EXTRACT FROM:
WORLD BANK PORT REFORM TOOL KIT
Financial Implications of Port Reform, Part II, Principles of Financial Modelling, Engineering and Analysis

The financial engineering of the project in terms of “political” risk management

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1 – Political risks and "investment guarantees"

Part I of this Module, devoted to risk management, mentioned the notion of "political" risk, an expression which covers all risks which may result from decisions of a unilateral and "improper" nature taken by the public authorities of the host country of the project, whether they are the State, local authorities or port authorities.

The management of these risks falls resolutely within a contractual type approach. Also, financial engineering of political risk management consists of setting up adequate insurance products to mitigate any financial consequences that may result from a public decision that is detrimental to the viability of the project.

Several comments need to be made regarding the financial treatment of these political risks:

- In the first place, the deliberately separate presentation of political risk and market risk (the exogenous financial risks presented above) within the framework of this study, needs to be precised. The risks of non-transferability and non-convertibility of the local currency, which are frequently rightly associated with the foreign exchange risk, can be used as an example. In fact, while it is clear that fluctuations in foreign exchange rates are partly due to market dealings, the fact remains that they are also wholly dependent on the monetary policy either set by the national central bank, if no foreign exchange control system is in place (which is the case with all developed countries) or the government of the day otherwise. Also, how can one set the exact split between these two classes of risk? This example is a good illustration of the "grey" area, which is difficult to apprehend in terms of "causality" of the risk and which undoubtedly makes the data of the problem a little more complex for the financial analyst.

- Secondly, the financial treatment of political risk management harks back to the notion of "investment guarantee" which poses the difficult question of knowing under which balance sheet headings to place this cover. While the answer may seem obvious with regard to the guarantees offered by "secured" loans (which were deliberately dealt with in the section covering the financial structuring of the project), existing insurance products relating to "investment guarantees" can, depending on the type of policy, relate either to a guarantee of equity invested by the sponsors or a guarantee relating to all the project's assets. This distinction, which is fundamental in terms of its potential consequences, is however difficult to grasp in practice.

- Finally, the calling in of these guarantees and indemnity procedures provided by insurance policies in the event of default are not without problems. Without going into detail, it should be mentioned that the notions of "events of default" and "subordination of rights" between an investment guarantee and a "secured" loan in practice prove to be particularly complex and difficult to manage for all private partners.

2 – Guarantees offered by multi-lateral agencies

i) Multi-lateral Investment Guarantee Agency (MIGA)

Undoubtedly the best known of the multilateral agencies offering investment guarantees is the Multilateral Investment Guarantee Agency or MIGA, the aim of which is to "encourage investments for productive purposes between member countries of the World Bank Group". In this sense, it is in a position to guarantee the SPC's investments against losses which may result from a **non commercial** risk, in other words:

- The risk of non transferability as a result of restrictions imposed by the host government;
- The risk of loss, as a result of legislative or administrative measures or omissions of the host government which effectively deprive the foreign investor of the right of ownership or the control he exercises over his investment;
- The risk of breach of contract by the host government vis-à-vis the investor;
- The risk of armed conflict and civil disturbance.

ii) Investment guarantees offered by the World Bank (IBRD)

The World Bank Guarantee Programme

Since 1994, the World Bank promotes the use of political risk mitigation guarantees to address the growing demand from sponsors and commercial lenders contemplating financial investment in the infrastructure sectors of developing countries. The Bank's objective in mainstreaming guarantees is to mobilise private capital for such projects on a "*lender of last resort*" basis whilst minimising the host government's requisite indemnity to the Bank as a condition of providing the guarantee.

World Bank guarantees are provided to private lenders, for infrastructure financing, where the demand for debt funding is large, political and sovereign risks are significant, and long-dated financing critical to a project's viability.

The Bank offers commercial lenders a variety of guarantee products: Partial Risk, Partial Credit, Enclave and Policy-based guarantees in IBRD countries, and Partial Risk Guarantees in IDA-only countries. Broadly speaking, all guarantees provide coverage against debt-service default arising from sovereign risk events, each guarantee issued is tailored to match the specific need of an individual transaction.

IBRD guarantees are offered for projects in IBRD eligible countries, with the exception of certain foreign exchange earning projects in IDA-only countries. IBRD guarantees can be both Partial Risk and Partial Credit in nature. Bank guarantees are generally available for projects in any eligible country, irrespective of whether the project is in the private or public sector. The bank may, however, at times limit the availability of guarantees in certain countries, for example in countries undergoing debt restructuring. IBRD Partial risk guarantees ensure payment in the case of debt service default resulting from the non-performance of contractual obligations undertaken by the government or their agencies in private sector projects. Sovereign contractual obligations vary depending on project, sector and circumstances. They typically include:

- Maintaining an agreed regulatory framework, including tariff formulas;
- Delivering inputs, such as fuel to a private power company;
- Paying for outputs, such as power or water purchased by a government utility;
- Compensating for project delays caused by political actions or events.

Partial risk guarantees may also cover transfer risks that may be caused by constraints in the availability of foreign exchange, procedural delays and adverse changes in exchange control laws and regulations.

Partial Credit guarantees cover all events of non-payment for a designated portion of the financing. While historically these guarantees have been used to encourage extension of maturity by covering the later years of the financing, the Bank recently structured a partial credit guarantee to cover a single coupon interest payment on a rolling basis throughout the life of the facility, plus the final bullet principal repayment.

Enclave guarantees are highly selective partial credit guarantees structured for export oriented foreign exchange generating commercial projects operating in IDA-only countries. Enclave guarantees may cover direct sovereign risks such as expropriation, change in law, war, and civil strife but may not cover third party obligations (such as those of an output purchaser or input supplier), nor will it guarantee transfer risk. In all cases, the scope of risk coverage under the guarantee would be the minimum required to mobilise financing for a given project.

Partial Risk guarantees are used in IDA member countries, in sectors undergoing significant reforms. IDA guarantees are offered on a pilot basis to private lenders against country risks that are beyond the control of investors and where official agencies and private markets currently offer insufficient insurance coverage. IDA guarantees are available selectively, where an IBRD Enclave guarantee is not available. IDA guarantees can cover up to 100 percent of principal and interest of a private debt trench for defaults arising from specified sovereign risks including government breach of contract, foreign currency convertibility, expropriation, and political violence.

Bank guarantees facilitate the mitigation of risks that lenders cannot assume, catalyse new sources of finance, improve borrowing costs, and extend maturity beyond what can be achieved without the bank guarantee. They also provide more flexibility in structuring project financing (currency, market, etc.).

Clearly, within the World Bank Group, IFC and MIGA are the preferred sources of support to the private sector. As such, sponsors and financiers should consult with IFC and MIGA as to their potential interest in financing or covering the project. IFC supports private sector projects through equity and debt financing, the syndicated B-Loan programme, security placement and underwriting and advisory services. MIGA provides political risk insurance primarily for equity investments, but it can also cover debt financing, as long as it is also covering equity finance for the same project. These agencies cannot accept host government guarantees.

3 – Guarantees offered by export credit agencies

Export credit agencies also issue guarantee policies covering investment operations abroad. These instruments usually provide a guarantee for the SPC against the political risks of:

- **Attack on shareholders' rights**
- **Non payment and non-transfer** of the payment or non-transfer of the investment or of the indemnity provided in the concession contract in the event of nationalisation.

The guarantee package (with a cover ratio in the region of 90 to 95%) relates not only to the initial investment but also the self-financing produced by the project, in other words the profits to be reinvested and the profits to be repatriated. Generally speaking, there is a ceiling on the basis of cover relating to the self-financing produced by the project: in the case of COFACE in France, the cumulative limits are respectively 100% (in respect of profits to be reinvested) and 25% (in respect of profits to be repatriated) of the initial investment.

Finally, we should point out that securing such a guarantee is conditional on the existence of a bilateral investment protection agreement between the country of the export credit agency and the host country of the project.

4 – The use of private insurers for covering "political" risks

Private insurers sometimes offer viable alternatives to public insurers for covering political risks. The periods of cover available are sometimes longer and there may also be geographical preferences. The cost of this insurance must of course be taken into account but it is sometimes the only alternative for making financing of projects in difficult countries possible.

A private insurer insures the banks against the occurrence of a political risk causing the loan to default. Private insurers are sensitive to the monitoring procedures that the banks put in place in order to assess the political risk and its development. The banks must therefore provide evidence of their ability to assess and avoid the political risk during the project set-up stage. This is a condition of underwriting the policies.