

# **ASIAN DEVELOPMENT BANK**

## **REVIEW OF THE PARTIAL RISK GUARANTEE OF THE ASIAN DEVELOPMENT BANK**

November 2000

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## ABBREVIATIONS

ADB	–	Asian Development Bank
AIG	–	American International Group
BOO	–	build-own-operate
BOT	–	build-own-transfer
CEND	–	confiscation, expropriation, nationalization and deprivation
CI	–	currency inconvertibility
CP	–	coguarantee program
CUP	–	Cooperative Underwriting Program
DMC	–	developing member country
IADB	–	Inter-American Development Bank
MIGA	–	Multilateral Investment Guarantee Agency
OPIC	–	Overseas Private Investment Corporation
PCG	–	partial credit guarantee
PRG	–	partial risk guarantee
PRI	–	political risk insurance
PSO	–	Private Sector Operations

## NOTE

In this paper, "\$" refers to US dollars.

## I. INTRODUCTION

1. In 1995, the review of the guarantee operations<sup>1</sup> of the Asian Development Bank (ADB) introduced the partial risk guarantee (PRG) as a new instrument to expand guarantee operations. The Board approved a second review of guarantee operations in 1999.<sup>2</sup> In April 2000, the Board approved a review paper on fees for partial credit guarantees (PCGs)<sup>3</sup>. The current paper reviews ADB's experience with the PRG and proposes possible improvements to the instrument.

2. The PRG provides coverage against certain well-defined political risks. To place ADB's PRG into the overall context of the political risk insurance (PRI) market, this paper presents an overview of the PRI market and its evolution. Section III reviews ADB's current policy on PRGs and analyzes the constraints that have limited its use. Section IV proposes changes to ADB's current policy on PRGs, while section V analyzes the benefits of a new and improved PRG program. Section VI presents the conclusion.

## II. AN OVERVIEW OF THE POLITICAL RISK INSURANCE (PRI) MARKET

3. ADB's PRG can provide coverage against well-defined risks. Depending on the requirements of a project, these risks may include some or all of the following categories: expropriation, currency inconvertibility or nontransfer, political violence, and breach of contract. In project finance, such risks are typically referred to as political risks, as distinct from purely commercial or project-related risks. Coverage against such political risks can be purchased from political risk insurers.<sup>4</sup> The following sections provide an overview of the PRI market.<sup>5</sup>

### A. Types of PRI Investment Coverage

#### 1. Expropriation

4. Expropriation insurance, the centerpiece of PRI for investments, is commonly referred to as confiscation, expropriation, nationalization, and deprivation (CEND or expropriation) coverage. CEND coverage is designed to protect a foreign investor when a host government interferes with the investor's fundamental ownership rights. This may take the form of a direct seizure of an asset, such as fixed investments or plant and equipment. It may also take the form of an action or a series of actions, the net effect of which is expropriatory, referred to as "creeping expropriation." Examples include the imposition of punitive or selective taxes that make a venture commercially unviable, wrongful termination of operating licenses, or refusal to grant visas to foreign managers critical to running the operation.

5. Under international law, a host government has the right to seize a foreign-owned asset. However, it is generally accepted that compensation must be provided on a prompt, adequate, and effective basis. When expropriation occurs and such compensation is not provided, CEND

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<sup>1</sup> R81-95: *Review of the Bank's Guarantee Operations*, 4 April.

<sup>2</sup> R135-99: *Review of the Bank's Guarantee Operations*, 31 August.

<sup>3</sup> R88-00: *Partial Credit Guarantee Charges*, 13 April.

<sup>4</sup> The concepts of guarantees and insurance are related. Both concepts imply risk transfer—a contract between two parties to exchange risk between them.

<sup>5</sup> The two broad categories in the PRI market are: (i) trade coverage, and (ii) investment coverage. Trade coverage is oriented toward export and import transactions, and addresses host or home country interference in the successful conclusion and payment of short-term, trade-related transactions. As the focus of the PRG program is on long-term, investment-related coverage, the paper does not review trade-related coverage.

insurance responds by providing compensation to an equity investor based on the net book value of the expropriated assets, or to a project lender based on the schedule of payments that were missed as a result of the expropriatory act.

6. CEND insurance providers take varying approaches to determining what constitutes expropriatory action. Some require that the action must have discriminated against the investor; others require that the action must have selectively or expressly restricted the insured's operations. Most expropriation coverage requires that the expropriatory action continue for an extended period, typically six months to one year, at which point the action is deemed permanent and compensable.

## **2. Currency Inconvertibility or Nontransfer**

7. Currency inconvertibility and/or nontransfer coverage (commonly referred to as CI coverage) is intended to ensure that dividends, profits, fees, share capital, and loan proceeds from an insured project are remitted or repatriated from a host country in a timely fashion and at prevailing rates. The conversion of convertible local currency into foreign currency, and the transfer of that currency out of the host country are covered for both "active blockage" (wherein a local law prevents conversion or transfer) and "passive blockage" (in which excessive delays in processing a request to convert or transfer currency by the governing monetary authority prevent repatriation). The amount of currency that could not be converted or transferred is the subject of the coverage.

8. CI insurance does not protect against currency fluctuation, devaluation, or any preexisting restrictions on conversion or transfer. If an investor applies to convert local currency into foreign currency and the host government's central bank not only failed to convert the currency in a predefined time period, but also refused to return the local currency to the investor, the investor would not be able to file a CI claim. In such a case, the currency will have been effectively expropriated. For this reason, CI coverage is almost always purchased in conjunction with coverage of such expropriation of funds.

## **3. Political Violence**

9. Political violence coverage refers to physical damage to an asset as a result of politically motivated strikes, riots, civil commotion, terrorism, sabotage, war, and/or civil war. While standard property insurance can cover losses due to strikes, riots, civil commotion and perhaps terrorism, damage due to war is usually excluded. Coverage usually applies to the lesser of repair, replacement, or fair market value. In addition, coverage for business interruption may be available for net profit lost, and compensates for defaults caused by political violence.

## **4. Breach of Contract**

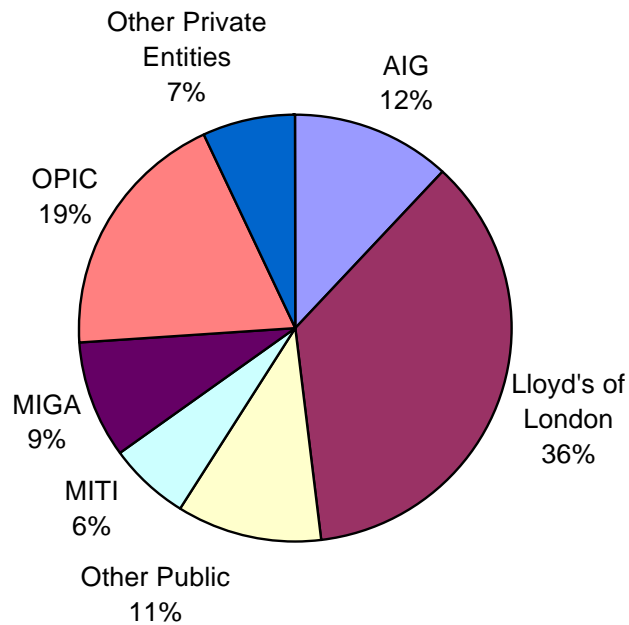
10. Breach of contract coverage refers to losses arising from a host government's breach or repudiation of a contract with the owner of an insured project. For example, for a power project such a breach may result from failure by a government-owned entity to make payments in accordance with the power purchase agreement between the independent power producer and the user or distributor. For a toll road project, such a breach may result from a government entity failing to comply with the agreed increase in toll levels. In the event of an alleged breach or repudiation, the investor or project company must normally be able to invoke a dispute resolution mechanism (e.g., arbitration) in the underlying contract and first obtain an award for damages. If, after a specified period of time, the investor is unable to implement the outcome of

the dispute resolution mechanism, or if the dispute resolution mechanism fails to function because of actions taken by the host government, PRI will be called upon to pay compensation.

## B. Major Underwriters in the PRI Market

11. Figure 1 provides an overview of the market share of the major institutions in the PRI market. The market is almost evenly divided between public sector institutions such as the Multilateral Investment Guarantee Agency (MIGA) or Overseas Private Investment Corporation (OPIC), and private sector groups such as Lloyd's of London and American International Group (AIG). Total premia paid in the PRI market in 1998 were estimated at approximately \$450 million.<sup>6</sup> The following sections provide a brief overview of the products and policies of the major participants in the market.

**Figure 1: Market Share of Major Underwriters in the Political Risk Insurance (PRI) Market**



AIG=American International Group, MIGA=Multilateral Investment Guarantee Agency, MITI=Ministry of International Trade and Industry, OPIC=Overseas Private Investment Corporation.

Source: Staff estimates.

### 1. Bilateral Institutions

12. Long-term political risk insurance has, until recently, been the domain of the bilateral institutions, which are owned and operated by an individual government.

13. The two largest bilateral providers of PRI in terms of premium generation are Export Insurance Department of the Ministry of International Trade and Industry of Japan, and OPIC of the United States. Other bilateral providers of PRI include Compagnie Francaise d'Assurance pour le

<sup>6</sup> The market share data provided do not differentiate between equity and debt coverage.

Commerce Extérieur (COFACE) of France, Export Credit Guarantee Department (ECGD) of the United Kingdom (UK), Export Development Corporation (EDC) of Canada, Export Finance and Insurance Corporation (EFIC) of Australia, Nederlandse Credietverzekering Maatschappij Holding NV (NCM) of the Netherlands, Sezione Speciale per l'Assicurazione del Credito all'Esportazione (SACE) of Italy, and Treuarbeit of Germany. These organizations, along with another 40, belong to the Berne Union—their umbrella organization—which meets quarterly and shares information on investment and insurance trends.

## 2. Multilateral Institutions

14. Multilaterals entered the PRI market only relatively recently. The World Bank Group started operations in the PRI market with the establishment of MIGA in 1988. The World Bank revitalized its own guarantee program in 1994. The key difference between the two institutions is that the World Bank only provides guarantees with a host government counter guarantee, while MIGA provides guarantees without such a counter guarantee.

15. The World Bank's current guarantee program started in 1994 with the introduction of a PCG and a PRG. Both guarantees are similar to the ADB guarantees with two major differences (i) a counter guarantee from the host government is always required, and (ii) stand-alone guarantees are possible.

16. Since the start of the program, the World Bank has issued five PRGs, ranging from \$30 million to \$240 million. These are for the Uch Power and Hub Power projects in Pakistan, power projects in Ivory Coast and Morocco, and a telecommunications project in the Russian Federation. Total PRGs provided by the World Bank amounted to \$721 million as of fiscal year 1999.

17. MIGA was created with an initial authorized capital of \$1.08 billion.<sup>7</sup> Since underwriting its first guarantee contract in 1990, MIGA has underwritten 420 guarantees in 66 countries, facilitating the flow of more than \$30 billion of foreign investments into developing countries.

18. MIGA provides coverage of equity investments, shareholder loans, and loan guarantees issued by equity holders. Loans to unrelated borrowers can also be guaranteed, provided equity or quasi-equity is concurrently insured with MIGA. Thus, no stand-alone guarantees can be provided to commercial banks, unless one of the project's shareholders takes out MIGA insurance on at least a portion of that investment. MIGA's term of coverage is typically up to 15 years, and the amounts that MIGA can guarantee for its own account can reach up to \$110 million per project.

19. In 1995, MIGA started a coinsurance program, the Cooperative Underwriting Program (CUP), designed to encourage private insurers to offer political risk insurance for projects in developing countries that are members of MIGA. The CUP aims to address instances when a private insurer may not wish to assume additional risk in a host country on its own, but may be willing to do so in conjunction with an international organization such as MIGA. The CUP is a "fronting" arrangement, whereby MIGA is the insurer-of-record and issues a contract of guarantee for the entire amount of insurance requested by an investor, but retains only a portion of the exposure for its own account. The remainder is underwritten by one or more private insurers using MIGA's contract wording. The premium rates, claims payments, and recoveries are shared on a pro rata basis. More information on MIGA is provided in Appendix 1.

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<sup>7</sup> Its capital was increased to \$2 billion in 1999.

20. The Inter-American Development Bank (IADB) has had the ability to provide guarantees since its founding in 1959, but only in 1994 did it develop a guarantee program. The program, which was inaugurated in 1995, issued its first guarantee in 1996, but demand was much less than expected. After an internal review in 1999, IADB implemented the following important modifications to its PRG program:

- (i) IADB can now cover up to \$150 million per transaction, or up to 50 percent of a project's cost, whichever is less. Under the 1995 program, PRGs could provide guarantees up to 25 percent of a project's cost or up to \$75 million, whichever was less. This was in line with IADB's prudential limits for private sector loan and equity investments. However, during the 1999 review process, both limits were doubled.
- (ii) The 1995 requirement for the host government to provide a counterguarantee was dropped, as IADB found it difficult to secure such counterguarantees.
- (iii) IADB renamed the product from "partial risk guarantee" to "political risk guarantee" to more clearly communicate to the market exactly what risks are covered. Users had been confused by the name of the program.

21. According to IADB's Private Sector Department, demand for the program has increased significantly following the modifications to their political risk guarantee program. IADB is processing a number of guarantee transactions in the current fiscal year.

### **3. Private Sector Institutions**

22. The two most dominant private sector underwriters in the PRI market are Lloyd's of London and AIG.<sup>8</sup> At Lloyd's, aggregate contingent liabilities for PRI are estimated to be approximately \$25 billion. Lloyd's has the advantage of being able to pool underwriting capacity to insure large exposures of \$1 billion to \$2 billion per transaction. Other private insurers, such as AIG, are limited to maximum coverage of \$150 million per transaction. While PRI coverage periods for private sector insurers have traditionally been limited to 3 – 5 years, some have recently offered to extend coverage for up to 10-15 years. Nevertheless, most private sector PRI policies continue to be issued for relatively short-term, mostly equity-related transactions in low-risk countries.

### **C. Premium Rates and Loss Histories of Major PRI Underwriters**

23. Economic sustainability of the PRI market depends primarily on three variables: (i) premium income; (ii) financial payouts of claims; and (iii) recovery rates (i.e., the amounts that the insurer or guarantor can recover from the host government, or otherwise, after a claim is filed and paid).

#### **1. Premium Rates for PRI**

24. In the public sector PRI market, base rates are typically established by type of investment, indicating how an average risk would be rated for specific coverage in specific

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<sup>8</sup> There are at least six additional significant underwriting markets in the private sector, including Chubb, Exporters Insurance Services, Lehman Brothers, Sovereign Risk, Unistrat, and Zurich-American Political Risks.

sectors. Actual premium rates can vary significantly by country and project. Because transactions tend to be underwritten on a project-specific basis, the underwriter may increase or decrease base rates by 30 percent (or more), based on an assessment of project-specific risk (Appendix 2 provides details on the pricing of PRI).

25. In the private sector PRI market, premium rates are a function not only of perceived risk, but also of underwriting capacity for specific countries and sectors, which may vary significantly over time. For example, during times of perceived political instability in a country, PRI underwriting premia for new projects may increase up to 500 basis points per annum, only to fall back again to their original level after the perceived risks subside. Premium rates in the private market are very much comparable to spreads on sovereign bond issues by developing country issuers that tend to fluctuate widely during times of political or economic uncertainty.

## **2. Claims Histories and Recovery Ratios**

26. Among the multilateral PRI institutions, MIGA has made only one payment since starting operations in 1990.<sup>9</sup> Few countries are willing to default on an exposure to a multilateral institution such as MIGA.

27. Among the Export Credit Agencies, OPIC has published its claims ratios since 1971. It has received several claims, in particular in Chile in the early 1970s, Zaire and Sudan in the late 1970s, Iran in the early 1980s, and the Dominican Republic and the Philippines in the mid-1980s. As of 30 September 1999, OPIC and its predecessor agency have paid 265 claims to investors, representing \$564.4 million over the last 28 years. OPIC has achieved a recovery rate of 95 percent, i.e., \$536 million was recovered from host governments, while the net loss to OPIC was only around \$28 million.

28. Because of confidentiality requirements, claims histories are not widely available for private sector PRI institutions. However, some data are available for Lloyd's of London from 1991 to 1995. Total claims for this period amounted to \$66 million, representing a 9 percent claims ratio as a percentage of total premia, while recovery ratios were estimated to be approximately 50 to 75 percent.

29. Between 1972 and 1997, AIG paid a total of \$378 million to clients to settle 211 claims. Its recoveries have totaled \$263 million, amounting to a 70 percent recovery ratio.

## **III. REVIEW OF ADB'S PARTIAL RISK GUARANTEE (PRG) PROGRAM**

### **A. Existing Policy Framework for PRGs**

#### **1. Coverage of PRG**

30. The PRG covers part (or all) of a lender's outstanding debt service against specific risks.<sup>10</sup> Coverage of equity risks is not authorized under ADB's Charter. Risks that are specifically mentioned in the 1995 review (footnote 1) include breach of contract and currency inconvertibility under build-own-operate (BOO) and build-own-transfer (BOT) projects. The

<sup>9</sup> In March 1999, MIGA received an expropriation claim related to a power project in Indonesia. MIGA paid the claim in the summer of 2000. MIGA's gross liability under the contract is \$15 million, of which \$10.5 million is reinsured.

<sup>10</sup> Debt may include forms of "mezzanine" ("mezzanine" is a summary term for hybrid instruments that combine the characteristics of debt and equity. These include subordinated debt, convertible bonds, and debt instruments with attached options and warrants to purchase equity).

guarantee is to cover mainly principal and base interest. Interest spread cover, although allowed, is discouraged.

## **2. Nonaccelerable Coverage**

31. ADB's obligations under the PRG may not be accelerated by the lenders covered by a PRG. Under Article 15.1 of ADB's Charter, however, ADB must reserve the right to terminate its liability with respect to interest (also referred to as the "buyout option") by offering to purchase the guaranteed obligation at par plus interest accrued from the date of default to the date ADB exercises its buyout option.

## **3. Trigger Events**

32. The 1995 review states that the PRG would be callable under two conditions:

- (i) noncompliance with one or more obligations of the host government is established, as specified in the guarantee agreement; and
- (ii) such noncompliance has resulted in a debt-service default to the lenders.

33. The 1995 review states that ADB will generally seek to include dispute settlement and/or arbitration provisions in the guarantee agreement. However, the review also notes that lenders may be reluctant to purchase coverage that requires lengthy dispute resolution procedures before calling on ADB's guarantees. Whether or not to include such dispute resolution mechanisms is, therefore, to be decided for each transaction on the basis of business judgment and negotiation.

## **4. Counterguarantees**

34. The 1995 review contemplated extending a PRG without a counterguarantee from the host government. While it is stated that a counterguarantee "will generally be sought," it allows extending a PRG without a counterguarantee under ADB's Private Sector Operations (PSO). PRGs without counterguarantees are subject to the same criteria and procedures as nonguaranteed private sector loans and equity investments (the maximum exposure per project is limited to the lesser of 25 percent of project cost or \$50 million). PRGs are to be included in the overall PSO allocation as well as the country-specific exposure.<sup>11</sup>

## **5. Participation Requirement**

35. Article 11(iv) of the Charter enables ADB to guarantee loans "for economic development participated in by the Bank." This provision of the Charter requires that ADB's guarantees, including PRGs, can only be extended in respect of projects or programs in which ADB has some other form of participation, such as a direct loan, an equity investment, or bond subscription.<sup>12</sup> As a result, ADB is unable to offer stand-alone PRGs, unlike World Bank, MIGA, and IADB, whose charters were drafted in a consciously different manner.

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<sup>11</sup> At face value of the PRG-supported loan.

<sup>12</sup> A legal memorandum regarding the participation requirement was prepared by The Office of the General Counsel and circulated to the Board on 15 September 2000.

## 6. Pricing

36. For PRGs with a government counterguarantee, the 1995 review recommends market-based pricing determined by the extent of the coverage, the nature of the risks covered, and individual and country circumstances. However, while the guarantee is market-determined, ADB will refund to the developing member country (DMC) government the excess between the 40 basis points per annum guarantee fee and the market-determined overall fee. The guarantee fee is charged on the face value of the guaranteed loan, and may be paid up front or on a periodic basis.

37. In the case of PRGs without a government counterguarantee, the 1995 review recommends market-based pricing and no fee sharing with the host government. This is analogous to the determination of interest rate charges for ADB's nonguaranteed private sector loans.

38. ADB's Guarantee Committee, which was established under the 1995 review, is responsible for determining applicable fees for specific guarantee transactions, reviewing the structure of specific guarantees, and (if required) providing guidance on conformity with ADB policies and procedures. The Guarantee Committee is composed of representatives of the Office of Cofinancing Operations (Chair), the Treasurer's Department, the Office of the General Counsel, the Private Sector Group, and the relevant project departments.

## 7. ADB Financial Policies for PRGs

39. In accordance with the current application of Article 12.1 of the Charter, ADB must ensure, at all times, that its capital base is sufficient to meet future obligations arising from loans and guarantees. Since PRGs may be called at any point in time—as opposed to PCGs, which are callable mainly in relation to later maturities—ADB's financial policies require that the PRGs be charged against ADB's lending authority at the nominal value of the guaranteed obligations, as compared to the discounted value used for PCGs.<sup>13</sup>

40. The 1995 review recommends that, in determining capital allocation requirements for PRGs, due consideration is placed on ADB's right to terminate its guarantee liability under the buyout option built into each guarantee (para. 31). In the case of PRGs generally, it is reasonable to assume that ADB will exercise its buyout rights at an early juncture, in order to minimize its liability with respect to interest coverage. Furthermore, the buyout option would most likely be exercised once it has been determined that the default has been caused by a political event,<sup>14</sup> and there is no reasonable prospect of the Government curing the default.

41. On this basis, the 1995 review indicates that from the date of effectiveness of the PRG the capital backing for PRGs should be set at a level equivalent to the guaranteed principal outstanding, plus the interest that will accrue for the succeeding interest period.<sup>15</sup> The capital backing is then adjusted periodically, to take into account the decline in the outstanding principal

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<sup>13</sup> For purposes of the application of Article 12.1 of ADB's Charter, ADB has traditionally not resorted to risk weighted valuations of liabilities, and has refrained from probability of loss analysis of contingent liabilities in general. However, it is widely accepted in the PRI market that the probability of loss on a political risk instrument such as a PRG is lower than the probability of loss associated with an uninsured commercial loan, which is exposed to the full range of political and commercial risks. MIGA, for example, sets aside \$1 for every \$3.5 guaranteed. Private insurers also leverage their capital, at different levels, depending on the risk assumed in their portfolio.

<sup>14</sup> This is a precondition for payment of claims by ADB under all PRGs.

<sup>15</sup> R81-95: *Review of the Bank's Guarantee Operations*, 4 April, Appendix 8, para. 11.

of the underlying guaranteed loan following amortization, as well as any possible changes in the base interest covered under the PRG.<sup>16</sup>

42. Should a payment default under a PRG-supported loan lead to a dispute or arbitration between the host government and the beneficiary of the guarantee<sup>17</sup> and, under the PRG, ADB is obligated to cover interest that will accrue during the dispute,<sup>18</sup> then, for purposes of the lending and guarantee limit calculations, ADB would reflect the principal outstanding under the guaranteed loan, and the face value of all future interest payments thereon, for the remainder of the life of the guaranteed loan.<sup>19</sup>

## B. Review of Experience

43. The 1995 review foresaw a large potential demand for PRGs, in particular, in the context of increased private sector participation in the infrastructure sector. However, by the 1999 review (footnote 2), ADB had not yet issued any PRGs. A PRG was considered for an infrastructure project in Pakistan, but did not proceed, as the project did not go ahead. Currently, two BOT projects in Bangladesh and Sri Lanka are being processed with a PRG supporting the commercial debt financing, and another PRG is being considered in Pakistan for import letters of credit confirmation.

44. The limited demand for ADB's PRG can be attributed to a combination of market factors, product-specific weaknesses, and organizational shortcomings:

- (i) **PRG Coverage is too Narrowly Defined.** Under the 1995 policy, the PRG is explicitly but, narrowly focused on breach of contract coverage and currency inconvertibility for BOT and BOO projects.<sup>20</sup> This covers only a small segment of the overall PRI market and artificially reduces the number of potential projects to which a PRG can be applied. For example, of the 40 PSO projects approved between 1995 and 1999 by ADB's Board, only 8 were BOT or BOO infrastructure projects. Since the Asian financial crisis started in 1997, the number of BOT/BOO projects has dwindled dramatically, reducing the number of projects for which a PRG can be considered.
- (ii) **Prudential Limit is too Low.** The PSO prudential limit (currently \$50 million per project or 25 percent of project cost, whichever is less) is applied to PRGs without a government counterguarantee. The market perceives the PSO limit to be too low to be effective for large-scale, capital-intensive projects in the region. If a choice is given to borrowers within this limit, they will always prefer to receive ADB assistance in the form of a direct loan, as opposed to a more time-consuming PRG-supported loan funded by commercial banks.

<sup>16</sup> Valuation of PRGs for accounting purposes may differ from those which apply for capital backing purposes.

<sup>17</sup> Disputes are likely when the cause of the default under the PRG-supported loan (i.e., a commercial or a political event) is unclear.

<sup>18</sup> Cover of interest which accrues during an arbitration period will not be a standard feature of ADB PRGs.

<sup>19</sup> ADB is scheduled to review the application of Article 12.1 of the Charter (lending and guarantee limit). The review will include a discussion and a proposal on the appropriate capital backing for guarantees, including PRGs, as opposed to loans. Accordingly, the current applicable capital backing provisions are to be considered provisional in nature.

<sup>20</sup> While placing emphasis on breach of contract and currency inconvertibility cover in relation to BOT/BOO type projects, the 1995 review allows the cover of a broader range of political risks and it does not limit the use of PRGs to infrastructure projects only.

- (iii) **Lack of a Coguarantee Program.** In addition to the low PSO limit applied to PRG operations, the potential leverage of ADB's PRG program is handicapped by the absence of a coguarantee program, similar to that of MIGA, and another cooperative program with public and private insurers. Under the coguarantee program, the ADB would be the guarantor of record. Under a cooperative program, the coinsurer would provide a guarantee parallel to that of ADB, in its own name. Such programs would allow ADB to expand coverage beyond the PSO limit by cooperating with other PRI institutions.
- (iv) **Difficulty in Securing Counterguarantees.** Demand for PRGs with a counterguarantee has been adversely affected by the limited willingness of DMC governments to provide such counterguarantees. The DMCs frequently view counterguarantees as running against the spirit of introducing private sector participation in infrastructure projects that aim to keep direct government obligations to a minimum. In addition, such counterguarantees are often included as foreign debt under International Monetary Fund programs, rather than as contingent liabilities. This reduces incentives to provide such guarantees. DMC governments are also averse to potential legal disputes if there are ambiguities about whether the PRG may be called.
- (v) **Lack of a Targeted Communication Strategy.** There has been no sustained marketing effort of PRGs by ADB. In addition, the market has been somewhat confused about differences between PCGs and PRGs, due to the similar names of the two instruments.
- (vi) **Lack of Organizational Focus.** Successful implementation of the PRG program requires cross-departmental cooperation within ADB. However, no interdepartmental working group has been established with a clear responsibility to implement and market the program.

#### **IV. RECOMMENDATION FOR CHANGES TO ADB's PRG PROGRAM**

45. Recommendations under the proposed review for Board consideration are as follows:

##### **A. Redefining the Coverage of the PRG Instrument**

46. The coverage of the PRG instrument must be made more explicit. Political risk events that may be covered by ADB's PRG instrument include one, several, or all of the following:

- (i) Expropriation (CEND),
- (ii) currency inconvertibility and/or nontransfer (CI),
- (iii) political violence, and
- (iv) breach of contract.

47. Making explicit the coverage of the four major areas of political risk will facilitate communication with the market and bring the instrument in line with established market practice by bilateral and multilateral organizations and the private sector. In addition, coverage of the PRG instrument should be expanded to go beyond BOT and BOO projects, as these have accounted for only a relatively small proportion of PSO.

## B. Defining the Fee Structure

48. Charges for PRGs without government counterguarantee will be determined by the Guarantee Committee in each case, on the basis of the principle of market-based pricing and the pricing guidelines stated below. Market-based pricing is substantially the same as the pricing principle applied to private sector loans, thus achieving private sector loan equivalency. The principle is derived from the concept that political risks are one of the two fundamental risk components of private sector loans without counterguarantee (the other component being commercial risks). Accordingly, the pricing of PRGs without counterguarantee will follow the same market-based procedures that apply to the pricing of the political risk component of private sector loans. This principle will also ensure that fees applied to PRGs will suffice to cover the risks taken by ADB under the guarantee, as well as ADB's administrative and processing costs.

49. A market-based fee structure for PRGs is proposed to make PRG pricing more transparent and consistent with market practice. This structure will have three parts: (i) a front-end fee, (ii) a standby fee, and (iii) a guarantee fee. These fees will be determined for each PRG by the Guarantee Committee.

50. **Front-End Fee.** Following the principle of loan equivalency, front-end fees are currently being applied to PCGs, with or without counterguarantee. The processing of PRGs—like that of loans and PCGs—will involve significant due diligence and other up-front costs, and thus a front-end fee will also be levied on PRGs with and without host government counterguarantees.

51. In line with pricing principles used for PCGs, ADB will charge a front-end fee calculated on the face value of the underlying debt instrument. For private sector PRGs,<sup>21</sup> the fee will be set at a market rate, which is currently at 100 basis points. For public sector PRGs,<sup>22</sup> the front-end fee will be set based on the ratio of the guarantee to the associated loan within a range of 10–90 basis points of the nominal guaranteed principal amount.<sup>23</sup> The front-end fee will be paid up front as a condition to the effectiveness of the PRG.

52. **Standby Fee.** In respect of the amounts for which ADB is committed under a PRG, but for which the underlying loan has not yet been disbursed, a standby fee will be charged on all PRGs.<sup>24</sup> This fee is in line with market practice and is intended to compensate ADB for the cost of capital that ADB may set aside to match the contingent risk pending disbursement of the underlying debt instrument. The Guarantee Committee will use a benchmark standby fee, to be set at 50 percent of the guarantee fee charged for the PRG, and will take into consideration any other standby or commitment fees payable by the borrower for the underlying debt instrument. The minimum standby fee is set at 20 basis points.<sup>25</sup> The standby-fee will be paid, in advance, on the interest payment dates specified in the underlying debt instrument and levied on undisbursed amounts of the underlying debt instrument.

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<sup>21</sup> Refers to PRGs which support BOT/BOO and other projects with private sector sponsors. Private sector PRGs may or may not benefit from a counterguarantee.

<sup>22</sup> Refers to PRGs where the underlying project or program is sponsored by the host government or an executing agency. Such PRGs always require a counterguarantee of the host government.

<sup>23</sup> For example, for a PRG with a guarantee to associated ADB loan ratio of 1 and above (where the guarantee is greater than the associated loan), the front-end fee will be at a maximum of 90 basis points, and for a PRG with a guarantee to loan ratio between 0.1 and 1.0, the front-end fee will be on a pro-rata basis within 10-90 basis points.

<sup>24</sup> To conform with the principles stated in the paper, R-88-00: *Partial Credit Guarantee Charges*, 22 March, PRGs with a counterguarantee will have the standby fee built into the guarantee fee.

<sup>25</sup> The minimum standby fee is equal to half the minimum guarantee fee, currently set at 40 basis points.

53. **Guarantee Fee.** The Guarantee Fee for PRGs without counterguarantee will be set by the Guarantee Committee on the basis of a minimum guarantee fee—presently set at 40 basis points—,<sup>26</sup> and following procedures similar to those used for the pricing of private sector loans. In the actual setting of the guarantee fee, the Guarantee Committee will take into consideration:

- (i) the types and extent of political risk coverage offered under the PRG;
- (ii) risk of potential loss and recovery expectation;
- (iii) availability and pricing of the same or similar types of political risk cover in the same or comparable sectors, markets, and countries; and
- (iv) the likely market spread on the underlying loan if there were no PRG.

54. For PRGs with host government counterguarantee the guarantee fee is set currently at 40 basis points (footnote 25) and the borrower will compensate the host government for the counterguarantee directly.<sup>27</sup>

55. Guarantee fees will be levied on the face value of the guaranteed loan outstanding, plus the interest that will accrue on that amount during the succeeding interest period. However, should a payment default under the guaranteed loan lead to a dispute or arbitration and the interest payments during the arbitration period are covered under the PRG, the guarantee fee will also be levied on the cumulative interest accrued during the arbitration period. For private sector PRGs, the guarantee fee will be paid, in advance, on the interest payment dates of the underlying debt instrument. To conform with the fee payment terms for PCGs, guarantee fees for public sector PRGs may be paid, periodically, in arrears or in advance, as the case may require.<sup>28</sup> A table summarizing the principles used in setting guarantee charges for PRGs is provided in Appendix 3.

56. Fees for private sector PRGs will need to be comparable to market premium rates charged by public and private sector PRI providers. Regular dialogue will be held with private and public PRI providers to assess current premium levels, fee structures, and payment terms.<sup>29</sup> A review of the fee structures and indicative PRI charges of MIGA, bilateral insurance agencies, and private insurers is provided in Appendix 2.

### C. Covering Interest

57. Under the existing policy, PRGs may cover part or all of the debt service.<sup>30</sup> The text of the 1995 review, however, appears to indicate a preference for covering principal and base interest only (i.e., excluding the credit spread). Prevailing market practice in the PRI industry is to cover the full interest rate that applies to a guaranteed loan (i.e., base interest plus the credit

<sup>26</sup> The proposed fee mirrors the guarantee fee for PCGs with counterguarantee which was arrived at based on the loan equivalency principle. Subject to changes in OCR loan charges and administrative expenses, the guarantee fee will change accordingly.

<sup>27</sup> ADB will advise the host government on the appropriate market rate it should charge for the counterguarantee.

<sup>28</sup> Different payment terms may be determined by the Guarantee Committee to accommodate the particular needs of a project.

<sup>29</sup> For each PRG, the Guarantee Committee will review the prevailing market terms for PRI at that time and reflect its findings in the terms of the PRG under consideration.

<sup>30</sup> R81-95: *Review of the ADB's Guarantee Operations*, 4 April, paragraph 68(vii).

spread).<sup>31</sup> It is therefore recommended that ADB continue to have the option to cover both base interest and credit spread of the underlying guaranteed loan.

58. However, in situations where the loan default is due to a political risk event and the default is permanent in nature, and ADB has not exercised its buyout option (para. 31) under the guarantee, the PRG will only cover principal and base interest.<sup>32</sup>

#### D. Introducing a PRG Prudential Limit

59. A separate prudential limit is recommended for PRGs without a counterguarantee (the PRG limit). Treating PRGs in the same way as loans and equity investments does not account for the different risk characteristics of the instruments. PRGs cover only certain well-defined political risks, while a direct loan faces default risk stemming from political as well as commercial events. Thus, by definition, the likelihood of a PRG being called is lower than that of a loan going into default.

60. The PRG limit is proposed to be twice the PSO limit.<sup>33</sup> This approach is similar to that taken by IADB (para. 20). The very limited loss history of MIGA and OPIC's high recovery rates illustrates that a bilateral or multilateral organization has significant leverage in the area of PRI.

#### E. Introducing a Coguarantee Program and a Collaboration Program

61. Once ADB has gained some actual experience with the PRG program, and possesses the necessary skill base, it is proposed that ADB establish a coguarantee program (CP), similar to MIGA's CUP program. Close cooperation with MIGA is proposed to share their experience with the CUP program. The terms of the proposed CP would be as follows:

- (i) **Guaranteed Amount.** Under the CP, ADB will issue a contract of guarantee for the entire amount of coverage requested by the applicant. However, ADB will retain only a portion of exposure under the contract for its own account. The remaining guarantee capacity will be underwritten by a private insurer or insurers.
- (ii) **Contract.** Only one guarantee contract will be issued to the insured for the entire amount underwritten under the CP. ADB will be the guarantor-of-record for both the insured and the host government for the entire amount insured, but ADB will assume liability and pay claims only for the portion retained for its own account.

<sup>31</sup>Typically, interest rates are the sum of a base or risk free rate (generally equal to the London interbank offered rate, or LIBOR) and a credit spread or margin that compensates the lender for the project-specific risks assumed under the loan.

<sup>32</sup>The project-specific PRG instrument would define the circumstances that would constitute a permanent default. As an example, for BOO/BOT type projects, termination of the project documents by the project developer following a political event would be deemed as a permanent default under ADB's guarantee. The reduction in spread cover following a permanent political event is justified on the basis that from the date of termination of the project, the guaranteed lender is no longer subject to any commercial risk, and only takes ADB's credit risk, for which base interest is an appropriate level of remuneration.

<sup>33</sup>If this proposal is accepted, total ADB assistance (whether in the form of loans, equity investments, PCGs, or PRGs) should not exceed \$100 million or 50 percent of project costs, whichever is less, with loan and equity investments continuing to be guided by the PSO Limit. The PSO W-Paper (*Private Sector Operations Strategic Directions and Review*, para. 70) has proposed an increase in the PSO single project exposure limit to \$75 million. If this increase is approved, total ADB assistance (whether in the form of loans, equity investments, PCGs, or PRGs) should not exceed \$150 million or 50 percent of project costs, whichever is less, with loan and equity investments continuing to be guided by the PSO limit.

Recoveries, if any, will be shared between ADB and the coguarantor on a pro rata basis.

- (iii) **Fees.** To cover the administrative expenses incurred to structure each CP project and to compensate ADB for “fronting” the coguarantor under the guarantee, ADB will charge the coguarantor an administration fee, by retaining a percentage of the guarantee fee the coguarantor is entitled to under the coguarantee facility.<sup>34</sup> The administration fee will be determined by the Guarantee Committee on a case-by-case basis.<sup>35</sup>

62. The proposed CP would have the following advantages:

- (i) **Increasing Availability of PRI Cover for the Host Country.** The host country would benefit from the increased amount of insurance capacity made available, facilitating projects that, without a sufficient amount of PRI capacity, might not go forward. The host government can also take comfort in having a multilateral institution such as ADB involved in the project, knowing that ADB will apply its standard project processing criteria, including an assessment of the project's environmental and developmental impact on the country.
- (ii) **Expanding Capacity for the Insured.** The insured benefits from the increased guarantee capacity available to cover investments in the DMCs, and enjoys the comfort of an ADB guarantee.
- (iii) **Opening Doors of Cooperation with Private Insurers.** Private insurers are able to offer coverage in countries where or for projects that they might not be able or willing to handle on their own. Having ADB as the guarantor-of-record is perceived as a risk-mitigating factor. They will benefit from ADB's lending expertise in the country, including ADB's project and risk analysis.
- (iv) **Risk Reduction for ADB.** The CP will allow ADB to reduce its underwriting risks by coinsuring with other PRI institutions, as ADB will not be liable for pay-outs by other participants under the CP umbrella.

63. It is also recommended that ADB develop a collaboration program to enable private and public insurers to offer guarantees with ADB, under their respective names. This would be most beneficial to insurers that do not need the benefits of ADB's “umbrella.” In some cases, private insurers may offer guarantees at terms that cannot be easily reconciled under the coguarantee program. In such circumstances, they may find the collaboration program a more effective tool than the CP.

## F. Improving the Product Name

64. It is proposed that the product be renamed from partial risk guarantee to “political risk guarantee”. “Political risk guarantee” is the technical term widely used and understood by the market. It captures the nature of the product more precisely and, therefore, facilitates

<sup>34</sup> As for PRGs outside the CP, ADB will charge the guarantee fee for coguarantee facilities directly to the borrower. Should the borrower default on guarantee fee payments, the guaranteed lenders will have the option to pay the guarantee fee directly to ADB to ensure continuation of coverage under the coguarantee facility.

<sup>35</sup> The focus group (para. 66) may consider setting a benchmark and or a minimum fee to guide the Guarantee Committee in determining the administration fee for a specific project.

communication with the market and potential users of the product. It also has the advantage of avoiding confusion with the partial credit guarantee. IADB recently introduced a similar change in product names and MIGA has always used the term “political risk guarantees” in its operations.

### **G. Improving Communications with the Market and Potential Users**

65. The advantages of using the PRG need to be communicated more effectively to the market and the potential users of the product. For example, the benefits stemming from reduced provisioning, credit enhancement, and reduced likelihood of loss through participation with ADB (as the region’s multilateral financial institution) need to be made apparent in ADB’s communications with the market.

66. Perhaps, most importantly, users need to know that the PRG is designed to fill “gaps” in the market not easily satisfied by the private sector, and be used in collaboration with other public and private PRI providers. The audience for such a targeted communications initiative includes equity investors, project sponsors, commercial banks based in both developed and developing member countries, export credit agencies, MIGA, and private insurers that could coguarantee with ADB.

### **H. Creating a PRG Focus Group**

67. A focus group has been formed to relaunch the PRG program along the lines recommended in this paper. This group is chaired by the Private Sector Group, and includes representatives from the Office of Cofinancing Operations, the Treasurer’s Department, the Office of the General Counsel, the Strategy and Policy Department, and from the projects and programs departments, in order to mainstream PRGs across ADB. A PRI expert was retained to advise ADB on various PRG issues and to provide access to the latest knowledge in this area.<sup>36</sup> Specifically, it is recommended that the PRG focus group take responsibility for

- (i) initiating PRG pilot projects and developing close cooperation with MIGA, ECAs, and other experienced PRI institutions from the public and private sector, as they have significant institutional experience in underwriting, risk analysis, documentation, and pricing;
- (ii) finding innovative ways to collaborate with existing PRI providers, both public and private, to expand the availability of cost-effective PRI coverage for the more challenging projects in the region which PRI providers might otherwise avoid or overprice;
- (iii) preparing operational guidelines for the PRG program, which will also show how the program compares and contrasts with the PCG and other credit enhancement products of ADB;
- (iv) providing additional inputs for the Guarantee Committee to assist with pricing of guarantees;
- (v) drafting standardized contracts, underwriting criteria, and provisioning policies; and

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<sup>36</sup> The focus group will tap external sources of PRG expertise when deemed appropriate.

- (vi) developing a targeted communication strategy and training program for use within ADB and with the outside market.

## **I. The Use of ADB's Financing Instruments and Staff Implications**

68. When considering assistance to a private sector project, ADB has often a choice between (i) lending a large sum directly to the project or (ii) reducing its loan and providing a PRG to support third-party lending. From ADB's perspective, supporting a project by means of a PRG is advantageous, as it would cover only political risks, while leaving commercial risks to the private sector lenders, which are better positioned to assess and absorb such risks. ADB, as a multilateral institution, is well equipped to assess and mitigate the political risks in its DMCs, but may have no comparative advantage in absorbing commercial risks that should properly be left to the private sector. Thus, in the first instance, it is recommended that ADB seek to provide enhancement, via its guarantee instruments, in preference to direct lending of large sums, whenever practical and advantageous to ADB.

69. In future, ADB will assess whether a PRG could be deployed to attract commercial funding. If a funding gap remains, ADB could then provide direct lending. This strategy will increase the use of the PRG product and enable ADB to focus its private sector assistance in areas where its comparative advantage lies—the assessment of country and political risks—while leaving commercial risks to the private sector.

70. ADB has two specialized staff positions in OCO, one in export credit financing and one (a new position provided in the 2000 budget) exclusively for guarantee operations. As the ADB pipeline of PRG-related interventions builds over the medium term, ADB's competencies in handling political risk related activities will need to be strengthened. In the meantime, current staff in this area will need to be supplemented through the flexible use of staff consultants services to provide immediate support to the focus group and help develop a comprehensive implementation program for PRG activities, thereby strengthening the organizational capacity to implement and market the PRG program.

71. As ADB builds a PRG portfolio, supervision and monitoring of ADB's guarantee operations will be needed. Monitoring and risk management of PRGs will be carried out by the concerned division. Since most PRGs will be private sector instruments, even with counterindemnities from the host government, this will mean that PSG will have a prime responsibility for PRGs. ADB-wide oversight will be provided by the existing Guarantee Committee and the new focus group.

## J. Summary of Proposed Changes to the PRG

72. Table 2 summarizes the proposed key changes to the PRG instrument.

**Table 2: Overview of Proposed Changes of the PRG**

Item	Current Policy	Proposed Policy
Coverage Scope	Coverage focuses on breach of contract and currency inconvertibility for BOT/BOO projects	Coverage is made more explicit to include expropriation and political violence. Sector coverage extended beyond BOT/BOO projects
PRG Prudential Limit	Same as PSO limit	Introduce a new separate PRG limit of twice the PSO limit
Coguarantee Program and Collaboration Program	Not mentioned	Introduce a coguarantee program and a collaboration program
Coverage Terms	Mainly principal and base interest. Cover of credit spread allowed but not encouraged	Up to full interest cover
Fees	Market-based guarantee fees	Introduce clearly defined market-based fee structure and pricing guidelines
Product Name	Partial risk guarantee	Political risk guarantee
Communications	Product not widely communicated	Develop targeted communication program
Creation of a Focus Group	Does not exist	Create a focus group

## V. POTENTIAL BENEFITS OF THE PROPOSED PRG PROGRAM

73. ADB should offer an effective and well-structured political risk guarantee product and be actively involved in this market for many reasons.

- (i) **Support for Poverty Reduction.** The PRG can contribute to economic and social development by helping catalyze long-term foreign investment in the DMCs. Promoting capital flows and long-term investment by foreign investors contributes to technology transfer, economic development, and expansion of growth in the industry and services sectors. These are necessary conditions (albeit not sufficient—direct poverty alleviation measures are also required) to

create employment, improve social living standards, and thus reduce the incidence of poverty in the DMCs. The poorest DMCs often have the highest perceived political risks. The PRG can be an ADB additional product to foster investment, growth, and poverty alleviation.

- (ii) **Promotion of Long-Term Investments in DMCs.** Foreign direct investment often involves long-term contracts between the project sponsor and a government-owned entity, e.g., in infrastructure projects. However, while foreign investors are often prepared to take certain commercial risks, they are not prepared to enter into long-term commitments in countries with significant perceived political uncertainty. Thus, a PRG is often perceived as a critical ingredient in a long-term investment decision.<sup>37</sup>
- (iii) **Contribution to Meeting Increased Demand for PRI.** Demand for PRI has expanded dramatically over the past decade. The Berne Union, the umbrella organization of PRI insurers, has reported more than a sixfold increase in annual PRI coverage (from \$2 billion in 1989 to \$15 billion in 1997). With the onset of the Asian financial crisis, demand in Asia has risen as private investors perceive that political uncertainties have increased. Thus, ADB's PRG product would be offered into an expanding market.
- (iv) **Have a Catalytic Role.** As the only regional multilateral development bank in Asia, ADB is uniquely qualified to catalyze foreign investment and capital flows to its DMCs, as stipulated under its Charter. As ADB is closely involved with the DMCs and has a stable long-term lending and advisory relationship with their governments, it is able to assess and mitigate political risks. ADB is perceived as an honest broker by governments and foreign investors, and is able to act as an intermediary between host governments and foreign investors and thereby maximize values to all parties.<sup>38</sup>
- (v) **Provide a Unique Product.** ADB has a potentially unique role to play in the PRI market. Unlike the bilateral agencies, ADB's assistance is not linked to the nationality and domicile of the foreign investor, as long as such investors come from ADB member countries. Compared with private sector PRI operators, ADB has the advantage of decades-long involvement with its DMCs; a close working relationship with their governments, not least through the DMCs' shareholding in ADB; and thus a reinforced ability to provide effective intermediation and assistance in cases of dispute. ADB's PRG product also differs from that of MIGA in that it focuses on backing long-term commercial debt financing, while MIGA is unable to insure debt unless it concurrently insures equity. In addition, MIGA has focused its underwriting activities on areas outside the Asian and Pacific Region.<sup>39</sup> ADB is, therefore, the only multilateral institution that focuses PRG instruments exclusively for the Asian and Pacific Region and, therefore, has a substantial potential comparative advantage compared to MIGA due to its significant presence and operations in the region.

<sup>37</sup> In a survey by MIGA, for example, a majority of its clients observed that PRI coverage was "absolutely critical" in their decision to proceed with the proposed investment.

<sup>38</sup> MIGA reports that it has acted as an honest broker between governments and private investors in several preclaim situations.

<sup>39</sup> As of 30 June 2000, 86 percent of MIGA's portfolio was outside the Asian and Pacific Region, with almost 51 percent concentrated in the Latin America and the Caribbean.

**VI. CONCLUSION**

74. It is proposed that the Board approve the modifications to the partial risk guarantee instrument as described in paragraphs 46 to 71 of this paper.

**APPENDIXES**

<b>Number</b>	<b>Title</b>	<b>Page</b>	<b>Cited on (page, para.)</b>
1	The Multilateral Investment Guarantee Agency	21	4, 19
2	Pricing of Political Risk Insurance	24	6, 24
3	Summary of Proposed PRG and PCG Fees	30	12, 55

## THE MULTILATERAL INVESTMENT GUARANTEE AGENCY

1. The Multilateral Investment Guarantee Agency (MIGA) was established in 1988, as part of the World Bank Group.<sup>1</sup> At that time, several national agencies and private insurers were already providing political risk coverage to international investors. However, the varying eligibility criteria of national agencies excluded certain investors, countries, or projects from consideration. Private insurers were constrained in the terms and extent of coverage that they offered.

### A. Rationale for Establishing MIGA

2. The MIGA Convention designed a guarantee program to complement rather than compete with national and regional investment insurance programs and private insurers of political risk. MIGA was to fill the niches, or gaps, in the market caused by the differing eligibility requirements of the other programs. In particular, MIGA could insure investments in countries that were ineligible for coverage by other programs, or in projects for which ownership, residence, or sources of procurement made the investor ineligible.

3. There was also a broader rationale for the creation of MIGA. Its shareholders comprised both industrial and developing countries, and MIGA would be uniquely placed to serve as an honest broker, guiding all concerned parties toward a common definition of fairness and equitable treatment. This neutrality would help avert disputes from arising altogether, or provide a channel for impartial mediation and amicable settlement when they did arise.

4. This position of honest broker was enhanced by the MIGA Convention requirement that MIGA must obtain the consent of a host government prior to issuing an investment guarantee. Thus, beyond providing financial compensation to investors for actual losses, MIGA's involvement in a proposed project was meant to mitigate the likelihood that such losses would occur.

5. Finally, supported by its own membership of developed and developing countries, and by virtue of its own status as a member of the World Bank Group, MIGA was designed to be particularly effective in recovering the greatest amount possible in a loss situation. Altogether, MIGA was meant to have a deterrent effect, which would be particularly valuable to investors in projects acutely vulnerable to changes in host government policies and commitments.

### B. Structure of Coverage

6. From the beginning, MIGA's guarantee program has provided extended protection (up to 20 years) against losses arising from transfer restrictions, expropriation, war and civil disturbance, and breach of contract.

7. Eligible projects include new investments, and the expansion, modernization, privatization, or financial restructuring of existing investments in a developing member country (DMC). Eligible forms of investments include equity, shareholder loans, loan guarantees issued by equity investors, and loans to unrelated borrowers (under certain circumstances). Technical assistance, management, and franchising and licensing agreements also are eligible, providing they have terms of at least three years and the investor's remuneration is tied to the project's operating results.

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<sup>1</sup> World Bank. 1999 *MIGA – The First Ten Years*, Washington, D.C.

8. Eligible investors should be nationals of a member country other than the country in which the investment is to be made. A corporation is eligible if it is either incorporated in and has its principal place of business in a member country, or if it is majority owned by nationals of member countries. State-owned corporations are eligible if they operate on a commercial basis.

### **C. MIGA's Development**

9. The early years laid the foundations for MIGA's takeoff in the midst of a major surge in global foreign direct investment (FDI) flows. In its first five years, country membership reached 107. Twenty-one guarantee contracts were written in 8 host countries in 1992, with \$313 million of coverage supporting \$600 million in investment. In the following year, 27 guarantee contracts were written in 14 host countries, with \$374 million of coverage supporting \$1.8 billion in investment.

10. During the following two years, MIGA grew to rank among the five largest investment risk insurers in the world, with over \$1.6 billion in outstanding contingent liabilities. In fiscal year 1996,<sup>2</sup> the total number of member countries climbed to 134. Sixty-eight guarantee contracts covering \$862 million of new contingent liabilities were issued, bringing the cumulative number of guarantee contracts issued to 223 and outstanding contingent liabilities to about \$2.2 billion. The amount of FDI facilitated totaled about \$14 billion.

11. In fiscal year 1999, the number of member countries reached 149. MIGA issued 72 new guarantee contracts for \$1,310 million in coverage and had about \$3.7 billion in outstanding contingent liabilities. Between fiscal years 1990 and 1999, MIGA issued 420 guarantee contracts for \$5.5 billion in total coverage, facilitating an estimated \$30 billion in FDI.

12. To assess MIGA's role in stimulating FDI activity around the world, MIGA conducted a confidential and anonymous survey of all current guarantee holders in 1994 and 1996. Seventy-three percent of all MIGA clients responded. A majority of the respondents in both surveys considered MIGA coverage to have been "absolutely critical" in their decision to proceed with their planned investment. Almost all reported a desire to use MIGA insurance again.

13. Some of the indicators of the direct development impact of MIGA-guaranteed projects include the flow of capital, amount of output produced, number of jobs created, and the exports and taxes generated. Between years 1990 and 1998, MIGA-supported projects directly created an estimated 46,800 new jobs.

14. A source of persistent concern has been that FDI tends to flow only to a relatively small number of developing countries. In 1997, for example, 10 developing countries accounted for some 72 percent of all FDI flows (Table A1). The People's Republic of China alone received about \$37 billion or 30 percent of the total.

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<sup>2</sup> MIGA's fiscal year ends on 30 June.

**Table A1: FDI Flows to the Top Ten Recipient Developing Countries**  
(\$ billions)

Country	1991	Country	1994	Country	1997
Mexico	4.7	PRC	33.8	PRC	37.0
PRC	4.3	Mexico	11.0	Brazil	15.8
Malaysia	4.0	Malaysia	4.3	Mexico	8.1
Argentina	2.4	Peru	3.1	Indonesia	5.8
Thailand	2.0	Brazil	3.1	Poland	4.5
Venezuela	1.9	Argentina	3.1	Malaysia	4.1
Indonesia	1.5	Indonesia	2.1	Argentina	3.8
Hungary	1.5	Nigeria	1.9	Chile	3.5
Brazil	1.1	Poland	1.9	India	3.1
Turkey	0.8	Chile	1.9	Venezuela	2.9
Top 10 share in FDI to all developing countries (%)	74.2		76.1		72.3

PRC=People's Republic of China, FDI=foreign direct investment.

Source: World Bank.

15. However, since its inception, MIGA has deliberately allocated its scarce guarantee resources in a manner that was contrary to the conventional follow-the-herd phenomenon among international investors. In fiscal year 1998, MIGA guarantees outstanding in the 10 largest recipients still amounted to only 27 percent of all guarantees.

16. Overall, MIGA's portfolio is well diversified by country. By the end of fiscal year 1998, MIGA had guarantees outstanding for projects in 52 DMCs. In all, MIGA has facilitated FDI into 62 DMCs. Of particular note, 28 percent of MIGA's portfolio consists of projects in the poorest countries, countries that are eligible for concessional lending by the International Development Association. Since it began operating, MIGA has issued about \$1 billion in coverage for investments in 26 of these countries, and has paid only one claim in 2000 in relation to an expropriation event relating to a power project in Indonesia.<sup>3</sup>

<sup>3</sup> The expropriation claim was received in March 1999 and MIGA paid the claim in the summer of 2000. MIGA's gross liability under the contract is \$15 million, of which \$10.5 million is reinsured.

## PRICING OF POLITICAL RISK INSURANCE

1. This appendix provides a brief overview of indicative premium rates and fees currently seen in the market for political risk insurance (PRI) cover from public and private sector institutions. While the actual fees charged depend on a number of factors, including (i) the risks covered, (ii) complexity of the transaction, and (iii) market conditions at the time the cover is offered, these rates would be used by the Guarantee Committee as reference points when setting partial risk guarantee fees in the current environment.

### A. Multilateral Investment Guarantee Agency (MIGA)

2. MIGA charges an application fee for definitive applications for guarantee. The fee is \$5,000 for guarantees up to \$25 million, and \$10,000 for guarantees over \$25 million in the manufacturing and services sectors, and \$10,000 for guarantees in the infrastructure, oil and gas, and natural resources sectors. There is no charge for filing a preliminary application.

3. The application fee is reimbursed under the following two conditions: (i) if an application is made, and a guarantee is offered and accepted, the fee will be credited against the first year premium; and (ii) if MIGA declines to offer coverage, the fee will be refunded.

4. MIGA also imposes a processing fee for the extra costs it incurs when considering projects that are environmentally sensitive (e.g., infrastructure projects) or that have a complex financial structure. The initial processing fee is \$25,000. The unused portion of this fee is reimbursed if actual expenses are less than this amount.

5. A commitment fee is charged if the applicant is not prepared to purchase the coverage when offered. The commitment letter issued by MIGA allows the applicant to reserve capacity. Commitments are valid for three months. Commitment fees range from 0.25 to 0.50 percent of the coverage offered.

6. Guarantee (or premium) fees charged by MIGA are now market-related and reflect a variety of factors including risks taken, complexity of the transaction, and pricing of other similar transactions. In the past, however, MIGA published so-called base rates to establish a benchmark for the pricing of its guarantee fees. These base rates are shown in Table A3.1. While these base rates were merely indicative and could be adjusted for each specific transaction to preserve maximum flexibility in the pricing of its guarantees, MIGA recently stopped publishing these base rates.

7. MIGA also charges a standby fee for the undisbursed amount of the approved guarantee. These standby fees are typically half the guarantee fee.

**Table A3.1: MIGA's Base Guarantee Fees**  
(percent per annum)

<b>Guarantee Cover</b>	<b>Manufacturing</b>	<b>Natural Resources</b>	<b>Infrastructure</b>
Expropriation	0.60	0.90	1.25
FX Transfer & Inconvertibility	0.50	0.50	0.50
Political Violence	0.55	0.55	0.60
Breach of Contract	0.80	1.00	1.25

FX=foreign exchange.

Source: MIGA.

## B. Bilateral PRI Providers

8. The Organization for Economic Cooperation and Development (OECD) recently established minimum premium benchmarks for officially supported export credits, which attempts to group countries with similar sovereign risk into seven categories and assign a minimum premium benchmark to each group. While these minimum premium benchmarks technically do not apply to PRI, increasingly they are being seen as a benchmark for PRI premia by some export credit agencies.

9. Nevertheless, there is no single approach to PRI pricing among export credit agencies. Some strictly follow market-pricing principles, while others apply preapproved premia more or less independently of the risks covered under the PRI. The indicative premium base rates currently used by Overseas Private Investment Corporation (OPIC), one of the largest and oldest providers of PRI, are provided in Table A3.2 below.

**Table A3.2: OPIC's Base Fees**  
(percent per annum)

<b>Guarantee Cover</b>	<b>Guarantee Fee</b>	<b>Standby Fee</b>
Inconvertibility	0.45	0.20
Expropriation	0.40-0.90	0.20
Political Violence	0.40-0.70	0.20
Breach of Contract <sup>1</sup>	n.a.	n.a.

Source: OPIC.

## C. Private Sector PRI

10. In the private sector, PRI premium rates are a function of supply and demand, and rates for a country are dependent on the supply of insurance capacity for that country. Thus, actual premium rates can vary by a factor of two to three, depending on political events and country risk assessment. During times of political crises in a country, PRI may become totally unavailable or be available only at prohibitively high rates.

11. The actual rating process of a transaction is somewhat arbitrary. Few PRI underwriters are inclined to refer to base rates or a rating book when they underwrite a transaction. Thus, it is difficult to predict the actual premia that are to be paid, as the rating process is a highly subjective exercise. Table A3.3 indicates how private sector PRI providers typically price their guarantees. Table A3.4 summarizes fees and charges of major PRI providers.

<sup>1</sup> OPIC provides breach of contract insurance within its expropriation cover. This is achieved by way of guaranteeing the risk of non-enforcement of arbitration awards. For example, OPIC can provide termination payment cover under, say, a power generation build-own-transfer project. In this case, the beneficiary of the guarantee is assured timely payment of the termination payment should arbitration proceedings determine that the government has not complied with its payment obligations under the legal agreement.

**Table A3.3: Illustrative Private Sector PRI Premia**  
(percent per annum, as of May 2000)

<b>Guarantee Cover</b>	<b>Premium Range</b>
Expropriation	From 0.45 upwards
w/ Breach of Contract <sup>2</sup>	from 2.50 upwards
FX Inconvertibility	0.25-2.00
Political Violence	from 0.30 upwards

<sup>2</sup> Breach of contract is sometimes included in expropriation cover. When this cover includes breach of contract associated with a government or semigovernment entity acting, for example, as an input supplier (e.g., raw water or fuel) or as a distributor or user (e.g., power), the premium charged will be significantly higher than for simple expropriation cover, especially if the cover goes beyond politically motivated disputes to commercially motivated disputes.

**Table A3.4: Summary of Fee Structures and Charges of Major PRI Providers**

		Coverage	Fee Structure	PRI Fees	Maximum Cover and Term <sup>a</sup>
<b>A.</b>	<b>Multilateral Institutions<sup>b</sup></b>				
	<b>MIGA</b>	Equity and loans against losses arising from transfer restrictions, expropriation, political violence, and breach of contract	Market-based, comprising an application, processing, commitment, and guarantee fee	Currently, base premium rates set at 0.5-1.25 percent, per single cover	Up to 95% of loan principal, plus 135% of principal to cover interest. Up to \$110 million per project
		Cooperative Underwriting Program (CPU) for private PRI providers	A fee is charged under CPU		Up to 20 years
	<b>IADB</b>	Covers loans against losses arising from transfer restrictions, expropriation, political violence, and breach of contract	Market-based with an appraisal and a guarantee fee, but no front-end fee. Guarantee fees are often set at around half of the lending spread	Appraisal fee of \$50,000-\$300,000, guarantee fee of (currently) 150-250 basis points	Up to 100% of the loan principal and interest; limit set at 50% of project cost, or \$150m, whichever is less
	<b>Proposed ADB PRG without counter-guarantee</b>	Loans only against losses arising from transfer restrictions, expropriation, political violence, and breach of contract	Market-based, comprising a front-end, standby, and guarantee fee	Minimum guarantee fee set at 0.4%	Up to 100% of loan principal and interest; "stand-alone" PRGs not available; total ADB financial assistance to a guaranteed project (including the PRG) not to exceed twice the PSO limit
		Coguarantee Program (CP) for private PRI insurers	A fee is to be charged under CP		Up to 15 years

Note: Information in the table applies only to market-based PRI investment cover (i.e., not related to official trade), as of April/May 2000.

<sup>a</sup> For loans only.

<sup>b</sup> World Bank PRGs are offered only against a counterguarantee by the host government. Accordingly, World Bank's PRG charges are not set in accordance with market principles and are not comparable to those of other PRI providers. While the European Bank for Reconstruction and Development can, in principle, offer political risk guarantees, these are currently not a priority area in its operations. Therefore, no clear pricing policy exists.

**Table A3.4: Summary of Fee Structures and Charges of Major PRI Providers (contd.)**

	<b>Coverage</b>	<b>Fee Structure</b>	<b>PRI Fees</b>	<b>Maximum Cover and Term</b>
<b>B. Bilateral Institutions</b>				
<b>OPIC</b>	Equity and loans against losses arising from transfer restrictions, expropriation, and political violence. Breach of contract may be available under expropriation cover	Market-based, comprising retainer fee, a standby fee, and a guarantee fee	Currently, base premium rates range from 0.4 to 0.9%, per single cover	Up to 100% of loan principal and interest  Up to 20 years
<b>MITI</b>	Offers both debt and equity coverage against losses arising from transfer restrictions, expropriation, and political violence, as well as breach of contract	Fees are based on internally-determined pricing criteria, rather than market rates	Complete coverage against political risks for debt products can be secured for less than 1%	Up to 100% of principal and interest is covered for the agreed maximum liability
<b>ECGD</b>	Offers both debt and equity coverage against losses arising from transfer restrictions, expropriation, and political violence, as well as breach of government undertakings	Fees are based on country and project-specific considerations. Annual guarantee fees are complemented by an annual commitment fee	As an example, premium rates for the PRC are 0.7% for expropriation, political violence and transfer restrictions cover	Up to 90% of the insured amount. Term is up to 15 years

**Table A3.4: Summary of Fee Structures and Charges of Major PRI Providers (contd.)**

	<b>Coverage</b>	<b>Fee Structure</b>	<b>PRI Fees</b>	<b>Maximum Cover and Term</b>
<b>EFIC</b>	Equity and loans against losses arising from transfer restrictions, expropriation, and political violence. Breach of contract may be available under expropriation cover	Market-based pricing, including an “establishment fee” of 0.3-0.5% (de facto an up-front fee), a standby fee, and a market-based guarantee fee. Pricing is based on a classification of all countries into six risk categories	Minimum guarantee fees are 10-40 basis points for each type of coverage; they can reach 1.5% for high-risk countries	100% of loan principal and interest covered for an agreed period
<b>Others (including EDC, COFACE, NCM, SACE)</b>	Equity and loans against losses arising from transfer restrictions, expropriation, and political violence. Breach of contract not always available	No single approach to PRI pricing; some follow market pricing, others apply preapproved premia independently of cover offered	OECD’s minimum premium benchmarks for officially supported export credits increasingly used as benchmark for PRI premia	Maximum coverages set for individual countries or group of countries  Up to 20 years
<b>C. Private PRI Providers</b>				
<b>Lloyd’s of London, AIG</b>	Equity and loans against losses arising from transfer restrictions, expropriation, political violence, and breach of contract	Market-based, comprising an up-front fee, a standby fee, and a guarantee fee	Currently, minimum premium rates are set at 0.25 – 2.5%, per single cover  Fee levels can fluctuate significantly, depending on the level of demand and underwriting capacity	Lloyd’s can “pool” up to \$2 billion of PRI cover, per project  AIG’s single project exposure limit set at \$150 million  Generally, 3-5 years. Up to 15 years possible

## SUMMARY OF PROPOSED PRG FEES

Guarantee Charges	Public Sector PRG	Private Sector PRG without Counter guarantee	Private Sector PRG with Counter guarantee
<b>Front-End Fee</b>	10-90 basis points on the face value of the guaranteed loan depending on the guarantee to associated ADB loan ratio, paid up front.	Market-based rate, currently set at 100 basis points, levied on the face value of the guaranteed loan, paid up front.	Market-based rate, currently set at 100 basis points, levied on the face value of the guaranteed loan, paid up front.
<b>Standby Fee</b>	Built into the guarantee fee.	Market-based rate determined by the Guarantee Committee. Benchmark fee currently set at 50 percent of the guarantee fee, typically, paid on interest payment dates of the underlying debt instrument, in advance.	Built into the guarantee fee.
<b>Guarantee Fee</b>	40 basis points, levied on the face value of the guaranteed loan outstanding plus (i) the interest that will accrue in the succeeding interest period, and (ii) any other interest covered under the PRG which has fallen due and has remained unpaid; payable in arrears or in advance, on the interest payment dates of the underlying debt instrument. A counter guarantee fee, if justified, will be paid directly by the beneficiary of the guarantee to the host government.	Market-based rate determined by the Guarantee Committee. Guarantee fees will be levied on the face value of the guaranteed loan outstanding plus (i) the interest that will accrue in the succeeding interest period, and (ii) any other interest covered under the PRG and has fallen due and remained unpaid; payable in advance, on the interest payment dates of the underlying debt instrument.	40 basis points, levied on the face value of the guaranteed loan outstanding plus (i) the interest that will accrue in the succeeding interest period, and (ii) any other interest covered under the PRG which has fallen due and has remained unpaid; payable in advance, on the interest payment dates of the underlying debt instrument. A counter guarantee fee, if justified, will be paid directly by the borrower to the host government.
<b>Administration Fee (for Coguarantee Program only)</b>		Market-based rate determined by the Guarantee Committee. The administration fee will be charged by retaining a percentage of the guarantee fee the coguarantor is entitled to under the coguarantee facility.	Market-based rate determined by the Guarantee Committee. The administration fee will be charged by retaining a percentage of the guarantee fee the coguarantor is entitled to under the coguarantee facility.