

# SNTA Briefs

Sharing knowledge, experiences, and innovations in sub-sovereign financing for infrastructure

## Partial Credit Guarantees for Sub-National Transactions

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### What is a Partial Credit Guarantee?

A partial credit risk guarantee (PCG) provides comprehensive cover to sub-national governments' (SNGs) lenders in the event the SNG fails to make debt service payments on their debt, or when any default occurs, for any reason. A PCG provides direct or indirect debt service payment coverage for an SNG commercial bank loan or domestic bond issue.

In a direct PCG the guarantor is willing to absorb the "first loss" of the SNG default. Guarantors provide a range of first loss options, but the most common is a payout of the the first SNG debt service payment failure. If the SNG continues to default on its debt obligation beyond the first payment, the first loss guarantor may or may not continue coverage, or another guarantor may assume the payments for any additional payouts. The specific amount of coverage will depend on the terms and conditions of the guarantee contract and the SNG obligations contained in the underlying loan or bond legal documents. Whether or not a PCG includes a single or multiple guarantors will depend on the risk appetite of the "first loss" guarantor and negotiations between the SNG, its creditor and guarantor<sup>1</sup>.

In an indirect PCG the guarantor may play a "behind the scenes" role, guaranteeing a portion of an SNG commercial bank loan. A commercial bank provides the funding for the SNG loan. The bank, in turn, may enter into a guarantee arrangement with a public or

private financial institution, often an international financial institution (IFI), to cover a percentage of the SNG's total debt service and/or the entire amount of any extended loan maturities. The IFI may agree to guarantee the first loss assumed by the bank under an SNG payment default, with the commercial bank assuming any additional SNG debt service payment defaults. Or the IFI may decide to cover additional SNG payment defaults beyond the first loss. The specific terms and conditions of the agreement between the IFI and the commercial bank determine the extent of the PCG coverage and the payout responsibilities between the IFI and the direct SNG lender, the commercial bank.

A PCG can also provide other improvements, or credit enhancements, to a debt obligation, such as extending and covering maturities beyond the term of bank loans or bonds normally available in the financial markets. This type of PCG helps an SNG match its debt maturity to the useful life of a project and lowers annual debt service payments. This allows the SNG to finance more of its infrastructure program.

The maturity extension PCG guarantees is the full amount of the interest and principal for a loan or debt obligation tenor that the market will not consider, often any tenor beyond the term of a local government's administration due to political risks associated with a new administration.

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### Box 1: PCG Savings Example

A local government wants to borrow the equivalent of \$100 million to finance the high priority infrastructure projects identified in its 5-year capital budget program. The finance director explores long-term borrowing options, preferably tenors greater than 15 years, from commercial banks or issuing a bond in the domestic capital market. The infrastructure projects include transportation improvements, such as several flyovers to reduce traffic congestion; expansion of the bus terminal; and several new parks associated with peri-urban developments that have accompanied the cities rapid economic growth.

This is the local government's first large borrowing for infrastructure investments. The commercial bank market has not financed SNG infrastructure projects, but it provides corporate loans with maturities up to 12 years. A few SNGs have issued 8-year bonds in the domestic capital market secured by general budget revenues. The national government, however, has issued 30-year treasury bonds and private corporations 15-year bonds.

The finance director decides to issue a bond and obtains a credit rating A-, from a qualified domestic credit rating agency. The director hires a financial advisor to monitor the sale and pricing of the bond, including the analysis of potential cost savings of a bond with a PCG to a bond without a PCG. The chart below shows the results of the analysis.

**A PCG provides a net present value (NPV) savings to the SNG for its debt, as compared to the cost of a debt obligation without the PCG**

Terms and Conditions	Bond Issued Without a PCG	Bond Issued With an AAA-rated PCG
Amount	\$100 million equivalent	\$100 million equivalent
Rating	A-	AAA
Tenor	8 years	20 years
Amortization	16 equal semi-annual payments	40 equal semi-annual payments
SNG Interest Rate/Yield <sup>2</sup>	Fixed 8%	Fixed 5.85%
PCG Cost	Not Applicable	2%
NPV Savings with the PCG	Not Applicable	\$150,000

Even though the SNG has a good credit rating, investors are willing to reduce the interest rate they receive from the SNG to a rate equivalent to the government's borrowing cost. Investors have confidence that the AAA guarantor more than offsets the risk that the A- SNG will default on the extended maturity debt. The savings also reflects the price investors, mostly pension funds and insurance companies, are willing to pay because of the scarcity of long dated securities required to match their long-term liabilities.

## What is the Cost of a PCG?

A PCG provides a net present value (NPV) savings to the SNG for its debt, as compared to the cost of a debt obligation without the PCG. A savings can only occur if the guarantor has a sufficiently higher credit rating than the SNG and lowers investor risk. The higher PCG credit rating results in a lower interest rate for the guaranteed SNG debt obligation than a debt obligation without the PCG. The lower interest rate results in a lower SNG cost. The SNG receives a cost savings with a PCG if the NPV of the lower interest rate payments over the life of the obligation is greater than the NPV cost of the guarantee (see Box 1).

## SNG Debt Management and Moral Hazard

Credit ratings express the probability that a borrower will not make a debt service payment and default on its obligation. They are often expressed in letter categories, with AAA the highest rating (zero probability of default) to C, the lowest (the obligation is in default)<sup>3</sup>. Theoretically, borrowers in the same rating category have the same default probability and payment risk and should pay the same price for their debt. Investors should offer the same yield for debt obligations with the same credit rating, as both obligations have the same default probabilities.

However, even in mature competitive capital markets, there are price differences between debt obligations of the same ratings due to government interest rate subsidies and other market distorting factors. For example in the United States, as a result of the income tax-exemption for investors that purchase municipal bonds, a AAA/AA<sup>+</sup> municipal bond usually has a yield less than the yield of an equivalent maturity AAA/AA<sup>+</sup> United States Treasury bond. The extent of the yield differential may vary from a few basis points to perhaps 100 basis points under volatile market conditions.

In emerging markets, the yield differential between equally rated debt obligations from different issuers is exacerbated by the lack of new issuance and secondary market volume, extensive government interest rate subsidies, and other government interventions that distort volume and prices. For example,

government-owned financial institutions that provide interest rate subsidies for a large number of borrowers overly distort yield differentials between borrowers of the same credit rating.

Another critical factor leading to pricing distortions between the same rated borrowers is the lack of default information for any type of issuer. In more mature international capital markets, credit rating agencies have over 100 years of default data for bond issuers in each of the letter rating categories. This data reflects defaults under every type of economic cycle, including the Great Depression in the 1930s, the recent Great Recession, and other less volatile economic ups and downs. Credit ratings and capital market issuance in emerging markets is relatively new and default data limited. In emerging markets, investors' default probability opinions are based more on subjective views of political and other risks rather than hard default data. Default probabilities for borrowers in the same rating category in these markets are subject to much greater uncertainty. As credit ratings and capital market volume in emerging markets increases and governments reduce market distortions, investors will have more confidence in the default probabilities expressed by credit ratings. PCG pricing should better reflect the risk spread between the guarantor's rating and the SNG rating.

## Advantages of a PCG

Below are some of the broader advantages provided by PCGs for SNG debt obligations.

- **More SNG financing options:** Gives SNGs more financing options, with less funding dependence on central government, thereby supporting true decentralization.
- **Off-sets market failures that limit SNG borrowing and raise the cost of SNG debt:**
  - An inadequate legal, institutional, and regulatory framework
  - An unstable macroeconomic situation and capital market constraints, such as low volume, high risk issuers; unsophisticated institutional investors with limited credit analysis capability; limited secondary market trading; government yield

**PCGs can be highly efficient in raising investor confidence to invest, guarantee and/or lend on a transactional or blanket basis**

curve lacking longer tenor benchmarks; a lack of bankable SNG projects; and a lack of good sponsors

- Poor SNG financial management practices characterized by antiquated information systems, poor tax collection, opaque procurement
- Unsophisticated local investors that require safe investments and transparency in financial dealing

• **Stimulation of the local capital market:** Through the creation of new investment products (e.g., longer tenor bonds of a given credit rating, higher rated bonds for a given sector) development guarantees can help stimulate local capital markets and provide future benefits for both public and private investors.

• **Improving the efficiency of scarce capital resources:** Given the scarcity of SNG capital budget, guarantees can use leverage to attract private funding (commercial bank loans and capital market bonds) and reduce public funding of suitable projects thereby using public funds more efficiently. PCGs can be highly efficient in raising investor confidence by using the guarantee to induce other participants to invest, guarantee and/or lend on a transactional or blanket basis.

• **Supporting sub-sovereign development:** Most SNGs do not have the public resources to fund needed development investments on their own. Even credit-worthy SNGs may not be able to attract finance on suitable terms because they are not well known in the market or are borrowing in small amounts. The use of a PCG can significantly reduce finance costs for sub-sovereigns.

- **Leveraging additional private funding:** PCGs can be highly efficient in raising investor confidence by using the guarantee to induce other participants to invest, guarantee, and/or lend on a transactional or blanket basis. Thus, the assumption by the guarantor of some fraction of the total amount of the borrower's credit exposure can leverage a substantially larger amount of capital into the transaction. For example, an IFI may collaborate with a commercial bank in a guarantee program.

### The Sub-National Technical Assistance (SNTA) Program

As more and more countries decentralize, the provision of infrastructure is increasingly becoming the responsibility of sub-national authorities (local governments and public utilities). These authorities are finding it necessary to seek long term private financing for their infrastructure projects. Using annual budget allocations to build infrastructure is difficult to manage because the funds required vary greatly from year to year. Long term debt financing allows sub-national authorities to smooth out the annual funding requirement by borrowing a large amount of capital at one time and then repaying the debt in predictable annual increments small enough to make the project affordable to the people served. The Public Private Infrastructure Advisory Facility (PPIAF) works with sub-national authorities to enable access to private financing on the best possible terms, and shares the lessons learned from its global experience.

#### Notes

1. The direct PCG guarantor may sell its payout obligation to a third party reinsurance company in the secondary insurance market. Indeed, most private financial guarantors spread the risks associated with their direct guarantees by selling a portion of the coverage to a re-insurer, much like commercial banks that syndicate loans.
2. The yield is the same as the interest rate in this example because the investor did not pay a premium (above \$100 million) or receive a discount (below \$100 million).
3. See SNTA Brief #3 for a further explanation of credit ratings
4. US Government Treasury Bonds have a split rating. Fitch Ratings and Moody's Investor Service retained the US AAA/Aaa rating, whereas Standard and Poors lowered the US rating to AA<sup>+</sup>

## SNTABRIEFS

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