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Guaranteeing the Goals: Adapting Public Sector Guarantees to Unlock Blended Financing for the U.N. Sustainable Development Goals

Chris Lee, Aron Betru, and Paul Horrocks

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EXECUTIVE SUMMARY

When the United Nations launched the Sustainable Development Goals (SDGs) in 2016, there were no illusions that traditional donor funds would suffice to meet the goals. It was always understood that both the private sector and developing countries themselves were required to be critical providers of funding to achieve the ambitious vision to end poverty, protect the planet, and engender prosperity for all. The estimated need of \$2.5 trillion over and above current resources means that public sector funds must not only supplement private capital, but also actively mobilize its participation. Mobilization refers to the ways specific mechanisms, such as guarantees and equivalent products, stimulate the allocation of additional financial resources, principally private capital, to particular development objectives.



Although the Business and Sustainable Development Commission has identified \$12 trillion in commercially viable market opportunities that are aligned to the SDGs, current financial regulations create disincentives for financial institutions to invest in those opportunities. After \$30 trillion of value was destroyed in public markets during the 2008 financial crisis, international regulatory bodies such as the Basel Committee rightly focused on ensuring stability in the financial system, and the resulting reforms have made the banking system safer. However, systematically discouraging lending to less stable markets, such as those principally represented by the SDGs, also deprives those markets of the capital needed to become more stable. Ultimately, while the SDGs seek to bring stability to developing markets, global financial regulations seek to ensure stability in established markets, and although these objectives should be reinforcing each other, they are actually diverging and creating challenges for filling the \$2.5 trillion annual SDG financing gap.

EXECUTIVE SUMMARY

The international development finance community invests approximately \$190 billion a year to overcome this divergence and attract commercial capital for SDG-aligned projects.¹ Providing grants and equity investments, subsidized loans, as well as guarantees and insurance products, these institutions must leverage their commitments by approximately 12 times in order to fill the SDG financing gap. Between 2012 and 2015, these institutions mobilized approximately \$81.1 billion of private capital, indicating that significant changes must be instituted in order to fill the gap.

¹ In 2016, donors deployed approximately \$158 billion of official development assistance (ODA), and development finance institutions committed approximately \$31 billion. In certain cases, DFI commitments result from ODA funding, therefore there may be some overlap between these two funding amounts.

In this paper, the Milken Institute Center for Financial Markets and the Organisation for Economic Co-operation and Development (OECD) partnered to study policy and regulatory issues that are impeding development finance tools, in particular key guarantees and relevant insurance products, from maximizing private capital mobilization. The OECD contributed survey data that illustrated that guarantees were the most effective leveraging instruments, achieving 45 percent of all private capital mobilization while representing only 5 percent of development finance commitments. The Milken Institute analyzed the guarantee and insurance products of institutions that represent more than 80 percent of the development guarantee market and found that approximately 50 percent of these agreements are not structured to maximize the mobilization of private capital.

Given the potential of guarantee and insurance products to help fill the SDG financing gap, it is important to address three broad issues in order to increase their use and effectiveness:

- 1** There are significant strategic and operational disincentives for development organizations to use guarantees and insurance as opposed to their other products.
- 2** Many guarantee and insurance products are incompatible with Basel financial regulations, including regulatory standards on risk weighting and liquidity.
- 3** Many guarantee and insurance products are incompatible with banking business models that focus on the origination and sale of loans to institutional investors.

EXECUTIVE SUMMARY

This assessment illustrates how the world's leading multilateral and bilateral guarantors fare in these three categories. Although overall the guarantees showed a range of misalignment, they fared best on compatibility with risk weighting standards, followed by claims processes, then liquidity, and lastly assignability. Fundamentally, guarantees and insurance products as a means to maximize private capital mobilization for development could be better utilized if best practices were adopted and incentives were aligned across development financiers, private investors and financial institutions, and developing country governments.

Based on our findings, we suggest a pragmatic set of short- and longer-term recommendations that can contribute to this alignment:

Short-Term Opportunities	Medium- to Long-Term Opportunities
Identify and implement best-practice standards	Promote enhanced regulatory treatment of blended financing tools
Promote the harmonization of the terms and conditions of cover across development institutions	Balance Rating Agency standard practices with Multilateral Development Bank missions
Develop a central guarantee fund capitalized by donor grants and development bank capital to accelerate scale and efficiency	Leverage data to realize impact
Create platforms for impact deal flow and transaction replication	

With smart design and implementation, guarantees and insurance products can be more powerful tools for mobilizing private capital and thus advancing the SDG agenda. Better alignment among the objectives and requirements of the private and the public/quasi-public parts of the global community is required to bring the world closer to realizing the SDGs.

While the scope of our analysis is on the banking sector, due to its role in the financial markets as both a source of investment as well as an intermediary of transactions for institutional investors, the regulatory constraints of other capital sources, such as Solvency II for insurance companies, or accounting regulations, such as International Financial Reporting Standards, were not included but are an important research endeavor that should be explored.

WHY GUARANTEES, WHY NOW

The G20, the Financial Stability Board and Basel Committee on Banking Supervision are all entrusted with the mission of ensuring that public policy promotes global financial stability. After the financial crisis of 2008, efforts were underway to ensure that capital flows transparently, effectively, and prudently. However, there needs to be a balance between global financial regulations that encourage less risky capital flow and the need for capital to flow into the places that require it the most. With stringent financial regulations, risk weightings, liquidity and capital ratio requirements, commercial banks are discouraged from financing growth in the very places that most need it. Perhaps the mass migration in the headlines today would have been less severe if populations in more developing countries had access to economic opportunity (i.e. robust infrastructure and a vibrant market for small and medium enterprises) in their home countries. While most developing countries are still harmonizing with Basel II recommendations on banking regulations, globally the push is toward Basel IV, the finalization of Basel III, which will bring additional challenges for private capital to participate in developing markets.

Fortunately, there is a path forward rooted in a vision of leveraging public and private donor commitments to catalyze private capital in blended financial engagements to achieve the SDGs. The ambitious SDG agenda of ending poverty, protecting the planet, and engendering prosperity for all by 2030 requires \$2.5 trillion in new investment annually, over and above current commitments. In 2016, donors deployed approximately \$158 billion of official development assistance (ODA), and development finance institutions committed approximately \$31 billion.² To raise the incremental \$2.5 trillion, these organizations must therefore leverage their commitments to mobilize private capital by approximately 12 times.³

² Recently released 2017 ODA figures: <http://www.oecd.org/development/launch-of-oda-figures-2017-france-april-2018.htm>.

³ <http://businesscommission.org/our-work/working-paper-the-state-of-blended-finance>.

The ambitious SDG agenda of ending poverty, protecting the planet, and engendering prosperity for all by 2030 requires \$2.5 trillion in new investment annually, over and above current commitments.

WHY GUARANTEES, WHY NOW

The development community employs various financing tools, ranging from grants and equity investments to loans, as well as guarantees and insurance products. Each of these can have an enormous impact; however, keeping in mind the 2030 SDG timeframe and the required private sector leverage, guarantees and insurance offer a particularly compelling opportunity. Guarantees and equivalent insurance products are credit enhancement tools that derisk SDG-aligned investments in order to incentivize private financing. Whether for a local bank that will not otherwise lend to an agriculture company that needs to buy heavy equipment, or bond investors that will not otherwise invest in an off-grid rural energy company, a third-party guarantee can meaningfully derisk investments and allow private sector financiers to provide funding for such projects. Guarantees provide immediate leverage by incentivizing private capital to increase the overall financing for needed projects, thereby accelerating and increasing impact. Furthermore, default rates on guarantee-backed transactions are quite low, indicating that in some cases perceived risk is greater than real risk and that the provision of guarantees can be a lower-cost means for the public sector to meet development objectives.

Therefore, maximizing both the frequency and effectiveness of guarantees and equivalent products is key to attracting the level of private capital needed to achieve the SDGs. This tactic aligns well with private investors' increasingly global search for yield and the growing economic momentum of developing markets. It also aligns with current policymakers' goal of maximizing private sector participation in development.

Unfortunately, there are some misalignments between the policies and requirements that govern guarantees and insurance products, and the regulatory and business requirements of the financial institutions that are the intended beneficiaries of such products. As a result, some guarantees are better aligned to the needs of the private sector than others. To bring private and public investment

Maximizing both the frequency and effectiveness of guarantees and equivalent products is key to attracting the level of private capital needed to achieve the SDGs.

WHY GUARANTEES, WHY NOW

together through guarantees and equivalent products, these products must bridge divergent policy and regulatory regimes. Critically, the post-crisis Basel financial regulatory framework steers financial institutions toward established credits and well-known risks, while development policy seeks private financing for riskier opportunities in order to drive investment and innovation in underbanked markets. Drawing on a detailed investigation of the core products of many of the largest development finance organizations, this document outlines the steps that the public sector, development finance community providers, and financial regulation policymakers can take to extract more value out of credit enhancement tools, better align with the business models and practices of private sector financial institutions and investors, and ultimately mobilize more capital to invest in sustainable development.

HOW GUARANTEES FIT IN THE BLENDED FINANCE MARKET

For bilateral and multilateral donors and development finance institutions (DFIs), getting maximum leverage for every taxpayer dollar is of paramount importance. Be it developed or developing nations, the ability to leverage public resources to mobilize complementary private sector funding is important to meeting universal public needs. With this in mind, guarantee and insurance products in particular enjoy certain advantages over direct funding solutions:

- Strategically, they reinforce the notion that developing markets represent a viable commercial opportunity because financing or investment is provided directly by the private sector, thereby pulling additional investment into such markets.
- Tactically, guarantees offer breadth and efficiency. The development community has a broad mission, and guarantees can be applied to myriad contexts—from serving as collateral for small businesses so that they qualify for commercial credit to backstopping large-scale infrastructure projects. They can be further tailored to take only specific risks in an otherwise bankable infrastructure project (such as construction period risk or the risk of breach on the concession needed for the project). Such products have particular development impact as they facilitate the mobilization of a large amount of financing by taking only a specific portion of the total risk involved.
- From an efficiency perspective, some bilateral donors transfer the face value of the exposure to their respective treasury departments and only set aside resources for expected losses, so guarantees and equivalent products are also a budget leveraging tool.

HOW GUARANTEES FIT IN THE BLENDED FINANCE MARKET

- For institutions that do not benefit from this budget leverage, guarantees and equivalent products still offer the opportunity for enhanced leverage of their operational and staffing resources because of the ability to shift much of the transaction structuring, arranging, and ongoing investment monitoring responsibilities to private sector partners.
- The scope of a guarantee can change over time in a way that reduces taxpayer exposure and thereby allows the private sector to shoulder an increasing amount of risk. This is akin to increasing the participation of private capital, thereby fulfilling the ultimate development goal.

⁴ The 2016 OECD Mobilization Survey: <http://www.oecd.org/dac/stats/mobilisation.htm>.

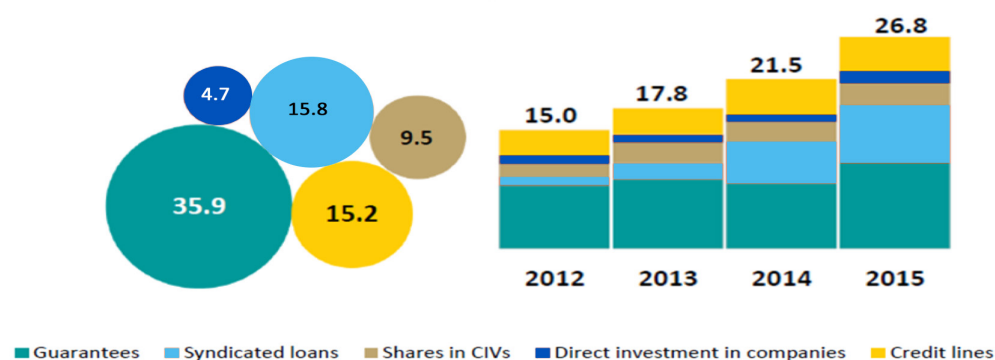
⁵ The OECD defines blended finance as *the strategic use of development finance for the mobilization of additional finance toward sustainable development in developing countries*.

⁶ The 2016 OECD Mobilization Survey: <http://www.oecd.org/dac/stats/mobilisation.htm>.

With the increasing importance of development finance in stimulating private sector participation in developing countries, the OECD carried out a survey⁴ to quantify the mobilization effect of blended finance instruments.⁵

The survey demonstrated that over a four-year period (2012-2015), \$81.1 billion was mobilized from the private sector by official development finance interventions. Guarantees and equivalent products stood out as the instruments that mobilized the most significant share, at \$35.9 billion or 44 percent of the total. In fact, having started from a relatively low base, such products are growing in use by the development finance community.

Figure 1. Type of Official Development Finance Interventions (2012-2015) Survey Results⁶



Key Takeaways:

Guarantees are clearly a blended finance instrument that the private sector likes to work with, despite the small amounts allocated and significant mobilization.

The most significant contributor to mobilization of the private sector over the period assessed were guarantees.

Guarantees made up more than double the next largest blended finance instruments, syndicated loans and credit lines.

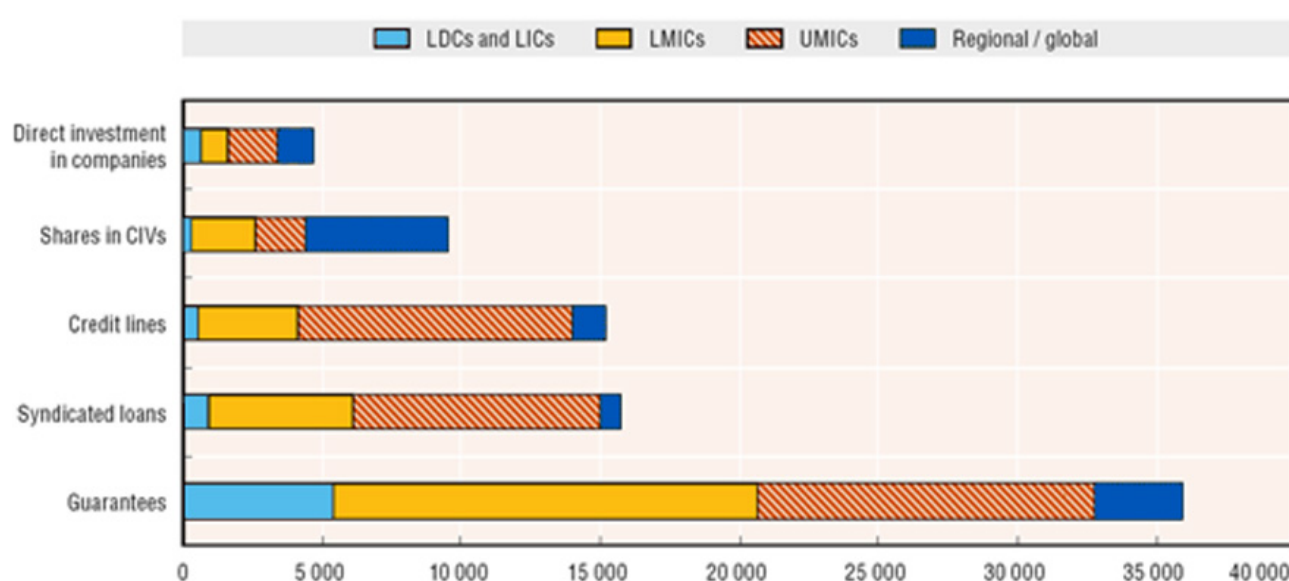
HOW GUARANTEES FIT IN THE BLENDED FINANCE MARKET

Out of the \$81.1 billion, the majority of the mobilization (77 percent) occurred in middle-income countries. Nevertheless, guarantees and equivalent products remained crucially important in terms of mobilizing private capital in Least Developed Countries (LDCs) and Lower Income Countries (LICs). Guarantees were the main leveraging instrument in Africa (62 percent of private finance mobilized to the region overall, or 73 percent to sub-Saharan Africa).

⁷ The 2016 OECD Mobilization Survey: <http://www.oecd.org/dac/stats/mobilisation.htm>.

⁸ OECD DAC Blended Finance Principles: <https://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/OECD-Blended-Finance-Principles.pdf>.

Figure 2. Private Finance Mobilized by Official Development Finance Instruments, by Income Group, USD Million, 2012-2015⁷



Key Takeaways:

Guarantees demonstrate an ability to mobilize private finance across income groups.

Guarantees were the most effective tool in mobilizing private capital in LDCs and LICs, which are critical to delivering the SDGs and where mobilization of private capital is critical.

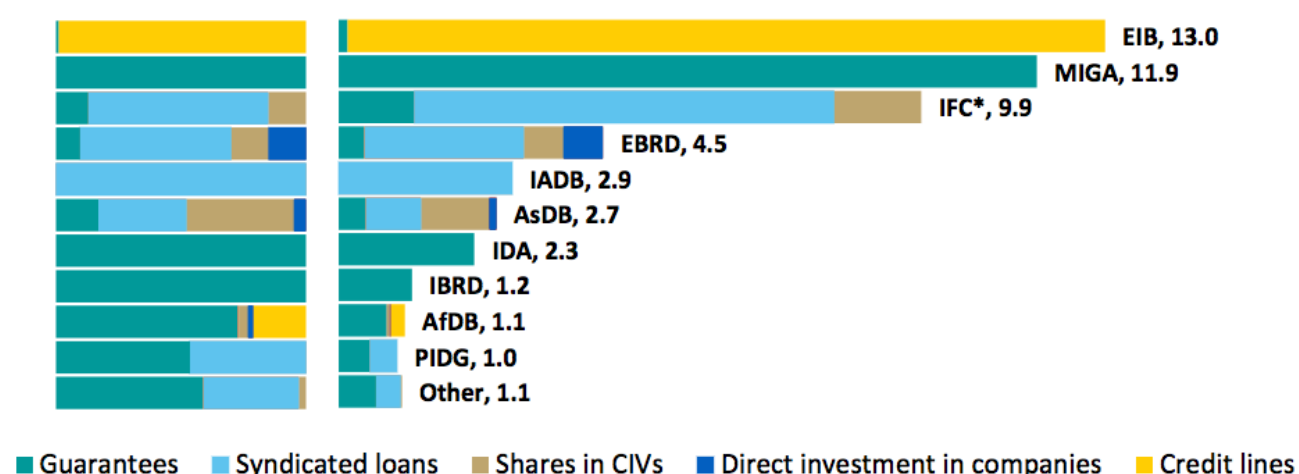
Though each instrument should be targeted to the program or project, such products were also the most effective in mobilizing funds from multiple sources (including both foreign and domestic capital). This is important in terms of local capital markets development, as stipulated in the OECD Development Assistance Committee Blended Finance Principles.⁸ Twenty billion dollars (one quarter of the total \$81.1 billion) was mobilized at the beneficiary country level. Contributing 21 percent of this amount, guarantees mobilized the second highest amount of local finance after credit lines (76 percent of the \$20 billion).

HOW GUARANTEES FIT IN THE BLENDED FINANCE MARKET

Multilateral development institutions were responsible for close to two-thirds of the private sector finance mobilized. The leading institutions providing these products are the Multilateral Investment Guarantee Agency (MIGA), the International Development Association (IDA), and the International Bank for Reconstruction and Development (IBRD) standing out for the multilaterals. Leading bilaterals were the United States (Overseas Private Investment Corporation and U.S. Agency for International Development), France (Agence Française de Développement) and Sweden (Swedish International Development Cooperation Agency). The products provided by these institutions were mainly in the form of guarantees, but some, such as MIGA's sovereign non-honoring cover, are in the form of comprehensive risk insurance cover. Bilateral DFIs were responsible for mobilizing 36 percent of the \$81.1 billion.

* The 2016 OECD Mobilization Survey: <http://www.oecd.org/dac/stats/mobilisation.htm>.

Figure 3. Top Multilateral Providers in 2012-2015, 100% and USD Billion⁹



Key Takeaways:

Overall, there is a broad adoption of guarantees by MDBs, with a number engaging exclusively with guarantees.

MIGA is the stand-out user of guarantees and leader in terms of mobilization.

There is still the potential opportunity for the further use of guarantees by MDBs to begin to use guarantees, considering they often represent a cost effective approach in terms of capital.

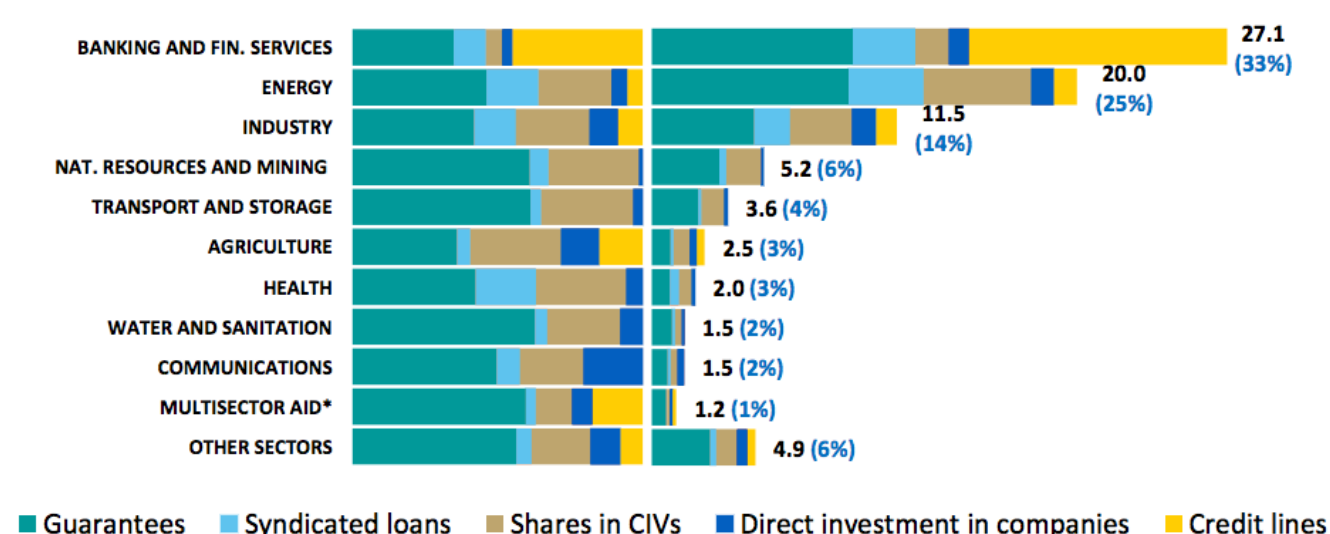
In terms of sectors covered, guarantees were effective across all sectors examined but stood out as being the primary mobilizers of private capital in the banking, energy generation and industrial sectors. As a general matter, private sector buyers of covers

HOW GUARANTEES FIT IN THE BLENDED FINANCE MARKET

instinctively prefer guarantees over insurance products based on concerns relating to proving causation between the insured risk and the payment default with insurance; however, insurance that covers both commercial and political risk (comprehensive insurance) or has a failure to pay as the insured risk (e.g., sovereign non-honoring covering for sovereign/sub-sovereign payment obligations) can remove such causation concerns and provide the functional equivalent of a guarantee.

¹⁰ The 2016 OECD Mobilization Survey: <http://www.oecd.org/dac/stats/mobilisation.htm>.

Figure 4. Amounts Mobilized by Main Sector, USD Billion¹⁰



Key Takeaways:

Guarantees are not sector specific and can therefore be used across a variety of sectors while ensuring mobilization of the private sector. Sectors where guarantees are particularly effective in terms of mobilization are banking and financial services, followed by energy and industry.

As the data illustrates, guarantees and equivalent products are a growing and important part of the development finance landscape and are critical to mobilizing private finance. However, the SDG financing gap remains a staggering \$2.5 trillion. To be able to reach the audacious agenda set out by the SDGs, stakeholders are not only going to have to utilize such products much more, they are going to have to dramatically increase their mobilization potential. This will mean increasing the willingness and ability of DFIs to utilize their balance sheets to provide such products instead of for direct lending, equity or grant purposes, when these products are not considered suitable. It will also mean increasing

HOW GUARANTEES FIT IN THE BLENDED FINANCE MARKET

the leverage potential of development-focused guarantees by creating products that are useful to both traditional banking institutions and to the large pools of non-bank funders (institutional investors, bond purchasers, investment funds) that are increasingly financing projects in more developed markets and better aligning development policies with the regulatory constraints of financial institutions and the business objectives of the private sector.

ANALYTICAL METHODOLOGY

This analysis provides recommendations to public institutions and DFIs that provide guarantees and equivalent products to attract private financing for development. Through qualitative expert interviews, we assessed the impact of such products and also scored the guarantee agreements regarding their compatibility with financial regulations and the prevailing business models of international banks and other private sector funders.

To attract bank capital to SDG-aligned projects, guarantees must be structured to overcome limitations imposed by the fee-driven banking business model of originating and selling loans, and address the growing constraints imposed by global financial regulatory guidelines (e.g. Basel), insurance guidelines (e.g. Solvency II) or accounting regulations (e.g. IFRS9, which specify treatment of financial assets and liabilities). However, for the purposes of this analysis, focus was given specifically to Basel guidelines.

Our assessment covered six of the major multilateral and bilateral guarantee providers that collectively hold approximately \$32 billion in guarantee exposure, representing more than 80 percent of the development guarantee sector.^{11,12}

Guarantees were scored on a scale of 1-5 according to compatibility with four issue areas—two of them regulatory and two more related to financial institution business models:

1. Financial Regulatory Issues
 - a. Basel risk weighting standards
 - b. Basel high-quality liquid assets (HQLA) features

¹¹ Four institutions provided copies of their guarantee contracts. Two institutions, whose confidentiality policies prohibited them from supplying contracts for non-transaction purposes, instead participated in detailed interviews with key legal or transaction staff. While other development institutions may also provide guarantees, they were not included in the analysis for one of two reasons: Either they do not have template guarantee agreements or they are not at sufficient operational scale to benefit from this analysis.

¹² Guarantee exposure was calculated through current, guarantee portfolio data, as self-reported by individual institutions. The broader guarantee market was determined through a similar assessment of self-reported portfolio data.

2. Financial Institution Business Model Issues

- a. Claims processes that dictate how lenders receive guarantee payments
- b. Assignment processes that dictate how lenders market guarantee-backed loans

A score of 1 indicates that the guarantee is highly incompatible with financial regulations in the banking sector or market conventions; conversely, a score of 5 means that the guarantee is strongly in line with such financial regulations or market conventions and thus is an effective instrument to mobilize private capital.

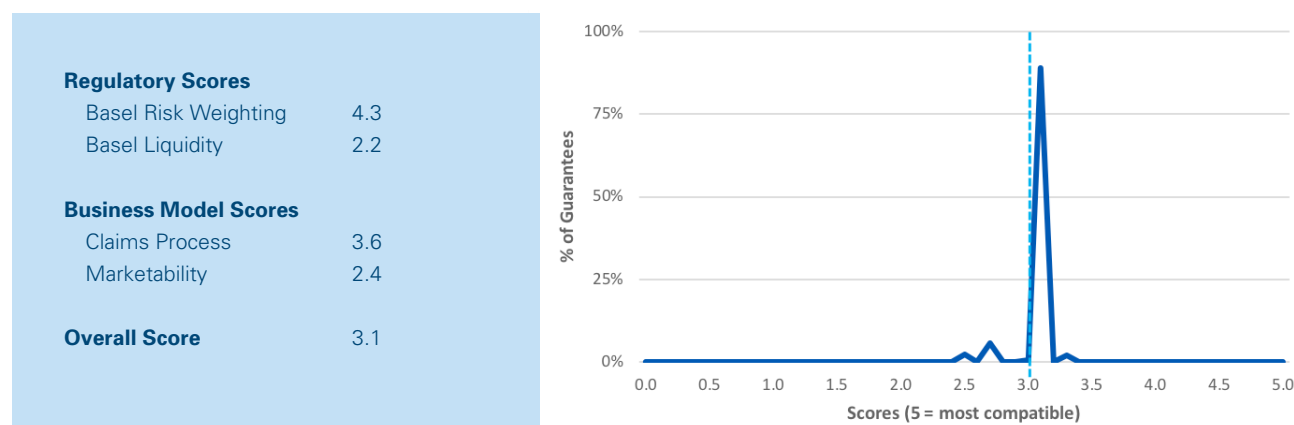
To preserve confidentiality, all responses to the diagnostic questions are de-identified. Results in each section are shown as a distribution of the overall analysis, which is weighted by the portfolio sizes of the responding guarantee institutions. Importantly, two of the institutions represent a particularly large portion of the sector, at 55 percent and 33 percent respectively, and thus influence the distribution in a substantial fashion.

While the scope of our analysis is on the banking sector, due to its role in the financial markets as both a source of investment as well as an arranger of transactions for institutional investors, the regulatory constraints of other capital sources, such as Solvency II for insurance companies, or accounting regulations, such as IFRS, were not included, but are an important research endeavor that should be explored.

RESULTS: KEY BARRIERS TO BLENDING

Overall, the scores of the analyzed guarantees ranged from a low of 2.5 to a high of 3.3, indicating that the analyzed development institutions take a substantially similar approach to the provision of guarantees. In addition, the weighted average score of 3.1 indicates that while guarantees have proven to be effective at attracting private capital to development projects, when utilized, nearly 50 percent of guarantees have been structured insufficiently. From a regulatory perspective, the sampled guarantees performed best in the area of risk weighting standards, with a weighted average score of 4.3, and most poorly in the area of liquidity standards, with a weighted average score of 2.2. From the vantage point of compatibility with financial institution business models, the sampled guarantees scored best in the area of claims process efficiency, with a weighted average score of 3.6; conversely, in the area of marketability, the guarantees produced a weighted average score of 2.4.

Figure 5. Overall Scores and Score Distribution



Prior to presenting the results of the guarantee contract analysis, it is important to delve into policies that underpin the structures of guarantees and that limit their use within development organizations.

RESULTS: KEY BARRIERS TO BLENDING

HOW DO DEVELOPMENT INSTITUTION POLICIES LIMIT THE USE OF GUARANTEES?

Based on Milken Institute analysis and interviews with key experts, from a strategic perspective, a number of issues are limiting the scale and popularization of guarantees within development organizations:

¹³ The Total Official Support for Sustainable Development (TOSSD) initiative aims to increase transparency and monitoring of the development finance landscape by including the use of risk mitigation instruments in development cooperation.

Key Insights: Strategic Limiting Factors

Accounting of OECD development assistance pledges should correct biases toward direct funding solutions. OECD countries have pledged 0.7 percent of their gross national income to ODA, and this target is measured based on money spent (countries only get “credit” for the full amount of the guarantee if it is triggered). Until the OECD’s TOSSD¹³ initiative concludes in addressing the treatment of risk mitigation tools, a systemic bias will remain against guarantees, which are not always fully funded.

Development theories of change should prioritize alignment with private capital incentives over risk-sharing policies alone. The policy premise of many guarantee programs is pari-passu risk sharing to put private capital on a short path to sustained participation. However, such products will not be effective to mobilize private sector bank capital in markets where banks need to transfer risks outright (for instance, in the context of a debt transaction with capped returns in developing markets where liquidity and certainty are low). In addition, many private capital providers aim to get refinanced or sell their exposure prior to maturity so as to free up country, sector or client exposure limits, and free up capital to reinvest and maximize fee income. Therefore, they do not evaluate the opportunity in the same light as the development organization.

A guarantee adds a third party to a transaction that could otherwise be a simple loan, and therefore adds complexity regardless of how the guarantee is written. In addition to this, public sector guarantee providers also face specific operational challenges when seeking to unlock private capital for development projects:

RESULTS: KEY BARRIERS TO BLENDING

Key Insights: Operational Limiting Factors

Personnel at development organizations need to be clearly incentivized to leverage private capital. Performance evaluation at development organizations is not structured to encourage private sector blending. Common metrics, such as the number of people or contracts managed, encourage large overhead engagements and create a disincentive to seek efficiencies or blended finance solutions. Furthermore, commercial skill sets and financial backgrounds are the exception rather than the rule at many development organizations.

Guarantee usage should be better aligned to encourage country-level borrowing capacity. Many of the multilateral institutions that also lend to countries directly (through their public sector arm) require a sovereign counter-guarantee when issuing a guarantee, and that exposure is recorded dollar for dollar against the beneficiary country's borrowing headroom. While guarantees are contingent instruments and could be recorded simply as a proportion of the full amount (based on risk levels), the current practice of full allocation removes a major potential incentive to country-level usage of guarantees.

Development finance operational performance should encourage blending rather than only return on equity and profit margins. In the drive to formalize development finance activities, emphasis has been made to apply the same yardstick used for commercial banks to show viability of market activities. As a result, rating agencies apply the same performance metrics, principally for multilateral development banks, which creates the same incentives on MDBs to act like commercial banks and focus on direct lending rather than guarantee-backed blended financing. Development finance policymakers should work with rating agencies to find a balance between standard practices and the development mission of MDBs.

Universal standards or approaches to encourage syndication or blending across multiple parties should be promoted. A byproduct of stakeholder breadth is a lack of uniform standards across institutions. Although near-universal approaches have been developed for specific areas, such as the application of International Finance Corporation's performance standards and guidelines in respect of environmental compliance, most aspects remain highly institution-specific, limiting the ability of private capital to blend with multiple sources in an efficient fashion.

Public organizations should avoid exerting more control than is justified by the value of a guarantee. Public sector organizations answer to a broad set of stakeholders, which adds many dimensions to their engagement criteria, instruments, and approval procedures that may ultimately confer excessive control over a transaction. In many instances, this deters private investors as they cannot justify the uncertainty and de facto ceding of control in exchange for the value of the guarantee.

RESULTS: KEY BARRIERS TO BLENDING

Collectively, these strategic realities and operating practices represent significant obstacles to scale for the guarantee sector. Unfortunately, they underpin the form and structure of guarantees provided by development organizations, which therefore do not always comport with the business practices or regulatory needs of the private financial institutions they seek to attract.

ARE MOST GUARANTEES COMPATIBLE WITH BASEL FINANCIAL REGULATIONS?

Differences in market focus and operating models among guarantee providers will mean that guarantee contracts must continue to carefully consider specific underlying project risks. However, as more countries implement Basel standards, the disparate providers within the guarantee and insurance sector will encounter common challenges in attracting banks to participate in or arrange blended finance transactions. With that in mind, this piece of the assessment evaluates how the major guarantee contracts interact with Basel risk weighting standards and liquidity requirements.

BASEL RISK WEIGHTING STANDARDS

The Basel regulatory framework prescribes that financial institutions hold a certain amount of capital so that losses can be sustained without jeopardizing overall stability. Each asset is assigned a weight, and higher risk assets carry higher weights, forcing the institution to hold more capital against them. Therefore, because many SDG-aligned projects are in developing countries and/or target vulnerable populations, this system requires financial institutions to hold more capital to finance SDG-aligned projects than to finance developed-market projects.

Development guarantees can counteract this disincentive. If certain structural features are present, the proportion of the asset covered by the guarantee can instead be weighted using the guarantor's risk rating, which is very strong in the case of development banks and donor institutions (a number of these institutions have AAA credit ratings). These features are as follows:

RESULTS: KEY BARRIERS TO BLENDING

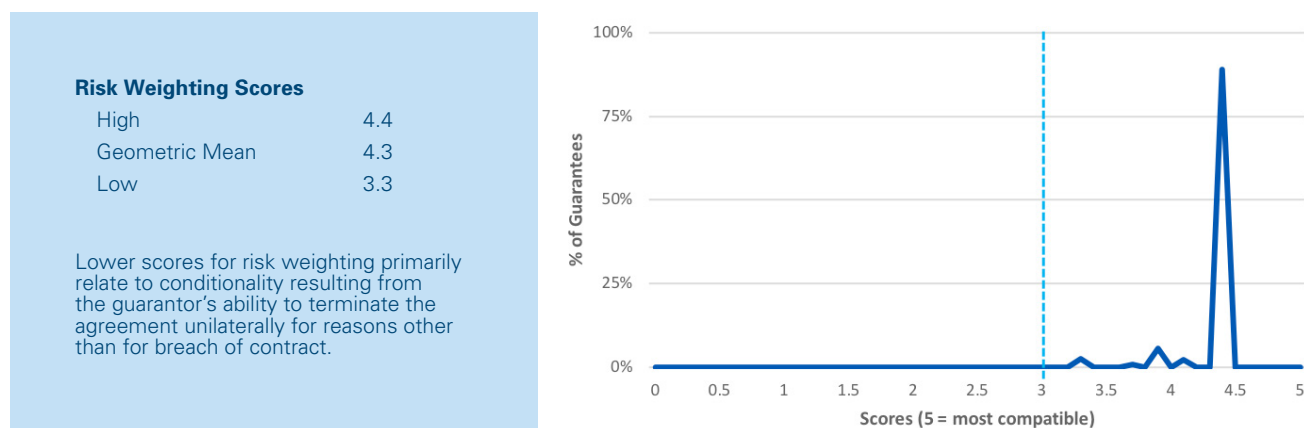
1. The guarantee must be unconditional. From the perspective of Basel guidelines, unconditionality generally means that:
 - a. The guarantor cannot cancel the guarantee for any reason other than for breach of contract and any conditions of cover must be within the control of the beneficiary
 - b. The beneficiary does not need to pursue the borrower before claiming on the guarantee
 - c. The cost or coverage of the guarantee does not change as a result of a change in the borrower's condition
2. The lender must be able to claim directly against the guarantor.
3. The guarantee must pay pro rata even if it covers less than all contractual payments.

Of all issue areas, guarantees scored best in the area of conformity with Basel risk weighting. The analyzed guarantee products produced a weighted average score of 4.3 out of 5, with a range from 3.3 to 4.4. All of the evaluated guarantees are—or can be—structured as a direct relationship between the guarantor and guaranteed party (satisfying point 2 above), and they do pay on a pro rata basis even if the coverage is less than 100 percent (meeting requirement 3). Lower scores in this area relate primarily to point 1(a) above in which guarantees can be canceled unilaterally for reasons other than breach of contract.

Most guarantees conform better with the two other measures of unconditionality. The majority of guarantees do not require the bank to pursue the borrower before claiming (other than, in some cases, for a fixed waiting period). Those that do require this typically are targeted at developing market banks for small business lending and are structured more as a collateral substitute for those borrowers. While this strategy may be effective in the near term, it will become increasingly difficult as developing markets adopt Basel standards over time. Similarly, of the evaluated guarantees, none of the coverages or costs change due to a change in the borrower's condition.

RESULTS: KEY BARRIERS TO BLENDING

Figure 6. Risk Weighting Scores and Score Distribution



Key Insights: Risk Weighting

Guarantees should seek to counteract risk weighting guidelines that inflate the cost of developing market transactions and prevent bank participation.

When a bank makes a loan or investment, it needs to set aside capital to absorb potential losses. Depending on the riskiness of the transaction and the jurisdiction in which it takes place, different amounts need to be set aside. Therefore, lending in higher-risk countries or markets carries a higher cost of capital. This contributes to the creation of hurdle rates that are untenable from a credit perspective and that prevent international bank participation in developing market transactions.

The guarantee should provide greater certainty. For policy and operational reasons, public sector/DFI guarantors are compelled to include provisions that decrease the certainty. Any unilateral termination rights or obligations on a beneficiary to ensure performance by a third party such as a borrower prevent banks from gaining the level of certainty needed for capital relief from a regulatory perspective. Although rarely invoked, some guarantees include open-ended termination rights at the guarantor's discretion, which negatively impacts the level of certainty they provide from a Basel perspective. We should note that given that the analysis focused principally on Basel, additional analysis is required on relevance to Solvency II for insurance products.

Guarantees should play a larger role in countering the dampening impact of country risk weightings on demand for transactions in developing markets.

Exposures to projects and institutions outside of OECD countries carry increased risk weighting under Basel guidelines. As a result, regardless of the strength of particular project or institution, exposure to a developing country jurisdiction has an immediate and significant disadvantage from a capital perspective. If structured appropriately, guarantees could mitigate country risk by transferring risk (rather than sharing) from the lender to the guarantor, and thus eliminate the additional capital charge for developing market jurisdictions. Key requirements to ensure the ability to transfer risk to a guarantor are the level of cover and the ability of the guarantee to be called on demand, without conditions and promptly paid without the delay or additional cost of long waiting periods for claims.

RESULTS: KEY BARRIERS TO BLENDING

BASEL LIQUIDITY STANDARDS

Liquidity requirements are another feature of the Basel regime that impacts resource availability for SDG-aligned projects. The requirements are currently being phased in, and by 2019 banks will need to hold HQLA equal to 100 percent of their projected net cash outflows on both 30-day and one-year horizons. Here again, the purpose of these requirements is to ensure that financial institutions are positioned to fulfill their obligations even in times of stress. If SDG-aligned investments are not deemed HQLA, then there will be a decreasing pool of resources to fund them.

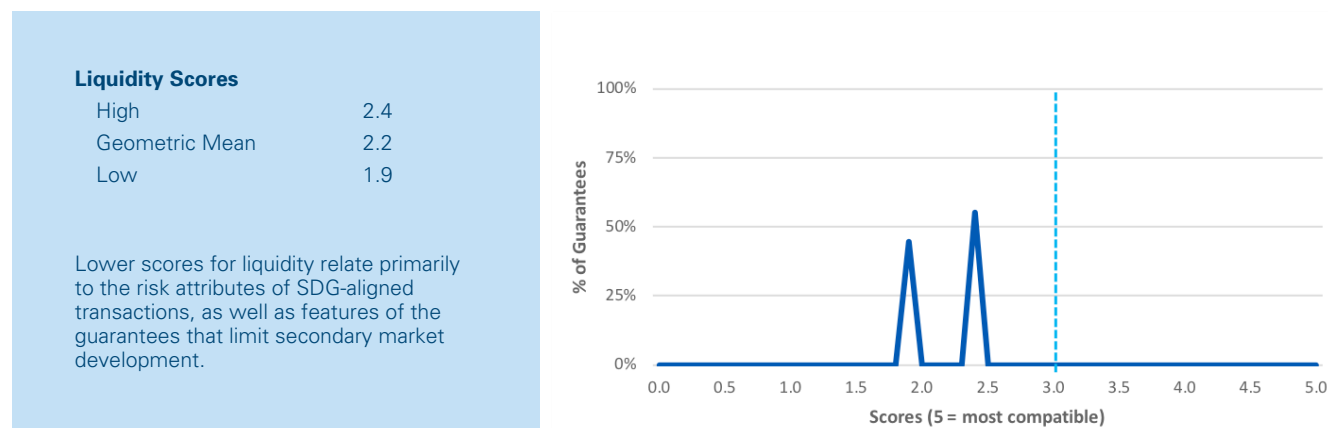
There are three types of HQLA. Level 1 HQLA includes cash, central bank reserves, and other marketable securities backed by sovereigns and central banks. There is no limit on the extent to which a bank can hold these assets to meet their liquidity minimums. Level 2A HQLA includes covered bonds and corporate debt securities, and certain other government securities. Level 2B HQLA includes lower-rated corporate bonds, residential mortgage-backed securities, and equities that meet certain conditions. In aggregate, the two forms of Level 2 HQLA cannot account for more than 40 percent of a bank's overall HQLA, and Level 2B HQLA cannot comprise more than 15 percent of a bank's overall HQLA.

To meaningfully counteract the impact of increasing liquidity requirements, a guarantee would need to transform an SDG-aligned investment into HQLA. To be sure, the breadth of SDG-aligned projects creates varying challenges to achieving this; however, certain characteristics of HQLA are universal, and guarantee products could aim to manufacture those attributes where they do not exist as part of the underlying asset/transaction.

Overall, development guarantee scores for conformity with Basel HQLA definitions were the lowest of all evaluated areas. The analyzed guarantee products produced a weighted average score of 2.2, with a range of 1.9 to 2.4. Three key attributes of HQLA impede eligibility of SDG-aligned projects backed by guarantees, as detailed below.

RESULTS: KEY BARRIERS TO BLENDING

Figure 7. Liquidity Scores and Score Distribution



First, HQLA benefits from scaled, diverse, and active secondary markets through which to liquidate positions. In the case of SDG-aligned investments, demand is less diverse and also highly dispersed without robust market-making infrastructure to facilitate active trading opportunities. For their part, while guarantees facilitate primary market expansion, they do not encourage the development of secondary markets. All evaluated guarantee contracts do not allow a sale, transfer, or assignment without prior written consent other than, in some cases, to specific types of eligible assignees, and no guarantee defines the mechanics of consent beyond stating that it shall not be unreasonably withheld. The reason for this is twofold. First, for political purposes, DFIs and public sector institutions are concerned with the identity of the entities that may make a claim from a reputational and Know Your Customer perspective. Second, for operational and strategic reasons, many guarantees are structured to rely on the credit analysis capabilities and risk participation of the guaranteed party. This structure means that the DFI/public institution needs to conduct due diligence on its guaranteed parties, limiting the liquidity of the instruments. In the end, for guarantors to try and manufacture market attributes similar to HQLA, a first step is to ensure that guarantees do not create impediments to secondary market development.

The second set of characteristics that guarantees would need to address for SDG-aligned investments to qualify as HQLA is the

RESULTS: KEY BARRIERS TO BLENDING

liquidity profile of the underlying asset. Here again, the argument is not to structure transactions in a way that disregards project risks; rather, guarantees should add Basel liquidity treatment to the set of structural considerations. For example, some of the evaluated guarantee products are structured to reimburse banks for realized losses, as opposed to covering borrower payment shortfalls, and therefore do not address banks' potential liquidity concerns. Paying on demand, in effect eliminating or reducing short-term liquidity risk, is an important component of achieving HQLA eligibility.

The last set of HQLA characteristics that development guarantees would need to address relates to valuation. For example, is there a market convention or standard method and formula for pricing the asset based on publicly available data? Furthermore, are the resulting asset prices volatile and are they correlated with risky assets? Regarding the guarantee sector, while some institutions have established reinsurance relationships that indicate a standard valuation methodology, some leading institutions do not have publicly available standard form guarantee templates, impeding a standard valuation across even individual portfolios. Similarly, most details of actual transactions are private, and this limits the ability to compare across institutions. This lack of standard approach all but eliminates the ability of projects to qualify as HQLA on the back of a development guarantee.

Key Insights: Liquidity

Donor agencies should seek HQLA recognition for approved development-focused guarantees. By 2019, Basel IV, the finalization of Basel III, will require banks to hold a stock of HQLA that fully covers projected net cash outflows. Compared to the 60 percent banks were required to cover until 2016, this increased requirement will significantly reduce banks' appetite for originating illiquid exposures. To counteract this effect, donors could seek a policy exception that would allow certain SDG-exposures they are guaranteeing to qualify as HQLA, and preferably Level 1 HQLA.

Donor agencies should adjust certain structural features of guarantees in order to give financial regulators comfort in granting such exceptions. For example, currently, development guarantees are not sufficiently tradable or transferable. Donor agencies should seek to align on an approved counterparty universe that would allow financial institutions to more effectively sell or transfer the assets in a secondary market or securitization.

RESULTS: KEY BARRIERS TO BLENDING

ARE MOST GUARANTEES COMPATIBLE WITH FINANCIAL BUSINESS MODELS?

Bank business models center on fee income in addition to lending (interest) income. Banks, especially large banks in G20 countries, increasingly are focused on structuring and arranging loans, and then selling those loans to other banks and institutional investors, such as pension funds, insurance companies, and other asset managers. Attracting more G20 banks into the development arena would bring not only those banks' expertise and resources, but also the resources of the institutional investors that have long-term investment horizons and deep pools of capital, and which the banks partner with as part of their loan sell-down strategies. To maximize this opportunity, development guarantees must adapt to the business objectives of G20 banks. This piece of the analysis evaluates the major guarantee contracts against provisions that will impact (i) the ability of banks to claim efficiently on a guarantee, and (ii) sell, transfer or assign the guaranteed loan with the guarantee.

GUARANTEE CLAIMS PROCESS

A key component of a guarantee's marketability is the processes through which the guaranteed party can make a claim and receive payment. Overall, in this area the analyzed guarantees produced a weighted average score of 3.6 out of 5, with a range from 2.6 to 4.6. Claims process efficiency affects three aspects of bank operations:

1. Financial statements
2. Product relevance
3. Operating intensity

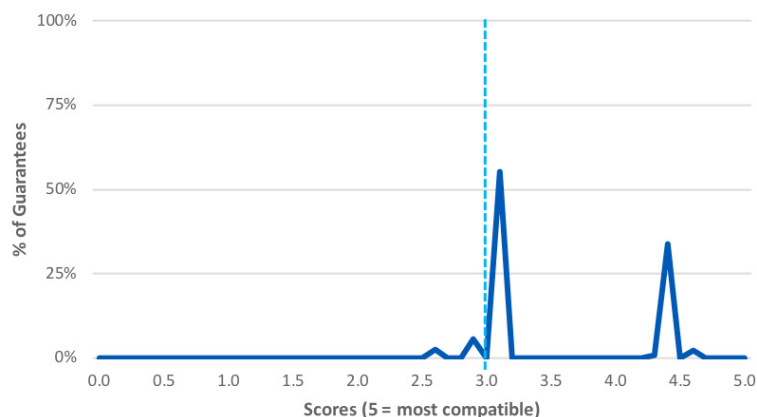
Development guarantees must adapt to the business objectives of G20 banks.

RESULTS: KEY BARRIERS TO BLENDING

Claims Process Scores

High	4.6
Geometric Mean	3.6
Low	2.6

Lower scores for claims process relate primarily to a high number of eligibility steps, waiting periods, and a requirement for the beneficiary to write off the exposure prior to claiming.



First, the claim requirements imposed by development guarantees can have a significant impact on a bank's financial statements, beyond those impacts already discussed in the context of Basel regulations. The most direct structural feature in the guarantee claims process that will impact the guaranteed party's financial statements is whether the guaranteed party must provision for or write off the loan. While forcing the guaranteed party to provision or write off the loan to claim on the guarantee is a means for the development institution to ensure that the bank is acting prudently, provisioning or writing off a loan hits many pieces of the financial statements negatively and thus can eliminate the attractiveness of the development project from the bank's perspective. Of the evaluated guarantees, only one product requires that the bank provision or write off the loan in order to claim, indicating the guarantee sector has a strong level of marketability on this component.

The second area that guarantee providers should consider in structuring their claims process is the types of bank products that can reasonably adhere to the requirements. Key criteria in this area are time periods and default triggers. For example, are there waiting periods before claims can be submitted or claim payments made? To the extent there are mandatory waiting periods before the bank can start the claims process or receive payment, some financing products become unsuitable. Syndicated or securitized products, or other

RESULTS: KEY BARRIERS TO BLENDING

products that rely on distribution or participation by third parties, can prove challenging from a payment sequencing perspective. Similarly, products with seasonal or timing features, such as agricultural lending facilities, must be carefully structured so as not to accentuate risks. In the area of time periods, the evaluated guarantee products are mixed. Three of the products involve mandatory waiting periods before a claim can be submitted, some up to 180 days. Similarly, once a claim has been submitted, three products provide standard definition around a maximum period before which payment will be made, but only two of those guarantees stipulate payment will be made in 10 days or less.

Further to the means by which the claims process can limit product relevance is whether claim eligibility is contingent upon specific reasons for default. In infrastructure project finance where specific risks are allocated to specific partners, attaching specific default triggers to claim eligibility can make sense. In other business lines, such as small and medium enterprise lending, default-specific claim requirements can be incredibly difficult to value from the bank's perspective. In this area, only two guarantee products had default triggers linked to specific events, and those guarantees are designed primarily for infrastructure project finance. Therefore, guarantees perform well on this metric.

The last area in which the claims process has implications for financial institutions is operating intensity, or the ease with which guarantee claims can be made and payment received. Generally speaking, the more hurdles placed on the banks outside of their usual business process, the less attractive the guarantee will become. Critical features evaluated in this area are the number of steps required to claim under the guarantee and whether or not the bank is required to pursue the borrower before claiming on the guarantee, and if so, for what period of time. Based on these two tests, as well as the waiting period and acceleration features, generally speaking, guarantees will be deemed "on demand" or not, a key determinant

RESULTS: KEY BARRIERS TO BLENDING

of the product's attractiveness for most financial institutions. Of the evaluated guarantees, only two had a single step to claim, with the others having two or more steps. However, only one guarantee required the bank to pursue the borrower in order to qualify for a claim.

Key Insights: Claims Process

Donors should structure guarantees to pay on demand when possible.

Similarly, rather than paying on demand, or before loan acceleration, some guarantors prefer to pay claims after a bank's collection efforts. A guarantee that requires such collection efforts has implications for a bank's liquidity and therefore has a negative impact on its financial statements and reduces the attractiveness of the guarantee. Insurance products fared better in this regard, but given that the focus of our analysis was primarily on guarantees and Basel, additional research is required on insurance products.

GUARANTEE SALE, ASSIGNMENT, OR TRANSFER

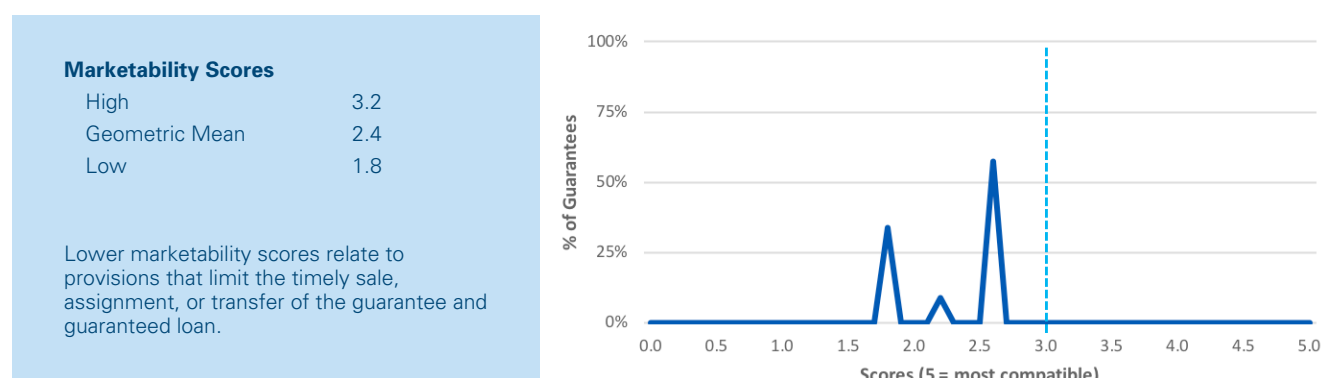
Given regulatory pressures, growing institutional investor resources, and profitability considerations, developed market financial institutions are increasingly relying on transaction fees as opposed to interest income. In effect, banks are increasingly functioning as product manufacturers for the capital markets as opposed to lenders. Therefore, to entice global financial institutions, in particular institutional investors (i.e. pension funds, asset managers and insurance investors) to participate in SDG-aligned projects, guarantee providers must recognize this reality and structure their products to accommodate for banks increasingly serving as intermediaries rather than lenders.

Overall, in the area of marketability, the evaluated guarantees produced a weighted average score of 2.4, with a range from 1.8 to 3.2. Key provisions that impact a bank's ability to be an effective intermediary relate to sale, assignment, and transfer mechanics. Only one of the evaluated guarantee agreements allows for a sale, assignment or transfer of the guarantee to certain eligible institutions without prior approval by the guarantor. This relates, again, to the

RESULTS: KEY BARRIERS TO BLENDING

need for public institutions to have control over what entities benefit from their resources. In addition to requiring prior approval, none of the guarantee agreements provide details as to the time in which approval will be granted. Two agreements stipulate that the approval will “not be unreasonably withheld” or that approval will be determined in a “reasonable” timeframe, but no more definition is provided regarding process. This lack of clarity can be limiting to the extent that financial institutions seek to sell part or all of the loan to another party at some point prior to maturity. Furthermore, the guarantees that require approval do not stipulate the criteria by which approval will be granted. Some guarantees have limitations on eligible investors, relating to country of origin or other tests, but no other qualitative, quantitative, or procedural criteria is provided in the contracts, which again limits the guaranteed party’s visibility into how marketable a guarantee will be to other investors in the future.

Figure 9. Marketability Scores and Score Distribution



Key Insights: Sale, Assignment, or Transfer

Guarantees need to allow for seamless exits through enhanced assignment provisions. G20 banks typically do not want to hold loans to maturity. This is particularly true for longer tenors, which create asset-liability mismatches for banks with deposit-based funding structures. Although guarantees typically do include assignment and transfer rights, the process usually requires guarantor approval of the potential assignee. Therefore, originating banks cannot easily or quickly sell their exposure, and this directly reduces the attractiveness of guaranteed loans to risk managers and regulators who focus on the illiquidity of the particular asset. Although achieving true tradability of development guarantees is not feasible in the near term, streamlining their assignment and transfer provisions to provide clean exit mechanisms could be an important step to activating banks and capital markets.

IMPLEMENTATION SEQUENCE

Guarantees cannot solve all SDG-related problems, but they are a key piece of the strategy that development finance must execute in order to achieve the scaled results called for by the SDGs. As our analysis indicates, many development organizations lack the strategic incentives and operational capabilities to provide guarantees at scale.

Moreover, currently, the structure of many guarantees does not comport well with the needs of international bank clients. From a regulatory perspective, few guarantees offer the certainty required to provide relief under Basel's capital requirements, and, almost by definition, the guarantees and underlying projects do not qualify as HQLA under Basel's liquidity guidelines. Furthermore, many guarantees are not structured to allow banks to serve as intermediaries, rather than lenders, which stymies their interest in transactions.

Tackling these issues requires active engagement from both the development and financial markets communities and thinking on both short- and long-term opportunities.

SHORT-TERM OPPORTUNITIES

In the near term and to address the key insights raised earlier in the paper, certain concrete structures and initiatives could be implemented to accelerate results and create demonstration effects. On the investor side, an efficient vehicle is needed to produce an appropriate risk-return profile. On the borrower side, a pipeline of tangible opportunities is key to justifying a broader reallocation of assets toward development.

IMPLEMENTATION SEQUENCE

- **Identifying and implementing best practices.** Best-practice standards are critical to increasing the frequency and effectiveness of guarantee-backed transactions. Best practice transactions offer clear incentives, close in reasonable timeframes, and balance commercial and development realities. For example, while a guarantee's cash cost may be minimal, its reporting requirements and decision-making authority can confer undue control to the guarantee provider and discourage the very investment it intended to encourage. Building capabilities within development institutions in order to deliver best practices also requires improving staff training and incentives.
- **Promote the harmonization of the terms and conditions of cover across development institutions.** Given the complex nature of traditional structured finance transactions, their application in emerging markets creates room for inefficiencies. Based on best practices, templates that maximize alignment with Basel regulations and the ability to leverage private capital should be developed and shared among donor institutions. A guarantee template for advancing blended financing for SDG-aligned investments that is as universally standardized as possible is needed, similar to near-universal approaches that have been developed in very specific areas, such as the application of International Finance Corporation's performance standards and guidelines in respect of environmental compliance.
- **For donors that must disburse ODA, develop a centralized guarantee fund capitalized by donor grants and development bank capital to accelerate scale and efficiency.** Development institutions have offered guarantees in only a limited way despite their mobilization potential. For donors concerned with ODA accounting, guarantees are less compelling than grants; for development banks concerned with profitability, guarantees are less compelling than investments. While bringing development institutions together in a single structure is challenging, a

IMPLEMENTATION SEQUENCE

centralized guarantee fund capitalized by donor grants and development bank capital and which operates in alignment with private investor needs could achieve significant development results.

- **Creating platforms for impact deal flow and transaction replication.** To achieve sustained and scaled results, public institutions need to prioritize interventions that can create impact deal flow. Whether subsidizing alternative energy sources, nutritious food production, or last-mile logistics of essential medical products, these interventions can potentially seed derisked impact startups. Said another way, public institutions should approach interventions as deal factories that are designed to create a steady supply of transactions that can spark commercial development, technology transfer, and private investment flow. This requires proper training and incentives for development institution personnel.

The policy dissonance between development finance and the private sector must be addressed.

MEDIUM- AND LONG-TERM OPPORTUNITIES

At the systems level, the policy dissonance between development finance and the private sector must be addressed. This is part of a broader need for increased policy coherence to align incentives, support new partnerships, and increase the development impact of private finance. This is an issue that is already being broadly tracked by various programmatic efforts of the Milken Institute's Center for Financial Markets, as well as the OECD through its Global Outlook on Financing for Development and other activities. The G20 and other key international processes are also increasingly striving to bring policymakers together and to develop a mechanism for effectively smoothing inconsistencies. These efforts must go hand in hand with ongoing initiatives to reduce the underlying risks themselves.

To increase the opportunity for guarantees to mobilize private financing, it is key to uncover regulations across systems that create discordant incentives. Once regulatory barriers are clarified,

IMPLEMENTATION SEQUENCE

best-practice standards can be identified to allow these systems to operate in concert. Important first steps include:

- **Promoting enhanced regulatory treatment of blended financing tools.** Although G20 governments create the regulations for both financial markets and international development, the two systems are not integrated. In the wake of the financial crisis, financial regulators created policies to decrease risk in the banking sector, with the unintended consequence of disincentivizing activity in developing markets; at the same time, development leaders are designing policies to attract more private investment to developing markets because access to capital is needed to stabilize those economies. To create effective blended finance solutions, instruments must be attuned to the policy drivers of both sides.
- **Balance Rating Agency standard practices with MDB missions.** Although it is critical to evaluate the performance of multilateral development banks with similar rigor as commercial banks, if the yardstick is exactly the same, the incentives will also be the same. For example, if the emphasis is on only return on equity and profit margins, the drive for MDBs may be to act like commercial banks and crowd out private capital, rather than enablers of blended financing. Development finance policymakers need to work with rating agencies to identify additional measures of performance, such as break-even, that are stability-neutral, but do not overemphasize direct lending above guarantee-backed blended financing.
- **Leveraging data to realize impact.** Commercial capital prefers to invest in clear, comparable opportunities. Without a deep transaction data set, developing markets will remain in the realm of uncertainty—where outcomes cannot be priced—and capital allocation will continue to go to other opportunities that allow fiduciaries, rating agencies, and others to justify their investment decisions and create risk-based pricing. Implementing common data conventions (such as publishing transaction results in a standardized and accessible format that allows private capital to contextualize opportunities) is key to encouraging private capital participation in the SDGs.

CONCLUSION

After the 2008 financial crisis, enhanced regulations did help reduce global financial instability. However, these regulations also disincentivize investment in the developing and emerging markets that are most in need of capital to stabilize. Although guarantees and equivalent products provided by development institutions have shown great promise in overcoming this disincentive, they are not realizing their full potential for mobilizing private capital to help achieve the SDGs. A thorough analysis of products from institutions representing more than 80 percent of the development guarantee market reveals considerable misalignments with respect to financial regulatory policies, DFI incentives, and financial institutions' business practices. Under our analysis, nearly 50 percent of guarantees are not written for maximum efficiency, leverage, and impact.

While this analysis documents the misalignment between development guarantees and banking sector regulations, there is a need for future research. Additional regulations, such as Solvency II for insurance companies, also inhibit the flow of capital. Exploring the compatibility of guarantees with these regulations is important to maximizing private capital participation in development. Furthermore, additional research into the development institution policies that create many of the challenges in guarantee contracts is needed to ensure that modifications are pursued in a holistic manner that is aligned with their private sector users.

Nonetheless, we suggest a series of modifications to development-focused guarantees to increase their potential to mobilize private capital in furtherance of SDG-aligned initiatives: better incentives to encourage donor utilization of guarantees; improved terms and conditions in the guarantee contracts; and better alignment between financial regulatory and development policies.

Although guarantees and equivalent products provided by development institutions have shown great promise in overcoming this disincentive, they are not realizing their full potential for mobilizing private capital to help achieve the SDGs.

CONCLUSION

From the development finance side, bilateral and multilateral stakeholders must cooperate to better align their theories of change with the financial regulatory policymakers that seek to safeguard global economic security, and with the private sector that seeks to commercialize and drive economic opportunities. From the financial regulatory side, the Financial Stability Board may take the opportunity to review the impact of post-crisis reforms on development finance and developing markets. For example, the decision to treat the activities of a developing market subsidiary of an international bank as foreign exchange or local currency has far-reaching implications from private sector lending to purchasing sovereign bonds, to providing market making services or managing deposits backed by local deposit insurance programs. There is an important opportunity to refine the rules that will enable broader participation in the SDGs, and now is the time to act.

APPENDIX

Key Insights: Strategic Limiting Factors

Accounting of OECD development assistance pledges should correct biases toward direct funding solutions. OECD countries have pledged 0.7 percent of their gross national income to ODA, and this target is measured based on money spent (countries only get “credit” for the full amount of the guarantee if it is triggered). Until the OECD’s TOSSD¹⁰ initiative concludes in addressing the treatment of risk mitigation tools, a systemic bias will remain against guarantees, which are not always fully funded.

Development theories of change should prioritize alignment with private capital incentives over risk-sharing policies alone. The policy premise of many guarantee programs is pari-passu risk sharing to put private capital on a short path to sustained participation. However, such products will not be effective to mobilize private sector bank capital in markets where banks need to transfer risks outright (for instance, in the context of a debt transaction with capped returns in developing markets where liquidity and certainty are low). In addition, many private capital providers aim to get refinanced or sell their exposure prior to maturity so as to free up country, sector or client exposure limits, and free up capital to reinvest and maximize fee income. Therefore, they do not evaluate the opportunity in the same light as the development organization.

Key Insights: Operational Limiting Factors

Personnel at development organizations need to be clearly incentivized to leverage private capital. Performance evaluation at development organizations is not structured to encourage private sector blending. Common metrics, such as the number of people or contracts managed, encourage large overhead engagements and create a disincentive to seek efficiencies or blended finance solutions. Furthermore, commercial skill sets and financial backgrounds are the exception rather than the rule at many development organizations.

Guarantee usage should be better aligned to encourage country-level borrowing capacity. Many of the multilateral institutions that also lend to countries directly (through their public sector arm) require a sovereign counter-guarantee when issuing a guarantee, and that exposure is recorded dollar for dollar against the beneficiary country’s borrowing headroom. While guarantees are contingent instruments and could be recorded simply as a proportion of the full amount (based on risk levels), the current practice of full allocation removes a major potential incentive to country-level usage of guarantees.

Development finance operational performance should encourage blending rather than only return on equity and profit margins. In the drive to formalize development finance activities, emphasis has been made to apply the same yardstick used for commercial banks to show viability of market activities. As a result, rating agencies apply the same performance metrics, principally for multilateral development banks, which creates the same incentives on MDBs to act like commercial banks and focus on direct lending rather than guarantee-backed blended financing. Development finance policymakers should work with rating agencies to find a balance between standard practices and the development mission of MDBs.

Key Insights: Operational Limiting Factors Continued

Universal standards or approaches to encourage syndication or blending across multiple parties should be promoted. A byproduct of stakeholder breadth is a lack of uniform standards across institutions. Although near-universal approaches have been developed for specific areas, such as the application of International Finance Corporation's performance standards and guidelines in respect of environmental compliance, most aspects remain highly institution-specific, limiting the ability of private capital to blend with multiple sources in an efficient fashion.

Public organizations should avoid exerting more control than is justified by the value of a guarantee. Public sector organizations answer to a broad set of stakeholders, which adds many dimensions to their engagement criteria, instruments, and approval procedures that may ultimately confer excessive control over a transaction. In many instances, this deters private investors as they cannot justify the uncertainty and de facto ceding of control in exchange for the value of the guarantee.

Key Insights: Risk Weighting

Guarantees should seek to counteract risk weighting guidelines that inflate the cost of developing market transactions and prevent bank participation. When a bank makes a loan or investment, it needs to set aside capital to absorb potential losses. Depending on the riskiness of the transaction and the jurisdiction in which it takes place, different amounts need to be set aside. Therefore, lending in higher-risk countries or markets carries a higher cost of capital. This contributes to the creation of hurdle rates that are untenable from a credit perspective and that prevent international bank participation in developing market transactions.

The guarantee should provide greater certainty. For policy and operational reasons, public sector/ DFI guarantors are compelled to include provisions that decrease the certainty. Any unilateral termination rights or obligations on a beneficiary to ensure performance by a third party such as a borrower prevent banks from gaining the level of certainty needed for capital relief from a regulatory perspective. Although rarely invoked, some guarantees include open-ended termination rights at the guarantor's discretion, which negatively impacts the level of certainty they provide from a Basel perspective. We should note that given that the analysis focused principally on Basel, additional analysis is required on relevance to Solvency II for insurance products.

Guarantees should play a larger role in countering the dampening impact of country risk weightings on demand for transactions in developing markets. Exposures to projects and institutions outside of OECD countries carry increased risk weighting under Basel guidelines. As a result, regardless of the strength of particular project or institution, exposure to a developing country jurisdiction has an immediate and significant disadvantage from a capital perspective. If structured appropriately, guarantees could mitigate country risk by transferring risk (rather than sharing) from the lender to the guarantor, and thus eliminate the additional capital charge for developing market jurisdictions. Key requirements to ensure the ability to transfer risk to a guarantor are the level of cover and the ability of the guarantee to be called on demand, without conditions and promptly paid without the delay or additional cost of long waiting periods for claims.

Key Insights: Liquidity

Donor agencies should seek HQLA recognition for approved development-focused guarantees.

By 2019, Basel IV, the finalization of Basel III, will require banks to hold a stock of HQLA that fully covers projected net cash outflows. Compared to the 60 percent banks were required to cover until 2016, this increased requirement will significantly reduce banks' appetite for originating illiquid exposures. To counteract this effect, donors could seek a policy exception that would allow certain SDG-exposures they are guaranteeing to qualify as HQLA, and preferably Level 1 HQLA.

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Donors should structure guarantees to pay on demand when possible. Similarly, rather than paying on demand, or before loan acceleration, some guarantors prefer to pay claims after a bank's collection efforts. A guarantee that requires such collection efforts has implications for a bank's liquidity and therefore has a negative impact on its financial statements and reduces the attractiveness of the guarantee. Insurance products fared better in this regard, but given that the focus of our analysis was primarily on guarantees and Basel, additional research is required on insurance products.

Key Insights: Sale, Assignment, or Transfer

Guarantees need to allow for seamless exits through enhanced assignment provisions. G20 banks typically do not want to hold loans to maturity. This is particularly true for longer tenors, which create asset-liability mismatches for banks with deposit-based funding structures. Although guarantees typically do include assignment and transfer rights, the process usually requires guarantor approval of the potential assignee. Therefore, originating banks cannot easily or quickly sell their exposure, and this directly reduces the attractiveness of guaranteed loans to risk managers and regulators who focus on the illiquidity of the particular asset. Although achieving true tradability of development guarantees is not feasible in the near term, streamlining their assignment and transfer provisions to provide clean exit mechanisms could be an important step to activating banks and capital markets.



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A nonprofit, nonpartisan think tank, the Milken Institute believes in the power of capital markets to solve urgent social and economic challenges to improve lives.

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ABOUT THE AUTHORS

Christopher Lee is a director at the Milken Institute's Center for Financial Markets and leads its Capital for Innovation program, which designs strategies and builds ventures to facilitate breakthroughs in areas ranging from global development to biomedical research.

Lee joined the Institute after his tenure as deputy director of the Development Credit Authority at the U.S. Agency for International Development. For this \$5 billion global credit platform, he oversaw strategy and product development, as well as investment origination involving more than 75 countries. In previous government roles and as an entrepreneur, private equity investor, and investment banker, Lee has been involved with launching many novel transaction structures, including funds for African agriculture private equity and environmental investments, financing facilities for global health commodities and education funding, and growth capital products for emerging market suppliers of multinational corporations. Over his career he has completed transactions across nearly 30 countries and more than 10 sectors ranging from health care to garments, technology, real estate, financial services, and telecommunications.

Lee is a member of the Bretton Woods Committee and serves on the advisory council for CureSearch Catapult, an organization that invests in new treatments for pediatric cancers. He earned a BS in finance and a BA in foreign affairs from the University of Virginia.

ABOUT US

Aron Betru is managing director of the Center for Financial Markets at the Milken Institute. Betru leads the Institute's Access to Capital and FinTech programs, as well as other strategic innovative financing initiatives to enhance social capital both in the U.S. and in developing countries. Betru is a member of the steering group for the Blended Finance TaskForce launched by the Business & Sustainable Development Commission, as well as co-chair for the Partnership for Lending in Underserved Markets, a joint initiative with the Milken Institute and U.S. Small Business Administration.

Prior to the Institute, Betru was the co-founder and CEO at Financing For Development, specializing in innovative financing solutions for international development. Betru pioneered new ways of leveraging guarantee-backed financing of public health commodities, mobilizing millions of dollars in both commercial lending for malaria and trade financing for reproductive health. His extensive experience includes international development roles at the United Nations Foundation, TechnoServe, and Dalberg Global Development Advisors, as well as private sector experience at McKinsey & Co. and Goldman Sachs.

Betru is a term member of the Council on Foreign Relations and a regular contributor to the Global Health and Diplomacy magazine writing on innovative finance in public health, as well as a contributor to the global dialogue on pandemic financing with speaking engagements at the National Academy of Sciences and Voice of America Interviews. He is a member of the board of directors for Calvert Impact Capital and FHI Foundation.

Betru holds an MBA from Columbia University, an MA from Johns Hopkins SAIS, and a BA in economics and international studies from Northwestern University.

ABOUT US

Paul Horrocks is the head of the private finance for sustainable development unit in the OECD in the financing for sustainable development division. Horrocks is working on a number of policy initiatives aimed at encouraging greater private sector investment in developing countries, in particular the policies and approaches that governments can adopt in order to scale up and mainstream blended finance.

Prior to this, Horrocks was a senior executive in the Australian Federal Treasury, advising the treasurer on investment and infrastructure policy, including providing proposals for Australia's G20 presidency on infrastructure. Horrocks has over a decade in senior leadership roles at the European institutions in Brussels, working in particular on European infrastructure policy and projects with the European Investment Bank. Prior to this Horrocks worked in a senior role in the private sector.

Horrocks has degrees from the University of Wales, a masters from the University of Liverpool, as well as an executive MBA from Vlerick Business School in Belgium. He also teaches blended finance at the Maastricht School of Management in the Netherlands.