline the features, terms, and benefits of the instrument and provide examples of how it can be utilized.

This will be deployed in a marketing plan targeted at RMC governments, project sponsors, financial institutions and our co-financing partners. Internally a training and awareness program will be developed for task managers and other operational staff involved in identification and appraisal of Bank operations.

3.5 Identification and Appraisal

Guarantee operations, whether developed in conjunction with a Bank loan or on a stand-alone basis, would be identified, prepared and appraised to ensure that they meet normal Bank standards. This would include assessment of the technical, environmental, economic and financial aspects of the project. For private sector projects, where private investors and financiers bear a significant financial risk, the Bank would undertake its appraisal in close collaboration with the private financiers who normally require a thorough technical, environmental and financial review by competent parties as a part of their own due diligence. In such circumstances, the Bank could allow its partners to take the lead in those aspects of appraisal and focus its own efforts on ensuring consistency of the project with sector policy. A similar approach would be applied for projects appraised by other multilateral financing agencies whose appraisal practices and processes are satisfactory to the Bank.

3.6 Board Approval

Board approval of guarantee operations would, in general, be in accordance with the process applicable to loans. The approval of the Board would be sought only after the structure of the guarantee is fairly well defined.

3.7 Supervision

Bank supervision would be consistent with the approach followed for loans. When the guarantee is to support a private sector project, in which the investors and commercial lenders bear the risks normally associated with commercial aspects, the Bank would supervise the project in close collaboration with the private financiers. However, the focus of the Bank's supervision efforts would be on periodic monitoring of the government's contractual obligations, which are backed by the Bank's guarantee. When a guarantee is for a public sector project, all normal supervision requirements of the Bank would be followed.

3.8 Procurement

The Bank's concern for the appropriate use of funds and for economy and efficiency applies equally to its public and private sector operations, including its guarantees for loans made by other lenders. Procurement of goods, works or services shall be undertaken by the Bank's guarantee beneficiary in accordance with established commercial practices, acceptable to the Bank. Wherever appropriate, the Bank will encourage the use of International Competitive Bidding tendering method by its private sector clients,

particularly for large contracts. In all cases, the Bank requires procurement processes that are competitive, transparent, observe the highest standards of ethics and give proper consideration to the eligible nationality of contractors or consultants and origin of goods in accordance with the provisions of the Bank's *Rules Of Procedure For Procurement Of Goods And Works and Rules of Procedure for the Use of Consultants*. The appraisal report or the minutes of the guarantee negotiation shall clearly indicate the rules of procedure to be followed.

3.9 Environmental Assessment

All projects, which are funded, partially or fully, from the proceeds of financing mobilized using Bank's guarantee would be required to comply with the Bank's environmental assessment requirements. The underlying projects will be classified according to the Bank's standard environmental categories.

3.10 Cooperation With Other MDBs

As is the case with direct financing, the Bank will seek whenever possible to work with financial institutions involved in development investments in Africa. The proposed guarantee program is complementary to programs that exist at other institutions, and will allow the Bank to participate in co-guarantee operations and achieve better risk sharing in projects. The existing relationship with institutions within the World Bank Group, such as MIGA and IFC, will be strengthened. For instance the Bank will not provide political risk insurance for equity, which MIGA provides. Thus in projects where MIGA is covering both debt and equity, the Bank and MIGA can co-guarantee the financing; with each institution underwriting the risk it is better equipped to absorb. Another area where cooperation will be reinforced is the area of PBGs. The introduction of guarantees will also open up relationships with the export credit agencies looking for co-financiers in large private infrastructure projects.

IV FINANCIAL POLICY ASPECTS

4.1 Capital Adequacy and Exposure Framework

4.1.1 As a contingent liability, a guarantee creates credit exposures similar to direct lending. The provisions of Article 15(1) and (3) of the Bank Agreement on maximum Bank exposure will therefore apply in respect of guarantees. For the purpose of measuring credit exposure, the loan equivalent of the guarantee would be computed. The loan equivalent is the present value, from the first callable date, of the outstanding guarantee amount, as increased or decreased by disbursements and repayments. The discount rate for calculating the present value shall be the applicable borrowing cost for the relevant maturity, in the currency in which the guarantee is denominated, as determined by the Bank on the date the present value is calculated.

4.1.2 In accordance with the policy on Capital Adequacy and Exposure Management (B/BD/WP/2000/29), the loan equivalent exposures created by guarantees shall be aggregated with the exposures of loans. The addition of a guarantee and any other form of Bank assistance shall not exceed the limits applicable to a Bank loan to a project or country, unless otherwise approved by the Board.

4.2 Borrowing and Liquidity Management

As a financial institution, the Bank has to harmonize its disbursement projections with its borrowing programs. To maintain the harmony, the Liquidity Policy incorporates the loan equivalent values of guarantees in the determination of the Bank's operating liquidity level.

4.3 Pricing of Guarantees

The Bank will charge the same fees for guarantees as for loans. The objective of the Bank is to be net income neutral whether it issues a guarantee or makes the underlying loan. In order to achieve net income neutrality, guarantee charges should be set on a loan equivalent basis (see definition in paragraph 4.1.1). Accordingly, the Bank will be able to use its risk bearing capabilities efficiently and be consistent in its pricing of products so that clients' choices are not distorted. The underlying rationale for this pricing methodology, which is in line with market practice, is that the risks of default for a given borrower would be the same for a loan and a guarantee. From a financial point of view, the Bank should be indifferent as to which instrument a borrower chooses. Borrowers on the other hand will choose the instrument that, in their view, will provide the greatest development return. An additional strong reason for aligning guarantee charges to charges on loans is that the cooperative nature of the Bank will make it difficult to justify charging different prices on guarantees and loans where they create the same exposure to risk.

4.4 Fees

4.4.1 On the basis of the principle of pricing neutrality between loans and guarantees, the following fees will be applied to Bank guarantees.

Front-end fee

4.4.2 The front-end fee applicable to guarantees will be the same as those applicable to loans. For private sector borrowers, the Private Sector Guidelines set the front-end fee within a range of 0.5-1% of the principal amount. However, when market conditions warrant otherwise, this fee can be set outside this range. Although the Bank does not currently charge front-end fees to public sector borrowers, in the event that such fees are introduced for public sector loans, they will similarly be applied to the guarantees.

4.4.3 The front-end fee will be charged on the Bank's possible maximum exposure under the guarantee and would be payable before or at guarantee signature, however when market and/or conditions warrant, the front-end fee may be paid up to thirty (30) days after guarantee signature or as agreed among co-financiers in co-financed projects.

Standby fee

4.4.4 This fee is similar to the commitment fee charged on loans. The level of the fee is equal to the contractual commitment fee on similar Bank loans and will be charged on the unused portion of the guarantee. Accordingly, for public sector borrowers, the standby fee will be 0.75%, and within the range of 0.5-1% for private sector borrowers. However, when market conditions warrant otherwise, the fee applicable to private sector borrowers may be set outside this range. The fee will begin to accrue sixty (60) days from the date of signature of the guarantee agreement. A waiver of a portion of the standby fee may be applicable on the same basis as the commitment fee waiver on Bank loans. The standby fee is payable by the Borrower on the Bank standard payment dates. The standby fee ceases to be applied once the guarantee facility is fully disbursed.

Guarantee fee

4.4.5 This fee is similar to the lending spread on a Bank loan. The level of the guarantee fee will be equal to the lending spread that would have been charged if the Bank makes a direct loan, plus a risk premium. The risk premium would reflect the risks associated with particular guarantee structures.

4.4.6 From the date of the launch of a bond or the date of the signature of a loan agreement in the case of a loan guarantee, the guarantee fee is applied on the guaranteed exposure. The guarantee fee will accrue on a daily basis and is payable either according to a schedule approved by the Bank or as a one-time up-front payment. When payable up-front, the fee is due not later than the date of receipt of proceeds by the borrower or the date of first disbursement on the underlying loan.

Late Payment Fee

4.4.7 The Bank may charge a late payment fee to cover the costs of delays in receiving payments of the front end, standby and guarantee fees. In line with the Bank's prevailing practice on loans, the fee will be at least 2% per annum above the applicable guarantee fee.

Cancellation and prepayment fee

4.4.8 The Borrower and Lender may cancel unused portions of the guarantee without penalty.

4.4.9 The Borrower and Lender may reduce the outstanding guaranteed amount by mutual agreement or prepayment of the underlying loan without penalty.

Other fees

4.4.10 Legal and other expenses incurred by the Bank during the initiation, appraisal and underwriting process of a guarantee, other than the Bank's traditional operational expenses, will be charged to the Borrower/Lender and are payable upon request by the Bank.

4.4.11 Other fees, which may be chargeable on equivalent Bank loans, shall be applied to guarantees, for example, appraisal fees for private sector projects.

4.5 Counter-Guarantee and other security

In accordance with the provisions of Article 18(3)(b) of the Bank Agreement , for public sector operations, the Bank may require, as in the case of Bank loans, a counter guarantee from the member country in whose territory the project is to be carried out, or of a public agency or institution of that member, acceptable to the Bank. Private sector borrowers and enclave projects would not necessarily be required to provide a counter-guarantee, as the Bank's guarantee would be backed by the normal project security that would have been taken if a loan was being made.

4.6 Provisioning

Provisioning for guarantees will apply the same procedure followed for reserving for loan losses. The basis for computing the appropriate provision will be the loan equivalent amount.

4.7 Accounting and Disclosure

Guarantees are off-balance sheet items. The Bank shall account for and disclose its guarantee activities in accordance with International Accounting Standards, which currently require that a note be included in our financial statements to disclose the face value of the Bank's total guarantees and all other pertinent information.

4.8 Maturities

4.8.1 The Bank can provide guarantees for up to a maximum period of 20 years for public sector borrowers and 15 years for private sector borrowers, subject to the following additional limitations:

- The principal repayment period of the financing is matched to the requirements of the project being financed;
- For structures with bullet repayments, the maximum period is limited to 15 years and an average life of 10 years.

4.8.2 Maturity restrictions may apply to certain guarantee structures and currencies, which may reflect particular market conditions.

4.9 Currencies

4.9.1 Generally, the Bank will consider guarantees for financing denominated in one of its approved lending currencies. Furthermore, the Bank's guarantees will be denominated in one of the approved currencies. However, on a case-by-case basis, guarantees for financing in local currency or convertible currencies that are not one of the Bank's lending currencies, may be considered, noting carefully, the Bank's ability to efficiently fund itself in such currencies in the event of a call, and the borrower's capacity to any attendant foreign exchange exposure. In accordance with Article 18(3)(c) of the Bank Agreement, the Guarantee Agreement will specify the currency for payments to be made pursuant to the guarantee. In this connection, payment will be in the currency in which the guarantee is denominated, except the borrower, on terms specified in the Guarantee Agreement chooses to pay in another currency.

4.9.2 Guarantees may be particularly useful in order to assist borrowers in obtaining financing in their own local currency. The Bank may provide guarantees for financing in local currency provided that:

- The guarantee is denominated in one of the Bank's lending currencies; due consideration being given to the potential appreciation of the local currency with respect to the lending currency;

- All fees will be payable, at the Bank's discretion, either according to a schedule approved by the Bank or as a front-end payment in one of the lending currencies of the Bank;
- The amount payable in local currency in the event of a call on the guarantee is capped, using the spot exchange rate, at the lesser of (i) the maximum guaranteed amount in the Bank's lending currency, or (ii) the amount, in local currency, that has been called;
- If the guarantee is called, the Bank will pay the appropriate amount in local currency and obtain a claim on the borrower/counter-guarantor in the applicable Bank lending currency at the spot exchange rate on the date of payment of the claim.

V. CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

- 5.1.1 Consistent with the General Authority on the Bank's Financial Products and Services (ABD/BD/WP/99/164 and the terms of Resolution B/BD/2000/01), this policy document outlines the principles and modalities, which will guide the use of guarantees.
- 5.1.2 The proposed guarantee program will give the Bank an important financial instrument to further catalyze commercial financing, introduce borrowers to the capital markets, and facilitate local currency financing.
- 5.1.3 All Bank guarantee operations, whether provided in conjunction with a Bank loan or on a stand-alone basis, would be identified, prepared, appraised and supervised to ensure that they satisfy Bank standards.
- 5.1.4 For all types of Bank guarantees, coverage for individual operations will be kept at the lowest level necessary to mobilize the financing, taking into account the nature and complexity of the operation and the need to protect and preserve the financial integrity of the Bank.
- 5.1.5 In accordance with the provisions of Article (18)(3)(b) of the Bank Agreement, the Bank, in the case of public sector operations and partial risk guarantees, may require a counter-guarantee from the member country in whose territory the project is to be carried out or an agency or institution of such member, acceptable to the Bank.
- 5.1.6 The legal issues related to the proposed guarantee program are within the Bank's capacity to resolve through negotiations and appropriate documentation.

5.2 Recommendations

The Board of Directors is hereby invited to:

- Approve the proposed Bank Policy on Guarantees;
- Approve the extension of the pilot program given the limited experience obtained to date, with a review of the guarantee program under the policy contained herein, following the approval of five (5) additional guarantee operations or when the face amount of all approved guarantees (including the two already approved) reaches UA 1.0 billion, whichever is earlier.
- Decide that the Bank Policy on Guarantees replaces and supersedes the document ADB/BD/WP/2000/48 entitled "Guiding Principles For Bank Guarantees".

Annex I

**Standard Terms And Conditions Of
The Proposed Guarantee Program**

1. Guarantee Structures

The guarantee agreement shall specify the scope of coverage, the events that can trigger the guarantee, and the type of losses to be compensated. The mutual rights and obligations of the Bank, the Lender, the Borrower and the Counter-guarantor (the parties to the guarantee agreement) are specified in the guarantee agreement. The Bank can provide a variety of guarantees to suit the project requirements, including:

- **Simple guarantees:** the Bank guarantees a fixed number of interest and/or principal amortization payments on the underlying debt;
- **Rolling guarantees:** the Bank guarantees a fixed number of interest and/or principal amortization payments and a “potential” guarantee is set on future payments. If the guarantee is not called it is “rolled over” to the next guaranteed payment until the guarantee agreement expires. A rolling guarantee can be reinstatable or non-reinstatable.
- **Non-reinstatable rolling guarantees:** where the guarantee cannot be “rolled over” if the guarantee has previously been called.
- **Reinstatable rolling guarantees:** where the rolling guarantee can be reinstated or “rolled over” if the borrower or Counter-Guarantor reimburses the Bank for payments made under the guarantee, within a predefined time period not exceeding 60 days from the date of payment by the Bank.

2. Amendment of guarantee

The parties to the guarantee agreement shall approve any amendments to the guarantee agreement.

3. Acceleration of a guarantee

Under no circumstances can the Bank be obligated by the Lender to pay amounts not yet in default under the guarantee agreement. However, an acceleration of the guarantee can be undertaken by mutual agreement between the parties to the guarantee agreement.

4. Restructuring of the underlying debt

The parties to the guarantee agreement shall re-negotiate the guarantee if there are any modifications, amendments to or changes in the terms of the underlying debt instrument.

5. Arrears on guarantees

Arrears on the payment of fees on a guarantee are treated in the same way as arrears on loans. In addition to the Bank Group sanctions policy, the Bank will reserve the right, after a 30-day cure period, to inform the Lender(s) and the Counter-guarantor that the borrower has defaulted on its obligations to the guarantee agreement and may terminate the guarantee agreement, in accordance with the guarantee agreement.

6. Claim process for a guaranteed loan

- 6.1 From a guaranteed debt service payment date the guarantee holder has fifteen (15¹) calendar days to send a written notification of default to the Bank. Upon receiving that notification, the Bank shall consult with the Borrower, the Lender(s) and the Counter-guarantor, if necessary, on ways to avert or minimize a claim.
- 6.2 From the time the Bank receives the notification of default, the parties to the guarantee agreement have forty-five (45) calendar days to agree and approve the claim specifying the amount and schedule of the payments to the Lender.
- 6.3 From the date the parties to the guarantee agreement reach an agreement on the claim the Bank has five (5) business days to process and settle the claim.
- 6.4 The Bank will not pay interest on the amount in default, related to the period from the default date to the settlement date.
- 6.5 Any payment in default not notified to the Bank within the prescribed period will not be included in payments due in the future and accordingly will lose the coverage of the guarantee.

7 Claim process for a guaranteed bond

If a guaranteed bond payment is not received by the Fiscal Agent two (2) business days before the payment due date, the designated Fiscal Agent must notify the Bank that the payment due has not been made. Upon receiving that notification, the Bank shall consult with the Borrower, the Fiscal Agent and the Counter-guarantor (if any), and make the outstanding guaranteed payment for value the payment date.

¹ The periods mentioned in sections 6.1, 6.2, 6.3 and 7.1 are indicative, the applicable period for each action will be fixed during negotiation.

8 Claim payment

- 8.1 Claim payments shall be treated as a disbursement where the claim approved by the Bank constitutes the request for disbursement. The Board will promptly be notified of any payments made as a result of the calls of guaranteed obligations.
- 8.2 The Bank's payment automatically activates the counter-guarantee agreement; whereupon the counter-guarantor must indemnify the Bank for payments it has made under the guarantee.
- 8.3 Any amount paid out by the Bank under the guarantee is immediately due and payable to the Bank by the Borrower/Counter-guarantor.
- 8.4 From the date that the Bank makes a payment under a guarantee, the amount owed by the Borrower/Counter-guarantor will accrue interest at an interest rate specified in the guarantee agreement.
- 8.5 Following a payment made on a call of its guarantee, the Bank may amortize the amount owed in the form of a loan over a period of time at its own discretion. Management will submit, for Board approval, the terms and conditions of the proposed loan.

9. Subrogation provisions

The payment of an amount in default automatically grants the Bank a claim on the counter-guarantee or an alternative procedure of indemnity and effects an assignment of all rights or claims related to the guaranteed investment, which the Lender may have had against the Borrower or other obligors. However, these assigned right shall be in addition of any other rights or privileges of the Bank.

10. Validity period of an approved guarantee

The Bank reserves the right to terminate the guarantee facility if the guarantee agreement it not signed within 180 days of the Board's approval.

Annex II

Legal Aspects Of
The Proposed Guarantee Program

I. Introduction

A guarantee is a promise by a third party (the "guarantor") who is not a party to an agreement between other parties, that the guarantor will be liable if one of the parties to the agreement fails to fulfill its contractual obligations. The guarantees envisaged in the proposed Policy on Bank Guarantees relate to an "undertaking" by the Bank to be liable for the payment obligations of a party to a borrowing transaction, in the event of default by such party. In addition, the proposed Bank guarantee will be in the form of a surety and should be distinguished from an indemnity agreement.² The law governing guarantees is not uniform, although there are similarities in both common law countries, and civil law countries.

II. Statutory basis for provision of guarantees by the Bank

- 2.1 The Bank Agreement, in Article 14(1)(d), authorizes the Bank to guarantee in whole or in part, loans made by others. Furthermore, Articles 17 (Operational Principles), 18 (Terms and Conditions for Direct Loans and Guarantees), and 32 (Board of Directors: Powers) provide specific guidelines for guarantee transactions.
- 2.2 In January 2000, the Board of Directors of the Bank adopted the General Authority on the Bank's Financial Products and Services (contained in Document ADB/BD/WP/99/164. The General Authority includes guarantees as part of the financial products offered by the Bank and provides general guiding principles for guarantee transactions.³

III. Operational issues

- 3.1 The general operational principles contained in Article 17 of the Bank Agreement are applicable to guarantee transactions. These include, the requirement for a specific project or group of projects to be financed (17(1)(a)), the non-objection of the concerned member-state (17(1)(b)), non-availability of financing on reasonable terms for the borrower (17(1)(c)), restriction of procurement with the portion of the financing guaranteed by the Bank to goods and services produced in member countries (17(1)(d)), and due regard to the prospects that the borrower will be able to meet its obligations (17(1)(e)). Furthermore, the Bank Group Credit Policy, adopted in 1995, will be applicable to determine the eligibility of the borrower for Bank financing.
- 3.2 The applicable terms and conditions for guarantees provided in Article 18 are also applicable. Accordingly, in keeping with sub-paragraphs 2 and 3 of that Article, the guarantee agreement will: (i) specify the terms and conditions of the guarantee; (ii) provide the options for termination of the Bank's liability

² An indemnity is an agreement involving a primary obligation to the creditor. In such cases, the obligation of the indemnifier is independent from the obligation of the principal debtor. A surety is an agreement where the surety is obliged to pay only if the primary obligor is in default.

³ See Section V of the General Authority.

with regard to interest; (iii) require, in accordance with the applicable Bank policy, a counter-guarantee in the event that the borrower is not a member; and (iv) state the currency of repayment.

IV. The Bank guarantee and the reimbursement obligations

The terms and conditions of the guarantee will be clearly defined in the guarantee documentation. In connection with capital market borrowings, the precise terms of the Bank's guarantee would be endorsed on the securities, together with the legend to the effect that the guarantee is not an obligation of any member or government. Irrespective of the type of guarantee offered by the Bank, the following additional elements would be covered:

- (i) **Indemnity from borrower.** To reinforce its subrogation rights⁴, the Bank would conclude a separate agreement with the borrower under which the borrower would agree to indemnify the Bank in respect of any payments made by the Bank under the Guarantee. The indemnity would entitle the Bank to repayment on demand, or otherwise, as the Bank may direct or as specified in the indemnification agreement. This agreement is particularly important, as the Bank does not enjoy exemption from legal action when it guarantees the issuance of security.⁵
- (ii) **Preferred Creditor Status.** The Guarantee Agreement and any other related documentation would be structured to preserve the Bank's privileges and immunities contained in Chapter VII of the Bank Agreement, and to give no appearance of a waiver thereof. The Bank's Policy of not participating in debt rescheduling or renegotiations or of not making new loans to provide for the servicing or repayment of outstanding loans shall also apply to guarantees.
- (iii) **Subrogation.** In the event of a call on the guarantee, and performance by the Bank, the Bank would be entitled to stand in the place of the private lenders to seek reimbursement from the borrower. The specific provision on subrogation will clearly stipulate that the Bank would be entitled to exercise its rights of subrogation immediately, without waiting for lenders to be paid any amounts not guaranteed by the Bank. Furthermore, noting that the lender may not have a preferred creditor status, similar to the Bank's, the Guarantee Agreement will specifically provide that the rights of the lender which are assigned to the Bank, on the basis of subrogation, shall be in addition to any other rights or privileges of the Bank, including its preferred creditor status.

⁴ Please note that under French Civil law, the subrogation right is statutory, that is to say, when the guarantor pays he is *ipso facto* put in the shoes of the creditor for the recovery of the money.

⁵ See Article 52(1) of the Bank Agreement.

- (iv) **Limit of ADB's obligations.** The obligations of the Bank would be limited to the terms of the guarantee. The Bank's role and potential liability would be expressly defined in such a way that the Bank would be liable only to the extent of the express commitments given in the legal documentation.
- (v) **Amendments.** Any amendment to the guarantee provisions would require the prior consent of all parties, including the Bank.
- (vi) **Optional cross default clause.** The Bank will require that the cross default clause included in the documentation restrict the ability of the lenders to suspend or accelerate the ADB guaranteed loan in the event of a default by the borrower or the government on a separate transaction so that the guaranteed loan may be suspended or accelerated only if there has been a material debt service default on the Bank guaranteed loan.
- (vii) **Governing Law.** The Bank will carefully select the governing law applicable to the guarantee to better ensure that its interests are adequately protected.
- (viii) **Dispute Resolution.** In light of the Bank's privileges and immunities, particularly its immunity from every form of legal process (except in the case of guarantees of securities), the Bank will ensure that the dispute resolution clause in the guarantee documentation does not waive or appear to waive the Bank's privileges and immunities. In this regard, the documentation will provide for arbitration as well as specify the forum, rules, and language of the arbitral proceeding.
- (ix) **Role of the Bank in administrative arrangements.** The lead manager would handle all administrative arrangements under a guarantee operation including paying agency functions and the channeling of documentation and information to lenders, or other commercial entity designated for these purposes.
- (x) **Decision-making and voting in a guarantee transaction.** The Bank will be entitled to be kept fully informed, and any measures that might affect the Bank's guarantee or contingent liabilities would require the prior consent of the Bank.

V. Conclusions and recommendations

The legal issues related to the proposed guarantee program are within the Bank's capacity to resolve through negotiations and appropriate documentation. Furthermore, the guarantee documentation will be carefully drafted to ensure adequate protection of the Bank's interests.

Annex III

**Risk Management Assessment Of
The Proposed Guarantee Program**

1. This annex responds for an independent assessment of the incremental risks associated with the proposed guarantee program and the measures that can be taken to mitigate these risks.
2. The agreement establishing the Bank provides for the use of guarantees to complement the Bank's regular lending operations. The principal advantages of using guarantees have been identified as:
 - Catalyzing commercial investment in regional member countries;
 - Assisting African borrowers to gain experience in the international capital markets; and,
 - Enabling the Bank to participate in local currency financing when it cannot efficiently fund itself.
3. To successfully implement the proposed guarantee program the Bank must manage a number of incremental risks. These risks, and possible mitigating measures (some of which have already been taken), are outlined below.

A. Credit Risks

4. Credit risk is the potential for loss if a borrower or market counter-party fails to honour an obligation to the Bank. Given the ADB's principal role of extending credit to African borrowers, credit risk is by far the largest source of risk for the Bank.
5. Full risk guarantees create credit risk exposure that is broadly the same as direct lending. The size and length of the Bank's credit exposure under a guarantee arrangement depends of the structure of the underlying instrument being guaranteed.
6. The credit exposure resulting from partial risk or partial credit guarantees is generally less than for direct lending because of the reduced set of default events or reduced underlying amount.
7. To mitigate some of the credit risks associated with guarantee operations and to adequately manage the others, the Bank should:

Apply the same eligibility criteria for public sector guarantees as for public sector loans. Apply the same creditworthiness tests for private sector guarantees as for private sector loans.

Limit guarantees to underlying debt or debt derivative instruments. This would exclude guarantees of equity investments but permit guarantees of risk management products such as swaps.

Limit guarantees on fast disbursing underlying instruments to select cases.

Limit guarantees on underlying instruments that have bullet repayment profiles to select cases.

Limit guarantees to a maximum of 20 years for public sector operations and 15 years for private sector operations.

Require a counter-guarantee from the host government for public sector guarantees.

Require a political risk counter-guarantee from the host government and structure appropriate security and loan covenants for private sector operations, i.e. partial risk guarantee.

Give the Bank the right to accelerate the full claim on the borrower in the event of default or to amortize it as a loan to the borrower.

Use an up-front guarantee fee reserve account, when possible, to reduce the risk of payment delays.

Price guarantees using a base lending rate plus a risk premium. The risk premium would reflect the risks associated with particular guarantee structures.

For private sector operations in default, if the Bank decides not to accelerate its claim, give the Bank the right to reset the lending spread at a higher rate to reflect the heightened credit risks.

Provision for guarantees on a "loan equivalent" basis. For private sector operations, the provisioning rate should reflect the updated risk rating.

Include guarantee operations into the Bank's exposure limits on a "loan equivalent" basis.

B. Liquidity Risk

8. Liquidity risk is the potential for loss due to a temporary shortfall in liquidity. The Bank maintains a very conservative liquidity risk profile through the application of the liquidity policy.

9. Default on an accelerable guarantee would create an immediate liquidity requirement equal to the full guarantee amount. A large default could put pressure on the Bank's liquidity position.

10. To reduce the likelihood or negative impact of a liquidity squeeze, a number of preventive measures can be taken:

Limit the use of accelerable guarantees to select cases.

Include guarantees into the computation of the prudential minimum liquidity on a "loan equivalent" basis.

Establish a short-term borrowing program to provide additional sources of liquidity if needed.

C. Operational Risk

11. Operational risk is the potential for financial loss or damage to the Bank's reputation due to human, system, or procedural errors and failures.
12. For guarantees on capital market operations, the borrower will want to set the final terms of the underlying instrument on or near the time of issuance. The required flexibility may be difficult to achieve within the Bank's current Board approval procedures.
13. Default events that trigger calls on the guarantees could sharply raise the Bank's borrowing requirement, which could have a negative impact on the Bank's credit rating.
14. Because the administration of the underlying instrument is managed directly between the borrower and the lender, the risk is increased that the Bank could have billing or claim errors/disputes due to incomplete information. Moreover, because of the ADB guarantee backing the credit, the lender may become complacent about supervising the loan.
15. Any delay in implementing recovery procedures in the event of default would increase the risk of impairment of the Bank's collateral/security.
16. The heightened operational risks can be adequately mitigated by:

Establishing a procedure that allows the Board to approve a "guarantee envelop" specifying the key risk parameters such as risk coverage, maximum UA equivalent amount, maximum final maturity, and maximum average life.

Updating the Bank's borrowing policies so that the key debt ratios incorporate the contingent liabilities associated with outstanding guarantees.

Upgrading the Bank's loan administration systems to include guarantee products.

Developing operational procedures for administering guarantees, which articulate responsibility for coordinating all information between the Bank, the lender, and the borrower. To off-set possible lender complacency, ADB supervision of borrowers with guarantees should be at least as rigorous as for loans.

Starting guarantee operations with a limited-scale pilot program.

Developing operational procedures articulating responsibility for recovery in the event of default.

D. Market Risk

17. Market risk is the potential for loss due to adverse changes in interest rates, exchange rates, or other market prices. The Bank generally maintains a very conservative market risk profile through its asset and liability management policies.
18. In the event of default the Bank will acquire a claim on the borrower. The interest rate or currency terms of the underlying instrument could expose the Bank to adverse market movements.
19. Generally a default event raises concerns about credit risk that far out-weigh any market risks. However, possible market risks, including but not limited to reputational risk and risk of confusion between the Bank's own bonds and bonds guaranteed by the Bank, can be largely eliminated by:

Denominating guarantees in the Bank's lending currencies.

Denominating any claim on the borrower in one of the Bank's lending currencies, if the underlying instrument is a local currency in which the Bank is unable to fund itself.

Giving the Bank the right to reset the interest rate basis of the claim on the borrower if the Bank chooses not to accelerate the claim in a default event.

Structuring the guarantee in such a way that the guarantee coverage is the minimum to raise the funds shall reduce the risk of confusion.

A strict implementation of the mitigating measures for the credit and operational risks by the Bank operation staff and a close monitoring of the implementation of these measures by the Bank risk unit would alleviate the factors generating reputational risk and hence the risk itself.

E. Conclusions and Recommendations

20. The proposed guarantee program would give the Bank an important financial instrument to further catalyze commercial financing, introduce borrowers to the capital markets, and to facilitate local currency lending. This note has identified a number of risks associated with this initiative and concludes that with the mitigating measures available, Management should be able to reduce these risks to levels consistent with the Bank's willingness to assume credit risk and its aversion for other forms of risk. However, given these risk preferences, we believe that special emphasis should be given to establishing the necessary procedures and systems to mitigate the specific operational and legal risks of using guarantees.

Annex IV

Administrative Guidelines

Purpose

1. The procedures that will be followed in the management of guarantees will be broadly similar to the procedures that apply to the Bank's loan products. There are however a few areas where the nature of guarantees call for a different approach. The purpose of these Guidelines is to highlight these areas of differences.

Appraisal

2. The Country Department or the Private Sector Department should consult with and if necessary involve FTRY in the appraisal of projects for which the use of an ADB guarantee is contemplated.

Negotiations

3. To give the client appropriate advice on the pricing and other terms of the ADB guarantee, FTRY staff should be invited to participate fully in project negotiations.

Board Approval

4. In situations where the structure and terms of the underlying loan or security issue may not be fully finalized prior to Board approval, particularly the case for bond issues and structured loans, the relevant OCD/OPSD should, in consultation with FTRY, submit a supplemental Information Note to the Board, advising them of the final structure and terms.

Signature and Effectiveness

5. The signing of an ADB guarantee will typically be done concurrently with the signing of the underlying loan or securities agreement. Where this is not feasible, the ADB guarantee agreement should be signed only after these underlying financing agreements have been signed.
6. The effectiveness of an ADB guarantee will also typically happen after the underlying financing agreements have become effective in accordance with their terms. Additionally, where a counter guarantee or other forms of project security underpin the ADB guarantee; its effectiveness will be conditioned upon evidence satisfactory to ADB that the relevant documentation has been agreed and is satisfactory.

Fees And Billing

7. The structure and level of ADB's fees for a guarantee operation and the timing of their billing and collection will be agreed with the client upfront and stipulated in the guarantee agreement. In addition to the standard fees such as the standby and guarantee fees, there may be other fees such as front end, appraisal and processing fees. The relevant OCD/OPSD, working with FTRY,

will advise the Accounting Department in writing when a guarantee becomes effective, on the level of fees, the methodology for their calculation, and the timing for the sending out of invoices.

Call on Guarantee and Disbursement

8. The lenders' agent will notify ADB when the borrower has not paid an amount in respect of the guaranteed obligations on the due date. Depending on the terms of the relevant guarantee agreement, the agent will give ADB a time limit within which to make payment for the amount in question.
9. If the structure of the guarantee allows ADB to seek acceleration of the loan because of this default in payment, the notice will also typically request ADB to indicate whether it wants to exercise this option, and a decision will have to be made by the relevant OCS/OPSD.
10. In either situation, the call on the guarantee is the event that triggers a disbursement in the currency in which the guarantee is denominated. Once the relevant OCS/OPSD has satisfied itself that the call is valid, they will initiate disbursement following the normal loan disbursement procedures.

Subrogation

11. Any disbursement against a called guarantee creates a loan obligation in the disbursed currency for the Project Company or Government (in the case of a policy based guarantee). Depending on the terms of the indemnity or counter guarantee agreement between ADB and this entity, this subrogated loan may become due and payable in full, or in installments. The procedures for documenting this obligation and for subsequent invoicing of payments will follow ADB's loan procedures.

Reinstatement of Guarantees

12. Depending on the structure adopted, some guarantees will be cancelled after a payment is made by ADB after a call. This will most likely be the case with accelerable guarantees. With respect to non-accelerable guarantees, it is common practice for the guarantee to be fully reinstated once the beneficiary company or Government has repaid ADB for the amount it disbursed after the call. The reinstatement of the guarantee shall be specified in the guarantee agreement. Once a guarantee is reinstated the billing and other procedures outlined above become applicable again.

Annex V

Comparison Of
Guarantees Offered By Selected
Multilateral Development Banks

Comparison of Guarantees offered by MDBs

Features	ADB	World Bank	laDB	AsDB
Type of guarantee offered	<ul style="list-style-type: none"> • Partial credit guarantee • Partial risk guarantee • Policy based guarantee 	<ul style="list-style-type: none"> • Partial credit guarantee • Partial risk guarantee • Policy based guarantee 	<ul style="list-style-type: none"> • Partial credit guarantee • Partial risk guarantee • Guarantee disbursement loans with sovereign guarantee (PBG) 	<ul style="list-style-type: none"> • Partial credit guarantee • Partial risk guarantee • Guarantee under the Asian Currency Crisis Support Facility (PBG)
Currency	All lending currencies	All lending currencies	All lending currencies	All lending currencies and also local currencies
Eligibility Borrowers	Eligible to ADB, private sector and enclave projects loans.	Eligible to IBRD and enclave projects loans. IDA guarantee for IDA only countries (Partial Risk Guarantee –PRG- only) Private sector guarantees are covered by IFC MIGA gives additional PRG.	Borrowers eligible for Bank lending would also be eligible to use Bank guarantees for projects located in member countries territories	All borrowers eligible for Bank lending, including Asian Development Fund (ADF)-only countries, are eligible for the use of Bank guarantees.
Eligible Instruments	The most appropriate lending instruments for the project: Bond issues, commercial Bank loans, private placements... However equity is excluded.	The most appropriate lending instruments for the project: Bond issues, commercial Bank loans, private placements, equity, ...	Loans to mobilize finance for projects	Bank guarantees covers a wide variety of debt instruments, including loans from private financial institutions and bond issues.
Link to Bank loan	Not necessary	Not necessary	Not necessary	The Bank provides guarantee to projects where it has a stake in the project in the form of a direct loan (including subscription to a bond issue) or an equity investment.

Comparison of Guarantees offered by MDBs

Features	ADB	World Bank	IaDB	AsDB
<p data-bbox="143 316 293 375">Guarantee Charges</p> <p data-bbox="143 499 304 587">Guarantee Charges (continues)</p>	<p data-bbox="380 316 822 587">Standby fee: 75bp applicable to the un-disbursed portion of the guarantee in the same condition as with loans commitment fee. A waiver of a portion of the standby fee is applicable on the same basis as for Bank loans commitment fee. Private sector and enclave projects will follow the pricing of similar loans.</p> <p data-bbox="380 619 822 954">Guarantee fee: 50bp plus a risk premium per annum on the guarantee exposure, as of the first callable date, determined on a present value basis. The guarantee fee is payable either according to a schedule approved by the Bank or as one up-front payment, in the currency of the guarantee. Private sector and enclave projects will follow the pricing of similar loans.</p> <p data-bbox="380 986 822 1074">Front-end fee: A front-end fee, as charged on Bank loans, would apply to the Bank maximum exposure.</p> <p data-bbox="380 1106 822 1377">Other fees = Legal and other expenses incurred by the Bank during the initiation, appraisal, underwriting and claim against the guarantee, other than the Bank's traditional operation expenses, would be charged to the borrower/Lender and are due upon request by the Bank.</p>	<p data-bbox="848 316 1232 555">Standby fee: 75bp applicable to the un-disbursed portion of the guarantee in the same condition as with loans commitment fee. A waiver of a portion of the standby fee is applicable on the same basis as for Bank loans commitment fee.</p> <p data-bbox="848 587 1232 1018">Guarantee fee: 75 to 100bp (for PRG) and 75bp (for PCG) on the guarantee exposure, as of the first callable date, determined on a present value basis. The Bank retains a guarantee fee equal to 50bp. The rest is awarded to the sovereign counter-guarantor. For enclave projects, IBRD charges up to 300 bp and retained from 50 to 100 bp. Private sector (IFC) projects will be priced as similar loans.</p> <p data-bbox="848 1050 1232 1169">Front-end fee: 100bp on the Bank maximum exposure. The fee is payable upon effectiveness of the guarantee.</p>	<p data-bbox="1254 316 1680 435">Facility fee: lending spread applicable for the current interest period and applied to the nominal value of the guarantee.</p> <p data-bbox="1254 467 1680 770">Guarantee fee: a risk premium reflecting the coverage of the risk involved in each transaction, applicable to the outstanding callable amount covered by the guarantee. This fee ranges from 15 to 75bp. This guarantee fee is reimbursed to the government counter guaranteeing the transaction.</p> <p data-bbox="1254 802 1680 890">Other fees: For partial risk guarantee, the Bank charges an appraisal fee.</p>	<p data-bbox="1706 316 2154 379">Standby fee: For partial risk guarantee, the Bank charges 20 bp</p> <p data-bbox="1706 411 2154 802">Guarantee fee: the lending spread on loan (currently 40bp) for guarantee for public sector borrower. For private sector borrowers the guarantee fee is market determined, however if there were a government counter guarantee these fee would be divided between the Bank and the government where the Bank retains 40bp. This fee is applied to the present values of the future guarantee obligations from their callable dates.</p> <p data-bbox="1706 834 2154 954">Front-end fee: For partial credit guarantee, the Bank charges 10-90 bp and for partial risk guarantees 100 bp.</p>

Features	ADB	World Bank	IaDB	AsDB
Payment of fees	Depending on the structure of the guarantee, up front or in installments for the standby fee and the guarantee fee. At request by the Bank for other fees.	Depending on the structure of the guarantee, up front or in installments for the standby fee and the guarantee fee. The front-end fee is paid upon effectiveness.	The fees are paid periodically	The fee may be collected periodically following loan-servicing schedule of the Bank loan involved or in one payment up front.
Acceleration	At the discretion of the Bank	At the discretion of the Bank	At the discretion of the Bank	Not allowed
Counter-Guarantee from the country government	Required for public sector projects and partial risk guarantees	Required for IBRD guarantee	A government counter guarantee is not necessary. However, a counter guarantee will provide a strong signal of the government's commitment to comply with the terms of its agreement and therefore will reduce the overall risk of the guarantee being called.	Guarantee to public sector entities would necessitate a counter guarantee from the host country government and guarantee to private sector would not need a counter guarantee. For a partial risk guarantee a counter guarantee would be generally required from the government.
Treatment of Claim	If the guarantee is called, the Bank pays and activates the counter guarantee or indemnity agreement whereby the counter-guarantor/borrower owes the Bank the money paid out according to the guarantee agreement. The terms of the amount owed is stipulated in the guarantee agreement.	If the guarantee is called, the IBRD pays and activates the counter guarantee agreement whereby the government owes the Bank the money paid out according to the guarantee agreement. The terms of the amount owed is stipulated in the guarantee agreement.	If the guarantee were called the funds would be disbursed promptly, becoming at that point a loan to be repaid by the counter guarantor or the borrower within a period to be defined by the Bank but no longer than the remaining life of the guarantee, following the first call on the guarantee.	If the guarantee is called, the Bank pays and would seek reimbursement from the borrower/counter guarantor

Features	ADB	World Bank	IaDB	AsDB
Procurement Issues	The proceeds must be used according to the Bank procurement guidelines	The proceeds must be used according to the Bank procurement guidelines	The Bank requires procurement processes that are transparent and give proper consideration to the eligible nationality of contractors and origin of goods	The same procurement procedures applicable to the parallel loan would apply to the guaranteed loans
Implementation and Supervision	Same criteria and standards as for direct loans.	Same criteria and standards as investment loans.	The Bank would use the same supervision requirement as for a direct loan, however in the case of a co-guaranteed project with multilateral institution, the Bank could rely on supervision by its partners if their procedures are acceptable to the Bank.	Same supervision requirements as for the parallel loan would be applied to the guaranteed loan
Documentation	The project Appraisal Document, the guarantee agreement between the Bank and the lender or the borrower, the counter guarantee agreement between the Bank and the government of the RMC if it is a public sector guarantee or a PRG, the indemnity agreement between the Bank and the counter/guarantor or the borrower. The loan agreement.	The project Appraisal Document, the guarantee agreement, the indemnity agreement and the project agreement.	The project report and legal documentation relevant to a guarantee would be required. In addition, where there is a counter guarantee, the indemnity agreement would be required.	Same supporting documents as for the parallel loan, in addition to the legal documentation relevant to a guarantee

Features	ADB	World Bank	IaDB	AsDB
Environmental Assessment	The Bank's environmental guidelines will be used for the EA study	The Bank's environmental guidelines will be used for the EA study	Compliance with the Bank's environmental policies and regulations, in addition to environmental conditionality of the recipient country.	Same environmental requirements as applicable to the parallel loan
Management review and Board Approval	Guarantees are reviewed like direct lending operations	Guarantees are reviewed like investment operations	Procedures and requirements for appraisal and approval of a guarantee are identical to those used for loans	Same procedures and requirements for appraisal and approval of the parallel loan would apply to the guarantee
Example of Projects	DBSA – South Africa (2000) USD 330 million MTN – Cameroon (2000) EURO 13 million	EGAT-Thailand (1988)-USD 300 million, Argentina (1999)-USD 250 million, Azito Power (1999)-USD 30 million	Trenes de Buenos Aires – Argentina (1998), Support railroad Improvement, guarantee de USD 75 million. Compania de Electricidad de San Pedro Macoris – Dominican Republic (1999), USD 150 million	National Power Corporation – Philippine (1995), JPY 12 billion Loan Thailand (1998) – USD 950 million

Annex VI

Questions and Answers

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This document is intended to provide clarifications to questions and comments on the Bank's Policy on Guarantees, which was initially presented to the Board on 18 April 2001. The issues were raised by Executive Directors (EDs) at the Board meeting as well as during discussions between staff and EDs.

1. How would the Rating Agencies view the guarantee operations of the Bank?

During the preparation of the policy paper, the Bank has consulted the rating agencies and they are comfortable with the Bank providing the guarantee product. In fact, to the extent that guarantees provide the Bank with another product, which may stimulate lending, the rating agencies would welcome them. As a substitute for lending, guarantees are treated on a loan equivalent basis and the policies for provisioning, capital adequacy and exposure management will be applied just as with Bank loans.

2. What is the relationship between the guarantees to be issued by the Bank under the new policy and the requirement for a counter-guarantee by the government of the borrowing country?

The two issues are not directly related and any confusion between them in the context of this policy document needs to be clarified. The guarantees as envisaged in the document "Bank Group Policy on Guarantees" are an additional instrument through which borrowers will be able to access financing from other lenders. Such lenders may be unwilling or unable to take on the risks related to the project or the borrower and the Bank may provide a guarantee of payment to the lenders. Under the guarantee, the Bank will undertake to fulfill the obligations of a borrower to the lender in the event the borrower fails to meet the guaranteed obligations.

The counter-guarantee requirement, on the other hand, is a requirement of the Bank that loans to public sector borrowers be guaranteed by the government of the borrower. This is referred to in the paper as the counter-guarantee to avoid any confusion between the two concepts. Guarantees as an instrument and as a substitute for lending, will also be required to be counter-guaranteed by the government of the borrower for public sector borrowers. In this way, loans and guarantees are treated on an equitable basis in terms of the requirement for a counter-guarantee. The requirement for a counter-guarantee for a Bank guarantee will remain the same as that for ordinary loans.

3. If a guarantee is provided for local currency lending, how will the Bank manage the foreign exchange risk arising on default?

For guarantees on financing provided by lenders in local currency, the Bank will still denominate the guarantee in one of the approved lending currencies of the Bank. If the guarantee is not called there is no foreign exchange exposure. If the guarantee is called, the Bank will pay its commitments under the guarantee agreement in the local currency, but will obtain a claim on the borrower in one

of the lending currencies of the Bank at the prevailing exchange rate. The amount payable under the call of the guarantee will in any event be limited to the lesser of the spot exchange rate equivalent of the local currency or the guaranteed amount in the Bank's lending currency. In this way the Bank is not taking any foreign currency risk, which is passed on to the borrower, as is the case for ordinary Bank loans. This is the most effective way of assisting borrowers in obtaining financing in local currency where the Bank will be unable to efficiently finance itself directly.

To illustrate how a local currency loan guarantee will work let us describe how the Bank's guarantee to MTN-Cameroon (MTNC) works. This guarantee is described in the policy paper in Box 1 on page 6. Generally speaking the MTN guarantee is a guarantee, on first demand, of the outstanding amount at the time of the default, which means that in case of default the Bank will take over the portion of the loan that it has guaranteed.

The facility is a guarantee of an amount not exceeding thirteen million seven hundred thousand Euros (EUR 13,700,000) to enable MTNC to mobilize a loan in local currency (CFA Francs) from local banks. This facility represents 37,50% of the principal of the local currency loan. If MTNC defaults, the lenders will call the Bank for the entire outstanding CFA amount. The Bank will use the Euro facility to purchase the required CFA amount to pay the lender. The CFA amount paid by the Bank cannot exceed the CFA equivalent of EUR 13 700 000. In case of a default the amount called is compared to the CFA equivalent of EUR 13 700 000 at the time of the default, if the amount called is lower the Bank pays this amount, if it is higher, the Bank will only pay the CFA equivalent of EUR 13 700 000 leaving the borrower to cover the difference. When the Bank makes a payment upon a call, the reimbursement by MTNC is due in EUR. The fees are calculated and paid in EUR.

4. Will the guarantee instrument be limited to ADB (category C) countries only?

This question is linked to the Bank's credit policy. Any borrower who is eligible for a loan from the Bank will be eligible for a guarantee. Since ADF only countries are not eligible to access ADB resources, the Bank will not be able to provide a guarantee to third party lenders to ADF only countries. However private sector and enclave projects that are eligible for ADB resources even in ADF countries will be eligible to access guarantees.

- 5. Why does the Bank not charge an extra commission (on top of the standard lending spread) to be reimbursed to the counter-guarantor at the end of the guarantee contract? This is done by several MDBs including the World Bank, the IADB and the AsDB.**

The overriding rationale for the pricing of the guarantees has been to price them on the same basis as loans; it is the same rationale that led the World Bank to revise its guarantee pricing by aligning it to the pricing of loans. In other words, a borrower should be indifferent, from a pricing perspective, to using a loan or a guarantee. Therefore, to align the pricing of guarantees to loans' pricing the Bank is not charging an additional fee that does not exist for loans. This pricing methodology is also used by the EBRD who does not charge additional fees to be refunded afterwards. In addition, for simplicity reasons, the Bank does not charge an extra fee to be given back to the counter-guarantor. We believe that it would unnecessarily complicate the pricing to charge additional amounts and then to refund to the counter-guarantor at a later date.

- 6. How would the Bank's provisioning policy be applied to guarantees?**

Provisioning for guarantees would follow the same procedure as reserving for losses on ordinary loans. The loan equivalent amount would be used to determine the amount to be provisioned.

- 7. How would guarantees be treated in terms of the lending limits?**

In accordance with the policy on Capital Adequacy and Exposure Management, the exposures created by guarantees will be aggregated with the exposures on loans based on a loan equivalent amount. The addition of a guarantee, therefore, shall not exceed the limits applicable to a loan, to a project or country, unless specifically approved by the Board.

- 8. What would the impact of guarantees be on the Bank's preferred creditor status and would guarantees not implicitly extend the preferred creditor status of the Bank to private creditors?**

A guarantee will not have a different impact on the Bank's preferred creditor status than a direct loan. If a guarantee is called, the Bank will make the necessary payment to the lender(s) according to the guarantee agreement, and will then obtain a claim on the borrower or the counter-guarantor. The Bank is then in the same position as when a default occurs under an ordinary loan.

Private creditors would have been reimbursed by the Bank for the payments owed to them by the borrower under the portion guaranteed by the Bank. As a result, there is no sharing of the Bank's preferred creditor status with the lenders who are covered by the Bank's guarantee. However, it is correct that the claim obtained by the Bank on the borrower/counter-guarantor, after the Bank makes a payment, has a preferred creditor treatment.

9. What is the status of the two guarantee operations already approved by the Board, namely, the bond issue by the Development Bank of Southern Africa and the local currency loan to MTN Cameroon?

To date the Bank has approved two guarantee operations, both in 2000. The first was in the amount of Euro 330 million to cover a bond issue by the Development Bank of Southern Africa (DBSA). Due to changes in its funding needs, DBSA did not utilize this approval, which has since lapsed. The second was for a Euro 13 million equivalent amount for MTN Cameroon, a private Telecommunications company to partially support a local currency syndicated loan. This has been signed and is effective. The experience gained in handling these two transactions has been taken into consideration in preparing this policy paper. The paper has also benefited from a review of the guarantee operations and policies of other Multilateral Development Banks.

10. For a guarantee under the private sector window of the Bank where a counter-guarantee from the government of the RMC would not be required, what recourse would the Bank have against the borrower in the event of a call on the guarantee?

For partial risk guarantees, where a project's success is based on undertakings from the Government, a counter-guarantee will be sought from the Government. In fact, the willingness of the Government to provide this counter-guarantee will be a good measure of their willingness to fulfil their contractual undertakings. An example is the Azito project, where the project's success relies largely on the undertaking from the Government of Ivory Coast to buy a determined proportion of the electricity production. For partial credit guarantees, the Bank will ensure that it receives the same security package on guarantees that it would normally receive on ordinary loans to private sector borrowers. These would include but not be limited to mortgages, charges over fixed and floating assets, etc.

11. Does the Bank have sufficient internal capacity to analyse and manage the complexity of a guarantee program?

The Bank has appraised two guarantee projects (one for the public sector and one for the private sector) that have been approved by the Board. The Board session, that has approved these two projects, has praised staff for the quality of the work on these two projects. We do not believe that a guarantee program would introduce any significant additional complexities that the Bank is not already capable of managing and that would justify the Bank not providing

guarantees as a lending instrument. As it is clearly demonstrated in the policy paper, guarantees and loans are treated in the same manner from an operational point of view; in fact, one can say that a guarantee is a loan that does not disburse. The current staffing is sufficient to handle the expected demand for guarantees.

12. The Bank should work closely with other institutions like MIGA

MIGA offers insurance to investors against non-commercial risks to promote private investment flows to developing countries, including equity investments. This product is slightly different to the guarantees being proposed by the Bank. Thus within the same project the Bank and MIGA will be able to underwrite different risks allowing for a better distribution of the risk between co-financiers and a better allocation of the risk to the institution that can better absorb it. Most of the MDBs have limits to the exposure that they can take for a single project, the fact that products offered by these institutions complement each other allows for an optimum usage of their capital resources. The Bank will seek, as it is currently the case with direct lending, to work closely with all institutions involved in development investments in Africa.

13. Should it not be a requirement that users should first approach other providers of guarantees (public or private) before being eligible for an ADB guarantee?

We do not believe that it should be necessary for users to first approach other guarantee providers before approaching the Bank. It is understandable that the Bank should take care not to crowd out the private sector when they are able to provide the necessary instruments without the Bank's assistance. On the other hand, however, the Bank needs to be careful that it is not then at the receiving end of those guarantees that are considered unviable by other providers.

14. Guarantees create different risks to loans, e.g. reputational risk. How does the Bank intend to manage these risks?

Many of the intangible and non-quantifiable risks can only be managed by a careful selection of the underlying project or borrower. The Bank will continue to evaluate and appraise projects and borrowers rigorously and according to stringent criteria. The risk unit of the Bank in its assessment of the use of guarantee has enunciated several mitigating measures for this type of risk ; operational staff will strictly implement these measures with close monitoring by the risk unit. In addition, the Board will continue to approve each guarantee operation as it does with loans, and Board members will be able to voice their concerns at the time of the Board presentation of each operation.

15. What is the maximum leverage that the Bank accepts in its partial credit guarantee?

The leverage ratio is measured by the ratio of unguaranteed private exposure to Bank exposure. The leverage required is determined by a number of factors: (i) overall market conditions i.e. financial and economic conditions that affect investors' appetite for market issues, these conditions are very critical for emerging market debt and (ii) investors' perceptions of borrower's credit, which depend on the borrower's creditworthiness.

The maximum value of a guarantee to the borrower is achieved by maximising the mix of the incremental market access, the leverage achieved from that access and the cost of such access. The Bank can arrange these three factors to achieve the maximum value of the guarantee for the borrower. The leverage limit is determined by the requirements of the market, the Bank, the investors and the borrower. In summary, it is critical for the success of the guarantee that the Bank keeps the flexibility to make an integrated decision on the appropriate combination of access, leverage and cost in each case in order to deliver the best coverage suitable to the specifics of each project.

16. When would the Bank require a sovereign counter-guarantee and how would the Bank set the guarantee fees?

For public sector sponsors that are majority owned by the state, such as parastatals, the Bank will require a sovereign counter-guarantee, in accordance with the same requirements for ordinary loans. The Bank will also request a sovereign counter-guarantee in case of a partial risk guarantee to back the government undertakings that are covered by the Bank guarantee. Sovereign counter-guaranteed guarantee will be priced at the Bank's standard lending spread, currently 50 bp, however, a risk premium will be added on a case-by-case basis to reflect the risk associated with complex guarantee structures.

Partial credit guarantees for private sector sponsors will carry the pricing similar to that of a similar loan plus a risk premium to reflect the risk associated with complex guarantee structures. For this type of guarantee the Bank would not require a sovereign counter-guarantee, but will request the same security that it requires for a direct loan.

17. What criteria will be used to determine whether the Bank should issue a full or partial guarantee?

The underlying principles of the Bank guarantee is (i) to cover the minimum risk that will allow the underlying project to attract private financing and (ii) to maximize the risk-sharing burden between the participants in an investment. This is in line with the rationale of a Bank guarantee, which is to cover risk that the market is not structured or is not willing to absorb. In most cases, specifically for guarantees for bond issues, the Bank will not issue full guarantees. The main reasons are twofold, (i) from our discussion with the credit agencies, that will have to rate the transaction, it is not in the best interest

of the borrower if one of the reasons to issue bonds is to establish a track record in the market, Also (ii) there is a risk of confusion in the market if the Bank issues a full guarantee on a bond.

18. Is there any difference in the application of the Bank safeguard policies (environmental review and information disclosure)? Is the Bank going to apply the same procurement rules to guarantees? What about international competitive bidding (ICB) for infrastructure concessions when the concessionaire seeks a Bank guarantee?

From an operational point of view, the underlying project will be treated exactly like a project where the Bank is making a direct loan, therefore to be eligible for a Bank guarantee a project must comply with all of the Bank's applicable policies regarding environment, procurement, project implementation and supervision. To ensure compliance with its safeguard policies, the Bank will use supervision missions to make sure that the project is executed according to Bank policies and also legal clauses in the guarantee agreement will state actions that the Bank can take if its policies are not followed.

19. Is there a difference between eligibility criteria for policy-based guarantees related to structural adjustment program and ordinary lending under a structural adjustment program? What will be the role of the Board for the approval of such guarantees?

The eligibility criteria for policy-based guarantees will be the same as the criteria for policy-based loans. As with all guarantees, each transaction will be submitted to the Board for approval.

20. Provisioning on and income from guarantees are based on what is termed the Bank exposure; can you elaborate on what exactly is meant by the words Bank exposure?

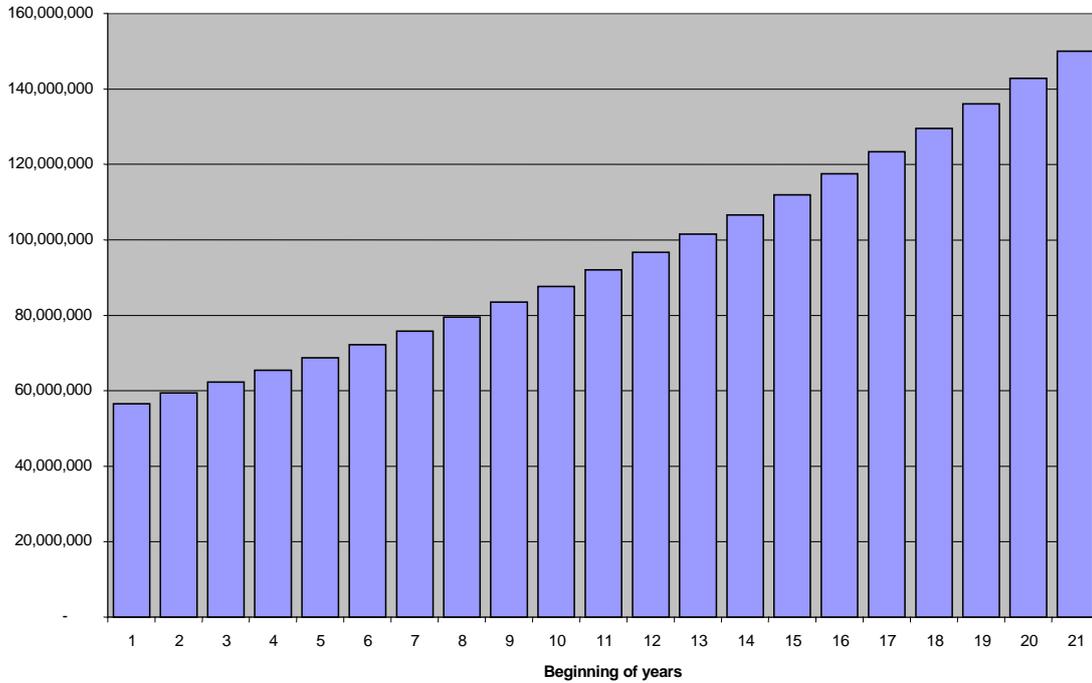
The Bank exposure is the present value of the payments that are guaranteed by the Bank. The best way to illustrate this concept is by taking an example. Let's imagine two types of partial credit guarantees:

- The first guarantee is on the principal repayment of a USD 150 million 20 years bullet loan; and
- The second guarantee is on the outstanding balance of a USD 150 million one-time disbursement loan that amortizes linearly over 15 years after a 5-year grace period.

The discount rate for calculating the exposure is 5%. In the first example, the exposure will grow linearly from USD 57 million to reach USD 150 after 20 years. In the second case, the exposure is USD 150 million during the grace period and from the beginning of the amortization period the exposure will fall linearly by the amortization amount to reach zero after 20 years. (See Graph 1 and 2 on page 50).

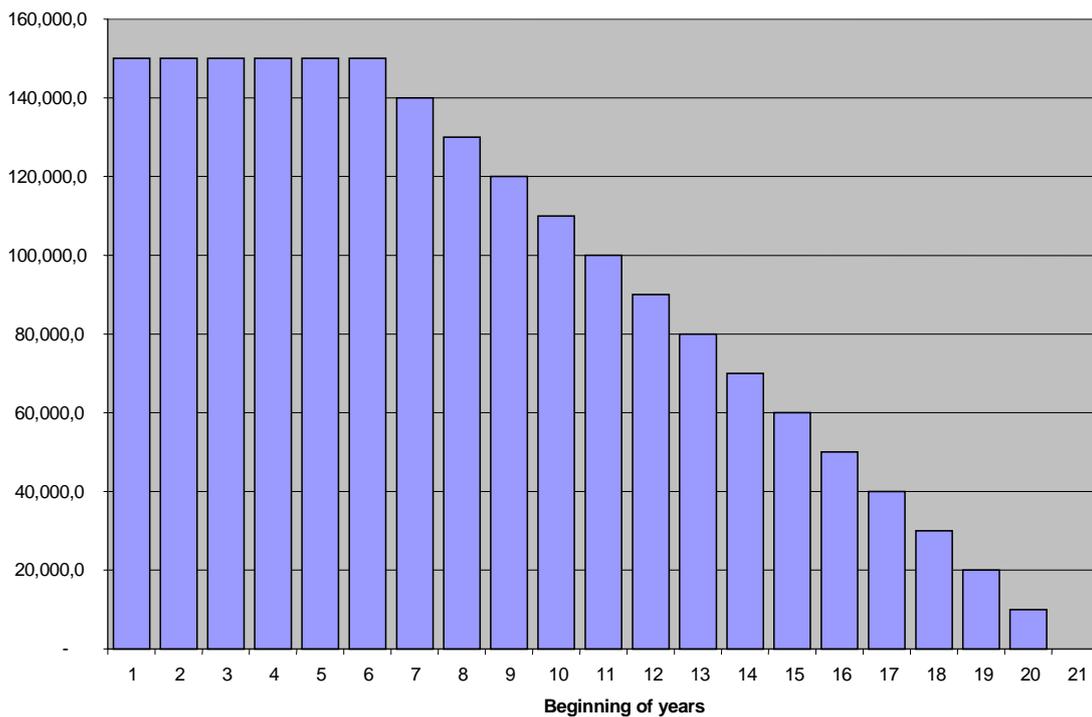
Graph 1: Exposure for a bullet loan

Exposure amount



Graph 2: Exposure for an amortizing loan

Exposure amount



Annex VII

**Explanatory note regarding
the default of Argentina on
the World Bank guaranteed bonds**

I. Introduction

1. On October 15, 2002 Argentina defaulted on its World Bank (IBRD) guaranteed bond “the bond”. The amount in default was USD 250 million. As the guarantor, the World Bank paid this amount to the investors holding the bond.

2. The purpose of this paper is to demonstrate that the guarantee instrument, per se, has little to do with the default of Argentina. The second section describes the structure of the guaranteed bond, while the third elaborates on the World Bank’s response to the default. The next section analyzes the market response to the World Bank’s treatment of the default. The fifth section gives several examples of guarantee transactions executed since the Argentina default. The sixth section reviews the Bank’s proposed Policy on Guarantees and finally, the last section provides recommendations vis-à-vis the Bank’s proposed Policy.

II. Description of the Bond and the guarantee mechanism

3. The bond consists of a series of six separate zero-coupon notes (Series A through F), each with a face value of USD 250 million to be repaid within a five-year period. Series A, C-F mature at the end of year one through five, except series B, which matures at the end of 18 months. The gross proceeds of the bond were about USD 1.165 billion.

4. The World Bank guarantees the payment of the amount due on a scheduled maturity date for a single series of notes at any time, up to a maximum of USD 250 million. Initially, only the Series A notes will be guaranteed. If Argentina pays the principal amount of the Series A notes on the scheduled maturity date, the guarantee will automatically roll forward to the principal amount of the series B notes and so on. If Argentina fails to pay the principal amount of the series then guaranteed, and the World Bank makes a payment, the guarantee will roll forward to the next series of notes only if Argentina reimburses the World Bank within 60 days of such payment.

5. The World Bank’s maximum exposure for the transaction is USD 250 million (21.5% of the gross proceeds) resulting in a leverage of about 4.6:1 over the IBRD’s maximum exposure. The following rating agencies - S&P, Duff & Phelps and Fitch IBCA - have given investment grade ratings for series B through F and a AAA rating for series A (the first of the series being fully covered by the World Bank guarantee). The World Bank’s objective in offering such a guarantee was to help Argentina mobilize capital market financing through a targeted and limited support.

III. Argentina’s default and the World Bank’s response

6. On October 15, 2002, the Republic of Argentina failed to pay the amount due to bondholders and the World Bank paid USD 250 million under its guarantee of the Series D Zero Coupon Notes. Following Argentina’s request to the World Bank to extend terms for reimbursement due to financial liquidity constraints

and severe social crisis, the World Bank decided that Argentina should reimburse them in four equal semi-annual installments commencing on October 15, 2005, with interest payable semi-annually at LIBOR plus four percent. Under the guarantee documentation, if Argentina has not reimbursed the World Bank for the guarantee payment within 60 days of payment, the guarantee will not roll to the Series E or Series F Zero Coupon Notes due October 15, 2003 and 2004, respectively. On December 15, 2002, the World Bank confirmed that the Republic of Argentina did not reimburse the payment it made under the guarantee. Therefore, the guarantee is no longer eligible for reinstatement on the remaining Series E and F Notes.

7. The Argentina payment was the first time the World Bank was forced to pay on one of its guaranteed bonds. Following this event, the World Bank put the rolling and re-instatable guarantees under review. Currently, all re-instatable guarantee structures are suspended pending this review. According to the World Bank's guarantee department, the rest of their guarantee program is robust and still has the trust of the Board of Directors. In fact, several requests have been processed since 15 October 2002 and the Board has approved some projects, which are cited below.

IV. Reactions of the market to the World Bank response

8. We understand from market participants that by giving Argentina four and a half years, including three years grace, to reimburse USD 250 million, the World Bank's action was not positively received by private creditors. This is because they feel that this decision has reduced the incentive for Argentina to repay the amount within 60 days, as it would be required to do in order to keep the World Bank guarantee alive on related bonds due in 2003 and 2004. Market analysts view this as "an invitation to default on bondholders".

9. Prior to Argentina's default, it had been widely assumed that no borrower would default on such debt because failure to re-pay the coupon after a 60-day grace period would result in the acceleration of other World Bank loans.

10. Fitch (one of the three major rating agencies) downgraded Argentina's Series E and Series F notes to 'CC' Rating Watch Evolving from 'B-' Rating Watch Negative arguing that the World Bank decision to extend the repayment period from 60 days to four and a half years makes it unlikely that the guarantee will roll and effectively leaves the subsequent Argentine Series E and Series F naked to sovereign default risk. In addition, Fitch views the World Bank's action as damaging to the value added by rolling and re-instatable guarantee programs and furthermore this leniency creates an unfavorable precedent, which dilutes the preferred creditor argument in relation to partial guarantees.

11. However, even though the rolling-guarantee and the preferred creditor umbrella has been tarnished, Fitch will continue to give credit to other types of partial guarantees offered by multi-lateral development institutions. Fitch believes these partial guarantees being offered will replace the rolling guarantee product and will offer investors a better means of protection against high

leverage transaction as they will reduce the probability or the severity of loss on an investment.

12. The general feeling is that guarantee structures leading to a high leverage, such as the “rolling-re-instatable” guarantee, will be difficult to sell in the market going forward. Most of the investment banks and the rating agencies have adopted a very cautious attitude towards such highly leverage structures to the extent of not recommending them.

V. Examples of MDBs guarantee since the Argentina default

13. The World Bank, on 15 October 2002, approved a partial risk guarantee of up to USD 75 million in support of commercial debt financing for the construction and operation of a gas-fired generation plant in Vietnam (Phu My 2 Power project).

14. The Guarantee Review Committee of the World Bank, in January 2003, approved a partial risk guarantee of up to USD 70 million for the BOAD (Banque Ouest Africaine de Developpement) in support of private, medium and long-term projects. The guarantee would be associated with a MIGA guarantee (USD 70 million).

15. In addition, the World Bank has several guarantee projects in the pipeline including SASOL (Mozambique), Nam Theum Power (Laos), Disi Water (Jordan) and Bolivia-Brazil Gas Pipeline.

16. The IADB, on 20 November 2002, approved its first private sector mortgage bond guarantee of up to USD 5 million in Colombia, in support of a USD 50 million mortgage bonds.

17. The Asian Development Bank (AsDB), on 04 December 2002, approved a partial credit guarantee for up to USD 500 million equivalent to promote power sector reform in the Philippines.

18. The IFC, on 29 January 2003, approved a partial credit guarantee of up to 300 million Colombian Peso in support of 1 billion Colombian Peso mortgage bond.

19. Since the Argentina default, other bond guarantees have been issued. They have, however, been simpler albeit with the rolling and re-instatable guarantee structure, with some variations to allow the guarantee to continue during difficult times and give more time to the borrower to become current on its obligations.

VI. Safeguards in the proposed Bank Policy

20. The rolling and re-instatable nature of the Argentina bond guarantee is the main factor that contributed to increasing the reputational risk of the World Bank i.e. the perception and information effect of this event of default on the World Bank's reputation. This type of guarantee structure, usually, translates into a high leverage ratio, which is measured by the ratio of un-guaranteed private exposure to Bank guaranteed exposure.

21. In the policy paper we have proposed several measures to mitigate the reputational risk and keep the leverage within acceptable limits.

- a. The guarantee is structured in such a way that the guarantee coverage is the minimum to raise the funds that shall reduce the risk of confusion between the Bank's borrowings and those of borrowers.
- b. The establishment of a procedure that allows the Board to approve a "guarantee envelop" specifying the key risk parameters such as risk coverage, maximum UA equivalent amount, maximum final maturity, and maximum average life.
- c. A strict implementation of the mitigating measures for the credit and operational risks by the Bank operations staff and a close monitoring of the implementation of these measures by FFMA should alleviate the factors, which create reputational risk.
- d. The maximum value of a guarantee to the borrower is achieved by maximizing the mix of the incremental market access, the leverage achieved from that access and the cost of such access. The leverage limit is determined by the requirements of the market, the Bank, and the borrower.
- e. The Bank, as is the case today, will closely work with other MDBs, share their experiences and learn from their successes and failures in order to design each guarantee transaction with the objective to protect the financial integrity and reputation of the Bank while taking account of the interest of the borrower and private investors.

VII. Conclusions

22. The failure of Argentina to honor its obligation on the bonds is not related to the guarantee instrument itself but rather the country was in global default vis-à-vis all its creditors including multilateral development institutions, which usually enjoy a preferred creditor status. However, the fact that the underlying transaction was a series of zero coupon bonds and that the guarantee applies to one coupon at a time, has created the perception that all the series were under the umbrella of the World Bank preferred creditor status.

23. Since 15 October 2002 the World Bank has suspended the re-instatable guarantees pending a further review. The rolling and re-instatable guarantee structure coupled with the zero coupon bonds led to a high leverage that declines over time as payments are made. In addition, there was an implicit assumption in the capital market that the World Bank will “enforce” its preferred creditor status.

24. Given the current environment, the Bank’s proposed policy on guarantees has identified a number of risks associated with the instrument including the risks that occurred in the Argentina bond default and concludes that with the mitigating measures available, some of which are cited in paragraph 23, Management should be able to reduce these risks to levels consistent with the Bank's willingness to assume credit risk and its aversion for other forms of risk.

25. We can reasonably conclude that this specific event of default does not negatively affect the proposed Policy on Guarantees.