FINAL REPORT
(For Limited Distribution Only)

COMPARATIVE REVIEW OF IFI RISK MITIGATION INSTRUMENTS AND DIRECT SUB-SOVEREIGN LENDING

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BNWP

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The report draws heavily on the outcomes of the Consultative Meeting of the International Financing Institutions (IFI). The meeting was held in Washington, DC on September 8, 2003, to follow up on the G8 request to The World Bank. The report also benefited greatly from discussions with staff members at various IFIs, which included: Paulina Beato, Inter American Development Bank (IADB); Lobe Ndoumbe, African Development Bank (AfDB); Stephen Wermert, Asian Development Bank (ADB); Gavin Anderson and Henry Russell, European Bank for Reconstruction and Development (EBRD); Patrick Thomas and Jose Frade, European Investment Bank (EIB); and Karim Allaoui, Islamic Development Bank (IsDB).

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1. Context for the Study

The Millennium Development Goals ("MDG") in the Water Supply and Sanitation sector (WSS, or hereafter, "water sector") call for halving the proportion of people without sustainable access to adequate quantities of affordable and safe water by 2015. Access to safe and reliable water and sanitation has also been recognized as fundamental to achieving the other goals of the United Nations Millennium Declaration. To meet the MDG in the water and sanitation sector it has been estimated that financial flows to the sector will need to double to $30 billion per annum through 2015[1].

The formation of the World Panel on Financing Water Infrastructure chaired by Michel Camdessus ("the Camdessus Panel") in late 2001, as a joint initiative of the Global Water Partnership, the World Water Council, and the 3rd World Water Forum was the result of the heightened awareness to the pressing need for improving and expanding access to water and sanitation in the developing world, and finding the capital to do so. The Panel's Report "Financing Water for All" released in March 2003, drew attention to the financial challenges of the sector.

Among other recommendations, the Camdessus Panel recommended that the Multi-lateral Financial Institutions ("MFIs" or "IFIs") take a number of steps to help meet the financing needs in the sector. Among these, the Panel recommended that:

> *"MFIs … should enhance and extend political risk coverage for projects, including the use of MFI guarantees… Guarantee and insurance schemes offered by MFIs should be expanded in scope and internal constraints on their use should be relaxed… The specific needs of the water sector should be better covered."*[2]
>
> *"MFIs that do not now lend to sub-sovereign entities should reconsider their policies, with the aim of permitting such lending subject to normal lending criteria."*[3]

The G8 summit noted the Camdessus Panel's message in its Water Action plan and called on the World Bank:

> *"in consultation with other IFIs to study and recommend necessary measures to implement the following proposals made by the World Panel on Financing Water Infrastructure [Camdessus Panel]: i) using their financing instruments in a more flexible manner to allow loans directly to sub-sovereign bodies, where appropriate; ii) developing guarantee and*

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[1] The Camdessus Report (page 3) provides a breakdown of estimated annual investment amounts required for the water and sanitation sector. The $30 billion figure includes only investments in Drinking Water ($13 billion) and in Sanitation and Hygiene ($1 billion), and does not include required water investments in municipal wastewater treatment, agriculture, environmental protection and industrial effluent. When including these investments the annual amounts required grow to an estimated $180 billion.

[2] "Financing Water For All", page 29

[3] Ibid, page 26

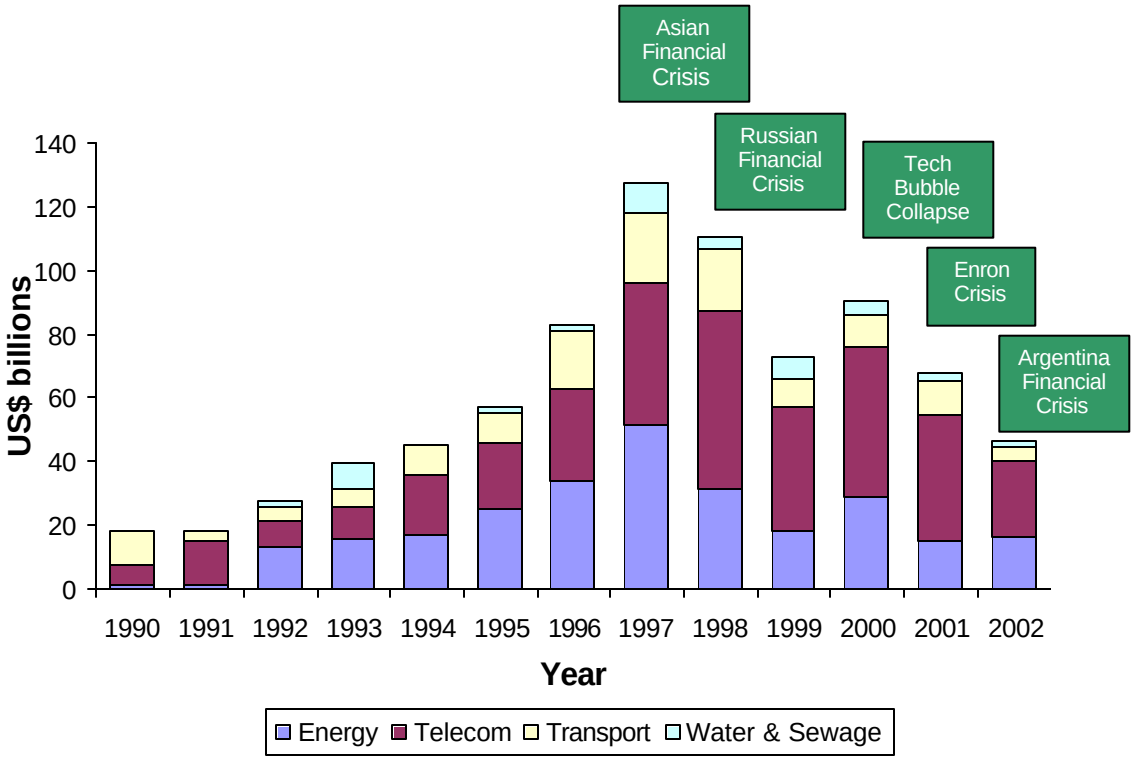
> *insurance schemes for risk mitigation, and; (iii) addressing the issue of sovereign and foreign exchange risk coverage."*

This study focuses on two of the three action recommendations noted above. Specifically, it looks at the current guarantee instruments offered by IFIs and their recent application in the water sector. Second, it looks at the current sub-sovereign lending programs and their recent levels of activity, particularly as related to the WSS.

2. Water and Sanitation Sector Investment Environment

For much of the 1990s the private sector played an increasingly important role in the provision of emerging markets' infrastructure and services in the power, water, transport and telecommunication sectors. From 1990 to 1997, private sector participation in infrastructure in the emerging markets grew at an average annual compounded rate of more than 32%, from $18.1 billion in 1990 to $127.5 billion in 1997, the peak year for such investments (see *Figure 2.1*). With the onset of the Asian financial crisis, however, private sector participation began to decline from its peak. Successive financial crises in both emerging and developed markets, challenged both existing investments in the emerging markets and the financial condition of many of the developed country investors in these markets. From its peak of $125.7 billion in 1997, private sector participation declined to $46.7 billion in 2002.

Figure 2.1: Private Sector Participation in Infrastructure by Sector, US$ Billions (1990-2002)



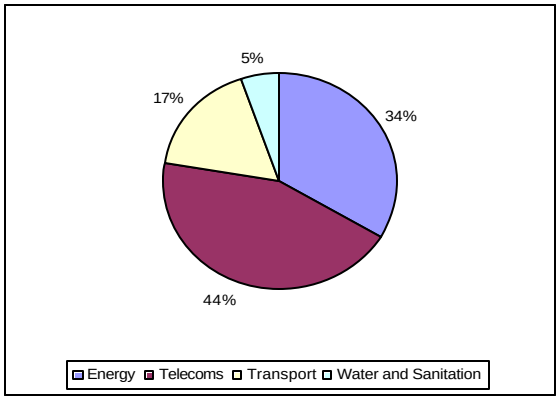
Source: PPI Database

While the gross value of private investments in infrastructure was significant during this period and was in 2002 still larger than the annual value of investment in 1990 in real terms, investor participation has varied greatly by sector. The telecommunications and power sectors have attracted the largest and most sustained investment flows. Between 1990 and 2002, private participation in power totaled US$270 billion, with an annual peak of US$51.6 billion in 1997. For the same period, private participation in the

telecommunications sector totaled some US$355.1 billion, with an annual peak of US$56.3 billion in 1998.

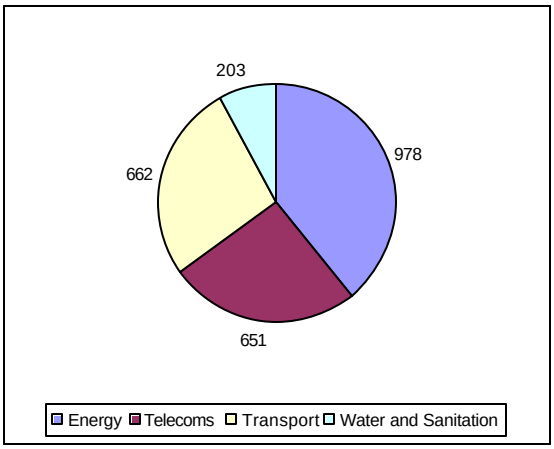
Thus, while the overall value of private sector participation in infrastructure totaled some US$805.2 billion from 1990 to 2002, the water sector accounted for only US$43.5 billion of this, or approximately 5.4%. (see *Figure 2.2*). Water supply and sanitation sector projects accounted for 8.1% by number of all infrastructure projects, or 203 of 2494 projects during the period between 1990 and 2001 (see *Figure 2.3*).

Figure 2.2: Private Participation in Infrastructure by Sector, 1990-2002 (US$ billions)



Source: PPI Database

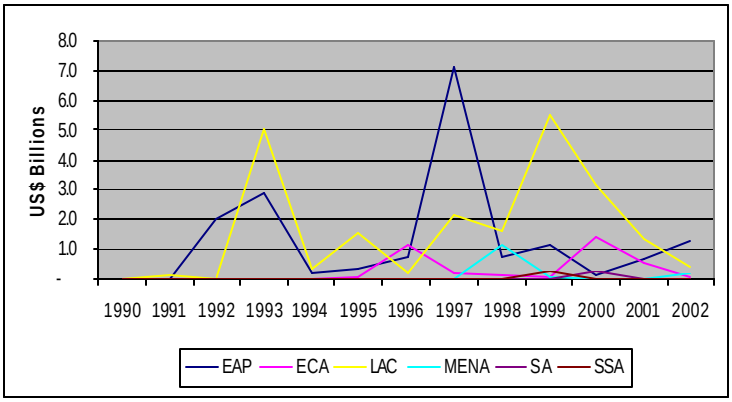
Figure 2.3: Private Participation in Infrastructure by Sector, 1990-2001 (number of projects)



Source: PPI Database

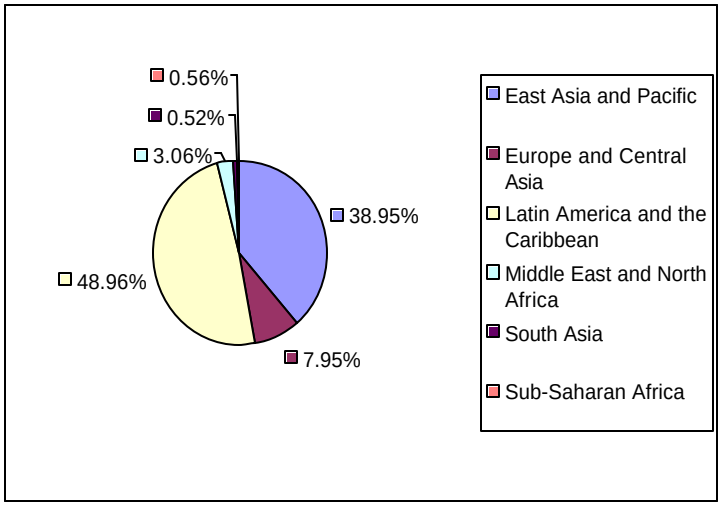
By region, WSS investment has been concentrated in both Latin America and East Asia. Latin America had accounted for 48% of total WSS private participation, with Argentina being the most prominent beneficiary of private sector involvement in the water sector. East Asia has accounted for another 38%. Taken together, both regions represent 87% of private sector investment in the water sector. Private sector investment in South Asia and Sub-Saharan Africa is so low, as to be virtually negligible. As highlighted in *Figures 2.4 and 2.5*, water sector investment in South Asia represents 0.43% of total infrastructure investment in that region, while that figure is 0.71% for Sub-Saharan Africa.

Figure 2.4: Private Sector Investment in the Water Sector by Region, 1990-2002



Source: PPI Database

Figure 2.5: Water Sector PPI by Region, 1990-2002



Source: PPI Database

At its peak in 1997, private participation in WSS brought $9.4 billion in investment to the emerging markets, approximately one third of the estimated amount needed to meet the MDG. By 2002, private participation in the WSS had fallen to just $1.9 billion.

The reasons for the limited amounts of investments are now widely known. The WSS suffers from several characteristics which make it more challenging for private sector investment than other infrastructure sectors. These include:

(i) *Water and sanitation as a "public/social good"*. Despite the fact that the poor often pay higher prices for bottled or trucked water than they would for privately provided tap water, there is a strong perception among some policy makers, NGOs, and advocacy groups that utility-provided water is a public or social good that should not be subject to for-profit provision. This

environment can make it difficult to effect agreed tariff increases or to enforce collection on bills.

(ii) *Relative small scale of water projects.* While major urban area water systems may be attractive investment targets, the majority of WSS system projects are at a smaller scale. The high costs of transaction structuring alone can make these investment opportunities too costly to justify.

(iii) *Unattractive economics.* The water sector is characterized by low returns on investment compared to other infrastructure sectors and by longer payback periods. In many cases, direct and indirect subsidies have kept tariffs well below even operations and maintenance costs, and substantial increases are neither politically nor socially feasible.

(iv) *Sub-sovereign risk.* Sub-sovereign governments typically have direct responsibility for water and sanitation. For investors, the sub-sovereign entity is frequently: (i) either the direct counterparty to their agreement; or (ii) the counterparty that stands behind a local utility. Many of these sub-sovereigns have limited experience with foreign investment or lending requirements, increasing political, contractual and financial risk for the investor.

(v) *Complexity and risks in the contractual and regulatory framework.* Water supply and sanitation sector transactions are often more complex than other infrastructure sector transactions. While most such transactions involve licensing, regulatory and contractual arrangements with multiple government entities. The sub-sovereign nature of most water projects can increase the number of parties to the transaction or subject the sub-sovereign parties to unanticipated mandated changes from the national level.

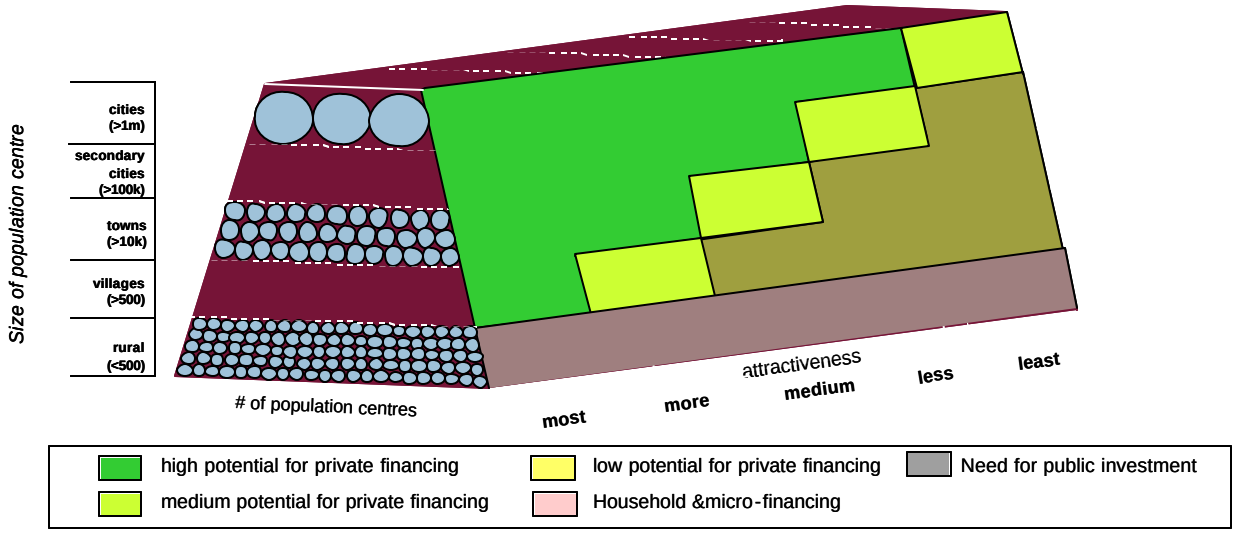
(vi) *Local currency revenues, foreign currency debt.* While water revenues are in local currency, long-term debt obligation are, in the absence of functioning local capital markets, typically denominated in foreign currency. Local currency depreciation will adversely affect the company's ability to repay the foreign exchange denominated debt, in the event that tariffs cannot be adjusted.

Figure 2.6 below visually depicts the private financing opportunity in the water and sanitation sector reflecting many of the challenges noted above. On the vertical scale is the size of the WSS system or opportunity. Generally, the larger the urban area served, the greater the attractiveness for private investment. The horizontal scale depicts the investment attractiveness based on perceived risk.

Assuming a reasonable ability to recover costs, in large population centers where the perceived risk is low, the potential for private finance in the water sector is high. As either of these factors decreases, i.e. smaller population centers and less attractive investments, the potential for private financing becomes lower. In rural areas with populations under 500, households and micro-financing options are favored over traditional private financing because of the smaller project scale. In slightly more populated areas such as villages, private financing is available only if the investment is

highly attractive. The potential for private investment becomes lower and eventually nil as an investment becomes perceived as less attractive. Private financing is most likely to occur in an urban setting with populations that are greater than 1 million. Given their scale and national importance, such projects have a high potential for private investment even if perceived risk factors are higher.

Figure 2.6

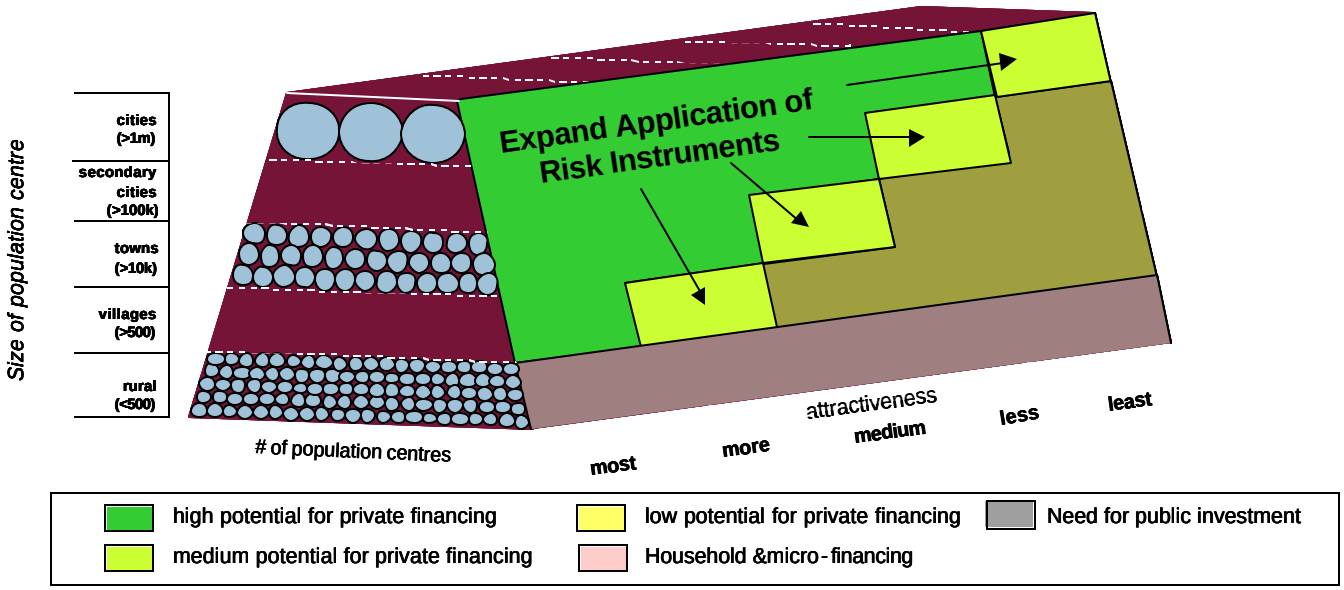


Source: The World Bank

The Camdessus Panel and G8 recommendations focused on seeking means to expand the use of IFI risk mitigation instruments to reduce perceived and real risks to investors in the sector and thereby to expand private sector flows, as depicted in *Figure 2.7.*

As the diagram demonstrates, there is a potential for the effective use of risk instruments in the medium to more attractive projects in villages and more populated areas. And there is a potential to expand the use of risk instruments to small population centers with less attractive investments. Projects that fall into the yellow areas that are not credit-worthy or low performing may also benefit from the expanded use of risk instruments, but are likely to need considerably more public sector investment and intervention before they would be attractive investment prospects even with improved instruments. Given the nature of the sector and domestic and foreign investors' interest, it is highly unlikely that the private sector alone will be able to meet the funding needs in the sector.

Figure 2.7



Source: The World Bank

As is evident, expanded use of risk instruments will not alone resolve the financing gap in the water and sanitation sector. Some parts of the sector will require continued public sector support for some time to come. The second recommendation of the Camdessus Panel and G8 to be reviewed in this study looks at the use of direct sub-sovereign lending as a means to expand needed financing to the sector. Expanded access to sub-sovereign lending could make a material difference in both improving financial flows to the sector and to prepare utilities for effective future private sector participation. In this regard, sub-sovereign lending may also be seen as an interim step to instill market discipline, and to achieve technical and financial efficiencies in the utilities' operations. As the study reveals, however, not all utilities are in a position to effectively utilize, account for, and repay such lending. Thus, while improved risk mitigation instruments and expanded sub-sovereign lending programs are necessary to mobilize financing for the sector, they are unlikely to be sufficient on their own to meet the funding shortfall for the sector.

3. Scope of Analysis

The Camdessus Panel and the G8 recognized the importance of risk mitigation instruments and sub-sovereign lending in contributing to closing the funding gap in the WSS sector. This study focuses on those two recommendations.

Covering the period 2001 to 2003, the study looked at the status and use of risk mitigation instruments—particularly in the water supply and sanitation sector—by the major international financial institutions (IFIs); and the status and use of direct sub-sovereign lending in the WSS sector by these IFIs. In addition, the study identified changes and improvements to these programs now being undertaken or contemplated by the IFIs to address the needs of the WSS sector.

The IFIs participating in the study include (in alphabetical order):

- The African Development Bank (**AfDB**)
- The Asian Development Bank (**AsDB**)
- The European Bank for Reconstruction and Development (**EBRD**)
- The European Investment Bank (**EIB**, non-EU programs only)
- The Inter-American Development Bank (**IADB**)
- The International Bank for Reconstruction and Development (**IBRD**, including IDA)
- The International Finance Corporation (**IFC**)
- The Islamic Development Bank (**IsDB**)
- The Multilateral Investment Guarantee Agency (**MIGA**)

The study was limited to looking at specific risk mitigation and guarantee instruments offered by the IFIs, and does not cover participation instruments such as A, B and C loan facilities or specialized instruments such as swaps. This report, however, does not explore the full range of devaluation risk instruments being considered in the market.

The remainder of the report is organized as follows:

Section 4 reviews the available risk mitigation (or guarantee) instruments offered by IFIs and their application to the water sector. Three classes of instruments are identified and reviewed: traditional political risk instruments (Section 4.1), contractual and regulatory risk instruments (Section 4.2), and credit risk instruments (Section 4.3). Each class of instrument is reviewed with respect to the kinds of risks covered, the IFIs offering that coverage, the basic terms and conditions for providing that coverage and use of those instruments, particularly in the water sector, since 2001. Indicative market perceptions of each class of instrument and perceived internal and external constraints to use of those

instruments in general and in the water sector are identified. While not a formal part of the study, the importance of addressing foreign exchange risk was evident from the outset of the work. Section 4.4 provides an overview of efforts IFIs are making to address these risks. Section 4.5 concludes the comparative review of IFI risk mitigation instruments with a review of the identified constraints to use of these instruments and actions IFIs are now taking to address these issues.

Section 5 of the report reviews existing and planned sub-sovereign lending programs, with particular attention to the WSS sector. IFIs use several mechanisms to provide financing to sub-sovereign entities. These include:

1. sovereign on-lending;

2. public sector financial intermediaries (such as national or sub-national development banks);

3. participation in investment funds;

4. direct lending to sub-sovereigns with sovereign guarantees; and

5. direct lending to sub-sovereigns without sovereign guarantees.

This study focuses on programs providing direct lending without sovereign guarantees.

Methodology and Limitations

The Comparative Review of Risk Mitigation and Direct Sub-Sovereign Lending Instruments (the Study) was undertaken to identify the instruments currently available from the leading IFIs, reported, constraints to their use, and plans underway at IFIs to address these constraints.

As designed, the study requested the Consultants to conduct a survey of international financial institutions' programs and products and to conduct interviews with responsible individuals at the IFIs. To enhance the findings of this survey, the Consultants also undertook limited interviews with private sector participants in the WSS sector, and with private insurers and brokers. The Consultants also drew on their own experience in advising on water sector and other infrastructure investment in the emerging markets.

For the purpose of this study, data on IFI guarantee and sub-sovereign lending activity was collected for the period January 1st, 2001 to June 30th, 2003.[4] Information initially compiled from IFIs and market interviews was presented at a World Bank hosted meeting, on September 8, 2003, of officials responsible for guarantees and sub-sovereign lending from each of the participating IFI institutions. Data updates and the conclusions and recommendations from that meeting were then incorporated into this report. During

[4] On September 30, while this report was in production, MIGA signed a $51.8 million guarantee for the WTE Moscow water treatment plant, covering equity and shareholder loan against expropriation and breach. This data is excluded from this analysis due to the timing of the transaction.

the course of this study, a number of revisions and improvements to IFI instruments and programs were being contemplated or undertaken. Therefore, the data contained in this Study represents a status report of evolving instruments and programs reported as of October 10, 2003.

4. Overview of IFI Risk Mitigation Instruments

While risk mitigation instruments have been available for foreign investment in the emerging markets for several decades, in the late 1980s the International Financial Institutions began to introduce a wider range of instruments and to develop programs to promote their use.

These instruments have been designed to address the need for non-commercial, political risk mitigation products by lenders, and debt and/or equity investors contemplating investment in emerging markets. In principle, these products have been developed to mitigate risks that investors have little ability to control. These are risks typically associated with the political, legal, contractual and social environment of a country. IFIs have sought to avoid covering commercial risks which investors should be able to manage on their own.

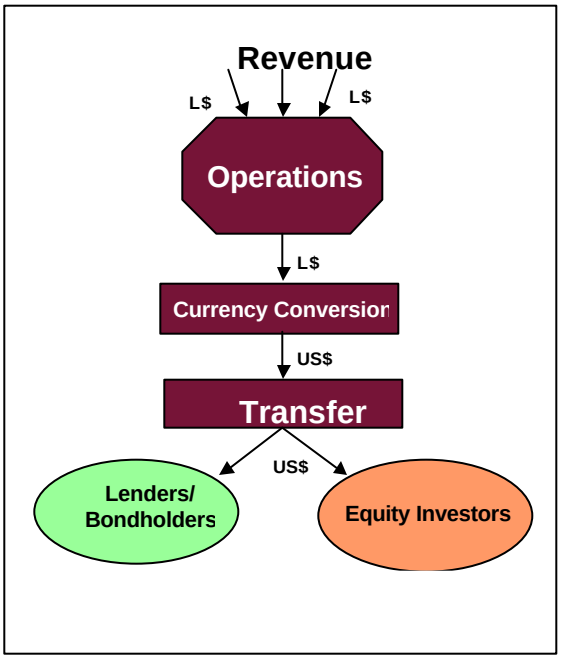
The risk mitigation products offered by the IFIs provide three important benefits for lenders, investors and participating countries/projects. They:

1. **Open markets to potential investment.** The ability to access these instruments at reasonable cost has expanded investor and lender interest in opportunities in the emerging markets. For many investors, countries not covered by these instruments cannot be considered for investment opportunities. Thus, the availability of the instruments themselves can serve as a threshold test for initial investment consideration.

2. **Enhance the credit-worthiness/lowering investment costs of an investment.** Use of these products enhances the credit-worthiness of a financing by mitigating specific risks, thereby lowering the costs of financing for investors and ultimately the tariff structure needed to repay that investment.

3. **Provide access to honest broker services**. IFIs are generally considered to be impartial parties to a transaction from both the investor and country perspective. IFI participation in the project through a risk mitigation instrument provides the investors additional comfort that should the project experience challenges, the IFI may be able to assist in resolving them fairly.

Figure 4.1: The Project Cash Flow Structure



To illustrate risk areas and risk mitigation instrument coverage, a simple project cash flow diagram has been used.

Figure 4.1 highlights in simple terms the financial flows of a typical emerging markets water project with foreign investment participation. Tariffs (and at times subsidies or transfers) provide revenues to the project company for provision of WSS services.

In this simplified model, after paying local operating and maintenance costs, funds are used to service debt and provide returns to equity. For foreign currency debt service and equity returns, the project company converts local currency into foreign exchange and transfers it out of the country to the lenders/bondholders (for debt service) and to the equity investors, usually in the form of dividends.

Figure 4.2 illustrates in simplified form a range of non-commercial risks that such a project faces. These risks and the products developed and offered by the IFIs to cover them can be generally classified into four categories:

1. "Traditional" Political Risks

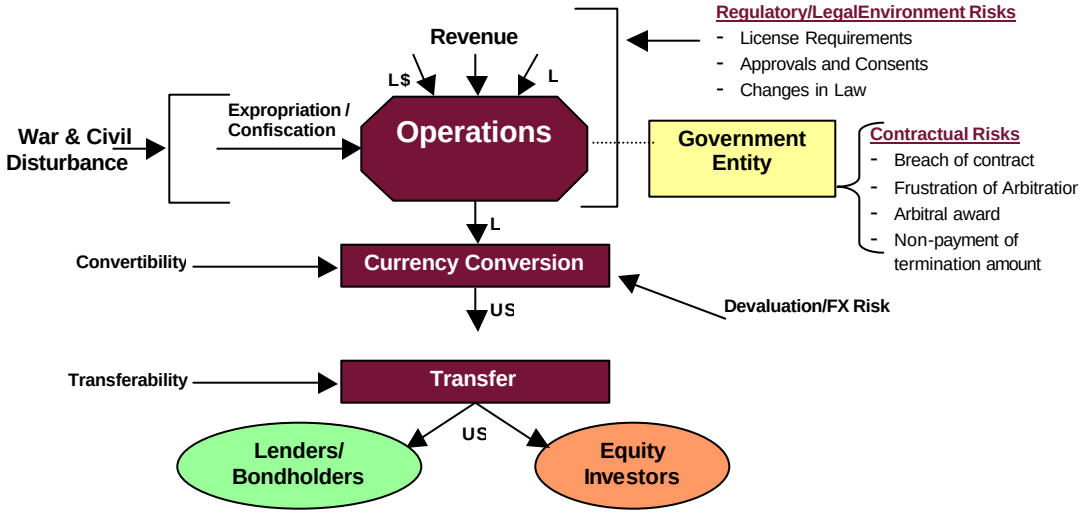
2. Contractual and Regulatory Risks

3. Credit Risks

4. Foreign Exchange Risks

IFIs have been broadening the coverage of their risk instruments and such categorization is a convenient but not rigid division of instrument coverage.

Figure 4.2: Risk and the Project Cash Flow Structure



Before reviewing these risks, the instruments available and their use in detail, the section below looks at the overall use of IFI risk mitigation instruments between 2001 and 2003, and their application in the water supply and sanitation sector.

Aggregate Application and Use of IFI Risk Mitigation Products, 2001 – 2003

One hundred and twenty-four guarantees have been issued by the nine IFIs since 2001. Of these, 52 were for infrastructure projects (42% of the total number of guarantees) accounting for $2.3 billion[5], or 36% of all guarantees issued by value. During this period however, only four WSS projects received guarantees—accounting for less than 1% of all guarantees issued by value or 1.5% of the value of all infrastructure guarantees.

Two of the four guarantees in the WSS sector were issued by IFC, one by IsDB and one by MIGA. One of the two IFC water projects was the result of the new efforts by the IFC/IBRD Municipal Fund Unit launched earlier this year. Of the four guarantees issued in the WSS sector, one was a traditional political risk instrument (issued by MIGA), one was a contractual/regulatory risk instrument (issued by IsDB) and two were credit risk instruments (both by IFC).

Figure 4.3 shows that of the guarantees issued for infrastructure projects, 46 covered traditional political risks, 14 covered contractual and regulatory risks and 6 were credit risk instruments[6]. The risks covered by these instruments, their use by IFIs and their utility in the WSS sector is evaluated below.

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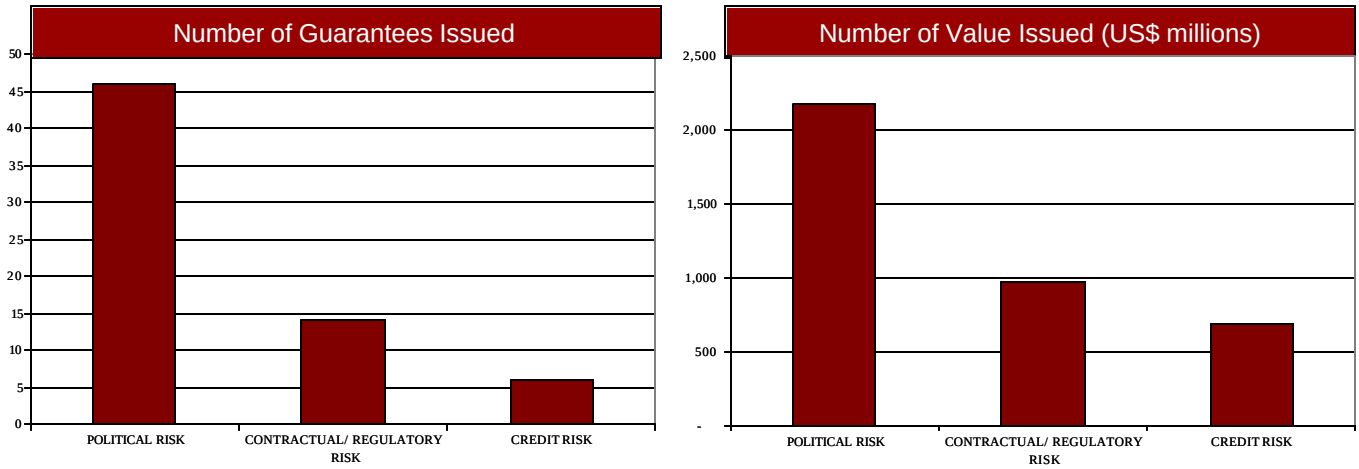
[5] The figure refers to the value of the debt and/or equity covered by the guarantee.

[6] While between 2001 and 2003 52 guarantees were provided to infrastructure projects, the sum of the breakdown into traditional political risk instruments, contractual and regulatory risk instruments and credit risk instruments is higher due to instruments covering one or more categories of risk. The guarantees provided by IBRD covered both traditional political risks and contractual/regulatory risks, and the

Figure 4.3: Types of Guarantees for Infrastructure Projects by number and value (2001-2003)



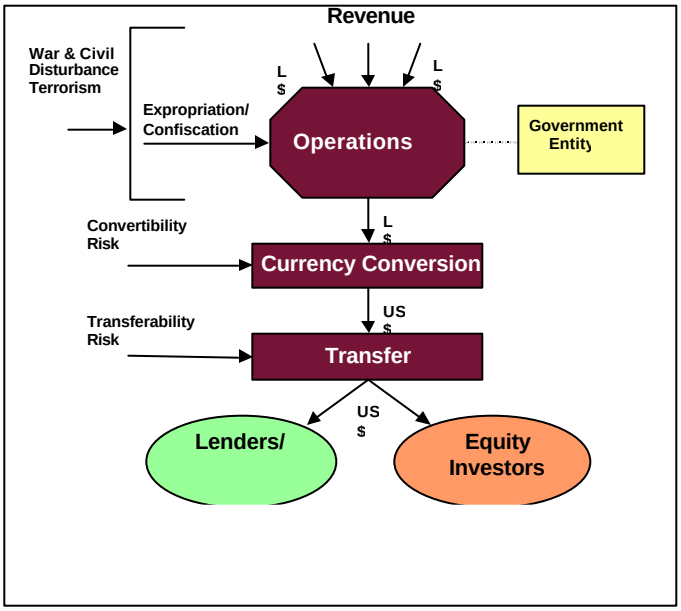
4.1. Traditional" Political Risk Instruments

"Traditional" political risk instruments are so called because they have a long standing and acceptance in the capital and investor markets. Introduced in the 1960s, the risks these products cover are now well understood in the capital markets and have established payment and claims processes acceptable to lenders and rating agencies. Specifically, these risks are:

- War and Civil Disturbance
- Expropriation and Confiscation
- Currency Convertibility/ Transferability

Figure 4.4 shows these risks as they impact a typical project. MIGA's definitions of these risks and coverages is similar to that of other IFIs and is used below. Recently, terrorism coverage has been added by some institutions. However, at present, coverage for terrorism is generally not provided by private insurers who also provide traditional political risk insurance.

Figure 4.4



guarantee provided by IADB covered the non-payment of a termination amount, which falls under the contractual/regulatory risk category, as well as other traditional political risks. Also five MIGA projects which provided coverage for Breach of Contract also covered for certain traditional political risks. In this analysis credit risk coverage, which by nature covers all other risks, has been counted separately.

War and Civil Disturbance insurance "protects against loss from damage to, or the destruction or disappearance of, tangible assets caused by politically-motivated acts of war or civil disturbance in the host country, including revolution, insurrection, coups d'état, sabotage, and terrorism. [It] also extends to events that, for a period of one year, result in an interruption of project operations essential to overall financial viability."[7]

"Expropriation [coverage] protects against loss of the insured investment as a result of acts by the host government that may reduce or eliminate ownership of, control over, or rights to the insured investment. In addition to outright nationalization and confiscation, "creeping" expropriation--a series of acts that, over time, have an expropriatory effect--is also covered."[8]

War and Civil Disturbance and Expropriation products cover the insured against acts that directly affect the business's operations. Convertibility and Transferability coverages provide insurance against an inability to convert local currency to foreign currency and the inability to transfer that foreign currency abroad. Specifically, as defined by MIGA:

Convertibility and Transferability coverage "protects against losses arising from an investor's inability to convert local currency (capital, interest, principal, profits, royalties and other remittances) into foreign exchange for transfer outside the host country. The coverage insures against excessive delays in acquiring foreign exchange caused by host government action or failure to act, by adverse changes in exchange control laws or regulations, and by deterioration in conditions governing the conversion and transfer of local currency. Currency devaluation is not covered."[9]

Figure 4.4 shows where these coverages apply in the simplified cash flow model of the water business.

Five of the nine IFIs offer traditional political risk insurance cover as shown in *Figure 4.5* below (please see the Appendices for details on each IFI's products). While MIGA offers these products on a standalone basis, AsDB and IADB offer them in conjunction with other products (typically a loan). IBRD and IsDB do offer the cover on a standalone basis, but tend to write it in as part of broader, usually regulatory and contractual coverages (see Section 4.2). *Figure 4.5* does not reflect the fact that credit guarantees offered by a number of institutions will, by nature, cover these risks also. (Please see Section 4.3 which discusses credit risk instruments).

[7] MIGA: Investment Guarantee Guide. See: http://www.miga.org/screens/pubs/guides/invest.htm.

[8] Ibid

[9] Ibid

Figure 4.5: IFI Political Risk Mitigation Products

	Coverage	**Political Risks**		
Institutions	**Debt/Equity Coverage**	**Expropriation/ Nationalization**	**Transferability/ Convertibility**	**War and Civil Disturbance**
Sovereign Guarantee Unnecessary				
IBRD PRG	Debt	?	?	?
AsDB PRG (Public Sector)	Debt	?	?	?
IsDB Export Credit Insurance Policy	Debt	?	?	?
IsDB Bank Master Insurance	Debt	?	?	?
Sovereign Guarantee Unnecessary		?	?	?
MIGA PRI	Debt/Equity	?	?	?
IADB PRG (Private)	Debt	?	?	?
AsDB PRG (Private Sector)	Debt	?	?	?
IsDB Foreign Investment Insurance Policy	Debt/Equity	?	?	?

IFIs also differ as to whether a sovereign guarantee is required. The private sector windows of IADB, IsDB and AsDB do not require a sovereign guarantee, whereas, IBRD and the public sector windows of AsDB and IsDB do. By charter, MIGA does not require a sovereign guarantee for any of its products. Notably, of the five institutions, only MIGA and IsDB provide coverage to equity investors.

Level of Activity 2001-2003:

Figure 4.3 above showed that the use of traditional political risk instruments far outweighed use of other available instruments, whether by number or value. *Figure 4.6* shows the guarantee activity by IFI in issuing these covers. With 39 guarantees issued, MIGA had the greatest activity level of all the IFIs in the study. However, program differences between the IFIs, the structure of MIGA and the structure and function of other IFI guarantee departments account for much of this difference. These matters are discussed further below.

Figure 4.6: Traditional Political Risk Coverage for Infrastructure Projects by IFI

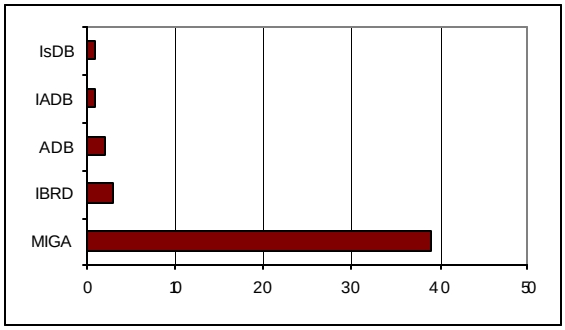
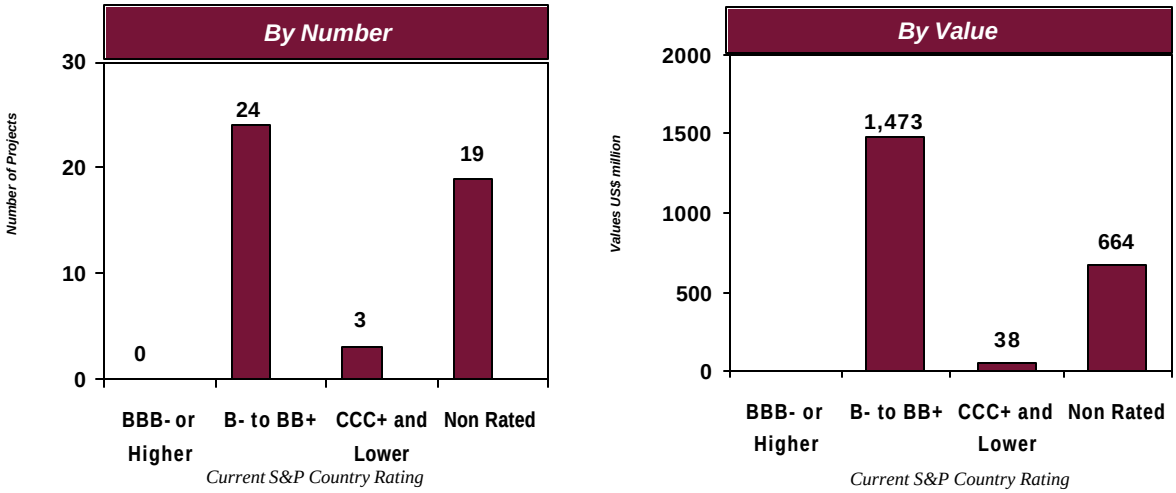


Figure 4.7: Traditional Political Risk Coverage and Country Rating



The analysis also looked at which countries the guarantees were being issued for. Using S&P country ratings[4] as a proxy for the stability and transparency of an investment regime, the distribution of guarantees issued to investment and non-investment grade countries was reviewed.

Figure 4.7 shows that the traditional political risk guarantees written by the IFIs were providing cover almost exclusively in non-investment grade countries. In fact, during the period 2001 to 2003, no traditional political risk guarantees were issued in investment grade countries by any of the IFIs, and nearly 50% of the covers written were issued in C-range rated or non-rated countries. Designed to cover political risks in uncertain markets, the data suggests that the traditional political risk instruments are serving this purpose.

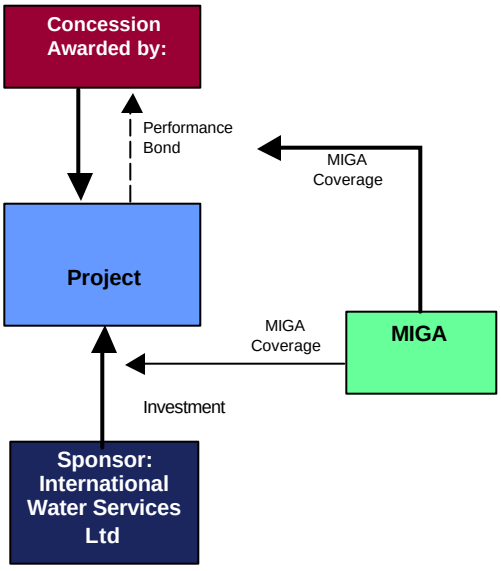
[4] Standard & Poor's sovereign ratings as of August 2003 and at the time the guarantee was issued were reviewed. Only three countries experienced substantial downgrades during the study period, these were Argentina, Brazil, and Ecuador. The ratings reflected in the Figures are as of August 2003.

Market Perceptions of Product:

A very significant aspect of the success of any guarantee instrument is its acceptance by lenders, investors, and other insurers in the marketplace. With more than 3 decades of experience with these instruments, the capital markets are now well accustomed to their use. In many respects, these instruments can be said to have been "productized." That is, the risks they cover are well defined, the basis upon which claims can be made and payments received is well established, the ability and willingness of the guarantor to make payments in accordance with the guarantee in a timely manner is recognized and the ability of the IFI to help effect remedies when these risks arise combine to make these coverages into well defined "products" readily acceptable to investors and lenders. This in turn is reflected in a lower cost of borrowing when these instruments are used. This characteristic is not yet well established with the other classes of instruments and is one of the key constraints identified for their wider use.

Application in WSS:

Despite the success of the traditional political risk instruments in the market generally, the reality is that they have rarely been used in the WSS sector. Since 2001, only two guarantees were issued to water sector projects. The first one was provided by MIGA to investors in the Guayaquil concession, and constituted MIGA's first water project. The details of this transaction are highlighted below. The second one was provided by IsDB to investors in the Port Sudan Desalination Facility. This limited use of traditional political risk instruments in the water sector vis-à-vis a much larger use for other sectors is generally attributed by IFIs to limited demand for the products in the WSS sector. In other words, the supply of bankable projects that could benefit from credit enhancement is limited. Water sector sponsors have indicated that while traditional political risk coverage is important, other risks and risk cover, such as for contractual/regulatory risks and devaluation risks, need to be addressed before traditional risk instruments can even be considered.



NOTABLE WATER PROJECT: Guayaquil

Figure 4.8: Guayaquil Project

MIGA provided its first water sector guarantee in 2001 (See *Figure 4.8*). The $18 million guarantee—against the risks of expropriation, war and civil disturbance and notably, wrongful call of the sponsor's performance bond—covers International Water Services (Guayaquil) BV of the Netherlands' investment in an Ecuadorian subsidiary to privatize potable and sanitary water services in Guayaquil. Guayaquil, Ecuador's major port, is the country's largest city with 50,000ha and some 2.5m residents. The project entails a 30-year concession to upgrade and operate waterworks services and was awarded by

Ecuador's state waterworks utility Empresa Cantonal de Agua Potable (Ecapag). Overall investment is expected to be around $1billion. The winning consortium, International Water Services, is to establish over 55,000 new connections in the first five years of the concession and have a service coverage of 95% by the 2011. The auction for the concession took place on December 18, 2000 and International Water Services consortium was the only bidder.

In addition to MIGA's traditional political risk coverage, the insurance also covers the investor against the wrongful call of a performance bond, guaranteeing the company's successful management, expansion, and operation of the water services. The bond was posted by the company in accordance with the 30-year concession awarded by the government. This was MIGA's first ever cover for a performance bond.

Internal and External Constraints to Use of these Instruments

MIGA's much greater activity level in issuance of these guarantees products provides useful insight into important differences between IFI guarantee programs. Founded in 1988 as a member of the World Bank Group, MIGA's primary purpose is "to encourage foreign direct investment (FDI) into developing countries by providing:

- Investment guarantees (i.e., insurance) to investors against the political risks of transfer restriction, expropriation, breach of contract, and war and civil disturbance in the host country; and
- Technical assistance to host governments on means to enhance their ability to attract foreign direct investment."[5]

A number of the IFIs reported that with the establishment of MIGA, they have sought not to duplicate its program and offerings but to provide a broader or different range of products, often tied to other activities of the IFI. For example, AsDB offers traditional political risk insurance products, but in combination with lending for the specific project or sector. The combined interventions are understood to provide better utilization of each of the products and more points of dialogue between the IFI and the government. The IBRD also offers these covers, but usually in combination with more complex regulatory and contractual guarantees—and rarely on a standalone basis.

IFIs reported that the extent and pace of use of these and other risk instruments is affected by a number of other factors both internal and external. These include:

- **Sovereign versus non-sovereign guarantee requirement**s. MIGA, by charter, does not require or request a sovereign guarantee. IBRD and the public sector windows of most IFIs do require sovereign guarantees. Securing such guarantees can be time-consuming and usually must be done in the context of the IFI's larger lending and assistance program. While MIGA's activities are coordinated with the

[5] MIGA: Investment Guarantee Guide. See: http://www.miga.org/screens/pubs/guides/invest.htm.

overall Country Assistance Strategy (CAS), they are able to issue guarantees without the complexity of seeking a sovereign counter-guarantee.

- **Internal constraints**. As an organization, MIGA is structured primarily as a risk insurer. Most other IFIs have broader mandates with an emphasis on development lending or private sector financing. Although many of these organizations have dedicated guarantee departments, these products and services are just one of a number of products and services available through the IFI and therefore must compete for management and task manager attention. Where lending is the priority of the bank, and guarantees are scored at parity with loans, guarantees are unlikely to be championed from within the institution.

- **External constraints**. Even where guarantees are scored preferentially to loans, where a sovereign agreement is needed, most country officials would prefer loan funds to guarantees. Therefore, host country government understanding and acceptance of the use of guarantee products can be a constraint.

- **Program constraints**. Finally, despite the fact that most significant infrastructure projects (particularly in the WSS sector) take a number of years to come to market, it is not often that guarantees are actively contemplated in the Country Assistance Strategy or water and sanitation sector strategy work. Given the requirements of some IFIs to program product use in accordance with the overall assistance strategy, inability to include the potential use of guarantees for projects in the sector can be a constraint.

Taken together, MIGA's focused, streamlined and non-sovereign dependent traditional political risk products and services are more "market-ready" than those of some other IFIs at present.

The overall actions IFIs are taking to improve access to their risk products is summarized in Section 4.5 below.

4.2 Regulatory & Contractual Risk Instruments

Regulatory and Contractual Risk coverages offered by IFIs include:

- Breach of contract;
- Changes in law;
- License requirements;
- Approval and consents;
- Obstruction in the process of arbitration;
- Arbitral award following a covered default;
- Non-payment of a termination amount

As private sector investment in emerging markets infrastructure began to increase significantly in the early 1990s, it became clear that there were a series of risks investors and lenders faced which were not addressed by the traditional political risk instruments. Private participation in infrastructure is enabled by structured legal and financial agreements which specify the rights and obligations of the investors, the government, and in the WSS sector, the sub-sovereign entity. The reliability and enforceability of these contracts and of undertakings by the government (national or sub-sovereign) emerged as a significant risk to infrastructure investors.

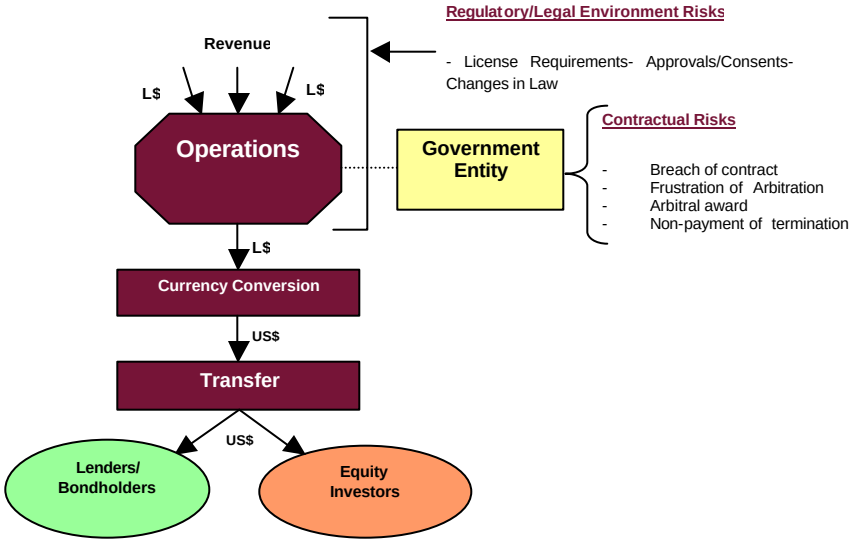
Moreover, in most countries the regulatory environment was undergoing rapid evolution—often involving the creation of an independent or quasi-independent regulatory body and the adoption of new forms of price and performance regulation. Licensing, tariff, universal service and other conditions of operation for regulated utilities were subject to material change. With contracts spanning ten to 30+ years in some cases, investors faced potentially significant risks to their business models from regulatory change.

Responding to these investor concerns, the IFIs began to introduce guarantee coverages to address contractual and regulatory risks faced by investors. By nature, such coverage is more complex to write than traditional political risk cover as it relies on the legal documentation underlying the specific transaction and the regulatory undertakings the government has given.

Events that would trigger a call of the guarantee must be clearly defined. And typically, the remedies specified in the contractual or regulatory documents have to be exhausted prior to receipt of payment from the guarantor. (In response to market concerns, a number of IFIs will now provide payment against a guarantee at the time of proof of legitimate claim, thereby enabling debt service to continue while the dispute is going through the resolution process).

Figure 4.9 depicts in simplified form where these risks are faced by investors. .

Figure 4.9: Regulatory/Contractual Risks and the Project Cash Flow Structure



Because of the specialized nature of these coverages, they have been until recently offered as a customizable menu of options for an investor/lender where specialized cover was written to address specific project requirements. As familiarity with these coverages has increased within the IFI and (to a lesser extent) the investment community, many of the specified risks are now being covered under a Breach of Contract policy.

MIGA's relatively recent Breach of Contract guarantee defines the product as "protect[ing] against losses arising from the host government's breach or repudiation of a contract with the investor. In the event of an alleged breach or repudiation, the investor must be able to invoke a dispute resolution mechanism (e.g., an arbitration) in the underlying contract and obtain an award for damages. If, after a specified period of time, the investor has not received payment or if the dispute resolution mechanism fails to function because of actions taken by the host government, MIGA will pay compensation. MIGA may make a provisional payment pending the outcome of the dispute resolution mechanism."[6]

IBRD's Partial Risk Guarantee "ensures payment in the case of debt service default resulting from the nonperformance of contractual obligations undertaken by governments or their agencies in private sector projects. Sovereign contractual obligations vary depending on project, sector and country circumstances…."[7]

As noted previously, IBRD and other IFI's extend these guarantees to also cover traditional political risks.

As shown in *Figure 4.10* six of the nine IFIs in the study provide some form of Contractual/Regulatory risk coverage. Of these, the World Bank's Partial Risk Guarantee appears to be the most comprehensive. However, all six offer breach of contract coverage, which can extend to all risk events noted in this chart. In principle, contractual risk instruments may mitigate devaluation risk, if tariff escalation provision clauses are carefully structured in the contract. Of note, only MIGA and IsDB offer equity coverage.

EBRD could also in principle offer such a debt guarantee product without sovereign guarantee but has found co-financiers ready to share such risks pari passu with EBRD provided EBRD is lender of record under it's A/B loan scheme. In the late 1990s it carved out breach of contract risk from sponsor guarantees on debt to two WSS projects, but has not since found sponsor demand for such an instrument.

[6] http://www.miga.org/screens/services/guarant/risks/risks.htm

[7] http://www.worldbank.org/guarantees/html/guar_ibrd_risk.html

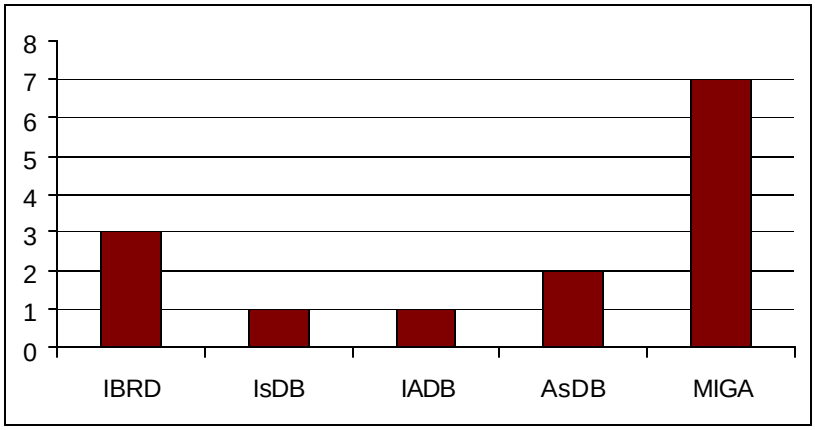
Figure 4.10: IFI Contractual Risk Mitigation Products

	Coverage	Contractual						
Institutions	**Debt/Equity Coverage**	**Breach of Contract**	**Changes in Law**	**License Requirements**	**Approvals and Consents**	**Obstruction in the process of arbitration**	**Arbitral award following a covered payment**	**Non-payment of a termination amount**
Sovereign Guarantee Requirement								
IBRD PRG	Debt	?	?	?	?	?	?	?
AsDB PRG (Public Sector)	Debt	?						
IsDB Export Credit Insurance Policy	Debt	?						
IsDB Bank Master Insurance	Debt	?						
AfDB (Public Sector)	Debt	?	?	?	?	?	?	?
Sovereign Guarantee Unnecessary								
MIGA PRI	Debt/Equity	?					?	?
IADB PRG (Private)	Debt	?	**Coverage Possible**					?
AsDB PRG (Private Sector)	Debt	?	**Coverage Possible**					
IsDB Foreign Investment Insurance Policy	Debt/Equity	?	?			?	?	

Level of Activity 2001-2003

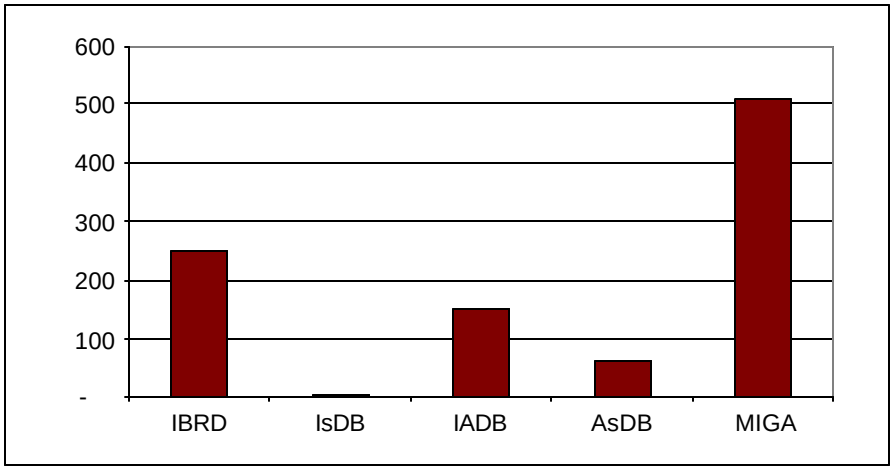
Between 2001-2003, 14 infrastructure projects have been covered for some form of contractual or regulatory risk (*Figure 4.11*). During this period, seven guarantees were issued by MIGA covering breach of contract. As with the traditional political risk instruments, MIGA has been the most active in providing contractual/regulatory coverage, even if its level of activity has been lower (39 traditional political risk products compared with 7 contractual/regulatory guarantees). The remainder of the guarantees were provided by four IFIs. Three guarantees were issued by IBRD and covered a wide range of contractual/regulatory risks alongside covering other more traditional political risks. These required sovereign counter guarantees. Also, two guarantees were issued by AsDB and covered a wide array of contractual/regulatory risks alongside covering other more traditional political risks. One guarantee was issued by the IADB and covered the non-payment of a termination amount. The $6 million guarantee issued by the IsDB was for the Port Suez desalination project in Sudan. It covered breach of contract as well as the more traditional political risks. This was the only WSS project closed during this period that made use of a contractual/regulatory guarantee. The cover was backed by a sovereign counter-guarantee.

Figure 4.11: Number of Contractual/Regulatory Risk Guarantees Issued between 2001-2003 by IFI



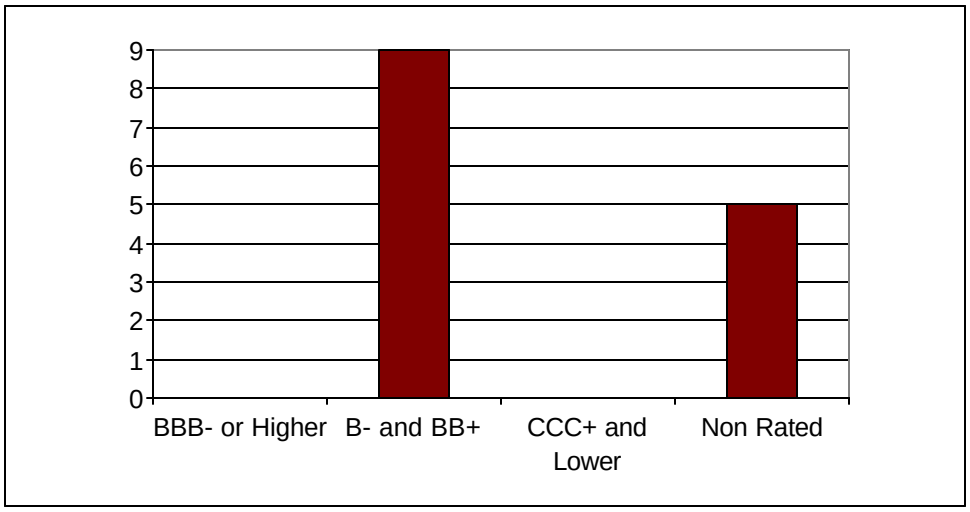
The volume and value of issue of these instruments was approximately 30% that of the traditional political risk instruments. Total value of coverage for these instruments amounted to $976 million, with MIGA coverage accounting for approximately half (*Figure 4.12*).

Figure 4.12: Volume of Contractual/Regulatory Risk Guarantees Issued between 2001-2003 by IFI (US$ millions)



Nine of the fourteen guarantees (*Figure 4.13)* were issued in countries with an S&P rating between BB+ and B-, and five in non-rated countries. No guarantee was issued for a project in an investment grade country. During this period, only one regulatory/contractual risk coverage was issued for a WSS projects. This was in Sudan, a non-rated country.

Figure 4.13: Infrastructure Projects Covered by Contractual/ Regulatory Risk Instruments



Market Perceptions of Product:

Feedback from project sponsors and lenders suggests that contractual/regulatory coverage is in strong demand, second only to devaluation risk coverage. The complexity of most infrastructure financings and the experience of investment and financial crises in the late1990s and early 2000s has demonstrated the need to mitigate the very risks that these products cover. However, many market participants were unclear regarding the availability of these instruments, reported that the processes for obtaining them were perceived to be complex and cumbersome, and that the risks they can cover and their actual value in the marketplace in reducing the costs of financing was uncertain. Further, for the investors themselves, the limited availability of equity coverage leaves them exposed to risks difficult to justify to increasingly reluctant boards. Thus while lenders may be provided some assurance regarding debt service, the risks faced by the core equity investors needing to mobilize debt financing are not addressed by most IFIs products.

Application in WSS:

In many respects, contractual and regulatory risk coverage is ideally suited to water sector investments. Complex, multi-party agreements and evolving regulatory frameworks characterize WSS projects even more than most other infrastructure sector projects. Nevertheless, only one WSS sector project since 2001 has taken advantage of these instruments, and that investment amount was modest. Once again, IFIs reported limited demand for these products from WSS sector investors.

Internal and External Constraints to Use of these Instruments:

While instruments to mitigate contractual and regulatory risks are among the top requests of infrastructure investors, broader use of these instruments face a number of constraints.

First, these coverages have not yet achieved the same level of market understanding and acceptance as the traditional political risk instruments. More recently introduced, and subject to the specific terms of the legal and regulatory agreements negotiated in an individual project, the trigger events for payment and the claims process are not yet standardized or well understood by investors or lenders. To a certain extent by nature, these instruments are unlikely to achieve the same level of "productization" as the traditional political risk instruments have. At the same time, a number of market participants have indicated only vague awareness of these instruments and how they function, suggesting a broader information outreach campaign may increase demand and use of the instruments.

Second, given potential uncertainty in the claims payment process or timing, as currently structured, lenders must be satisfied that debt service will continue even in the face of a contractual dispute. While a number of IFIs are now providing such assurances, it appears that the market is still not fully clear as to the terms and conditions under which lenders would be paid. As such, the structure of the instrument suggests a broader use for equity investors. Yet as noted above, only two IFIs offer this coverage to equity investors.

Third, these products suffer from the same internal IFI constraints and external host government constraints as do the other products. These include how guarantees are scored (versus loans), the need to include guarantees as a consideration in the Country Assistance Strategy process and host government preferences for loans rather than guarantees of third party investment. Moreover, due to their greater complexity, negotiating and finalizing the terms and conditions of this coverage is in general more time consuming than for traditional risk products.

Finally, and particularly for the water and sanitation sector, these guarantees must support undertakings by sub-sovereign entities. For the capital markets to value the IFI guarantee sufficiently to reduce the costs of a financing, the contractual documentation, dispute resolution, and claims processing procedures must be very well defined. Many sub-sovereign governments lack the experience and ability to be able to fully specify such terms and conditions and some are unable to exert effective influence over issues such as national regulatory reform or changes in license conditions. For these reasons, a number of investors have indicated that they prefer to see this coverage backed by a sovereign counter guarantee, effectively ensuring that the sovereign supports and stands by the agreements made by the sub-sovereign. While such preferences are understandable, involving the sovereign can add delays to the documentation and finalization of the deal.

4.3 Credit Risk Instruments

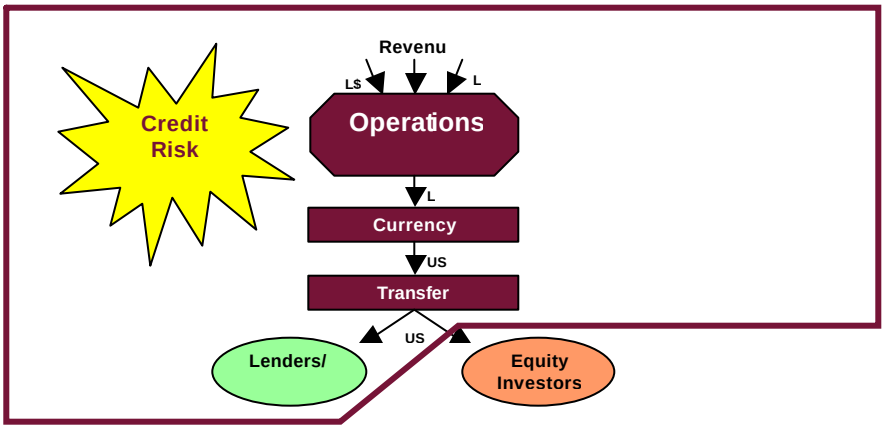
Credit risk instruments provide coverage specifically for lenders and/or bondholders. They do not cover equity. AsDB's definition of credit risk instruments applies to most of the IFIs' credit guarantee products.

"Partial Credit Guarantees (PCGs) are designed to cover that portion of the debt service that falls beyond the normal tenure of loans available from commercial lenders. They are generally used for projects that need long-term funds to be financially viable. PCGs cover all events of nonpayment of the guaranteed obligation. In that sense, PCGs are comprehensive guarantees of principal and/or interest for those maturities that cannot be obtained from commercial lenders without credit enhancement. PCG cover is particularly useful for projects in Developing Member Countries (DMCs) with restricted access to the financial markets, but which are considered fundamentally creditworthy and sound by ADB." [8]

While some institutions' coverage apply to later maturity, other institutions cover part of the debt service throughout the life of the loan.

As *Figure 4.14* shows, these instruments can cover all events of default, from political risks to commercial risks. These guarantees can be issued for both local and foreign currency borrowings. Their ability to credit enhance a local borrowing is emerging as a significant area of focus for many of the IFIs in promoting WSS investment.

Figure 4.14: Credit Risk and the Project Cash Flow



[8] *ADB's Private Sector Operations, Catalyzing Private Investments Across Asia and the Pacific; February 2002, see also: http://www.adb.org/Documents/Brochures/Private_Sector/2002/default.asp*

Most IFIs limit their coverage to a percentage of the total amount borrowed (thus the term "partial" credit guarantee) to reduce exposure to commercial risks covered by such comprehensive products. IFC states: "the amount that IFC pays out under the guarantee is capped at an agreed upon amount, for example 40 percent of the initial principal, or one year of debt service…The guarantee amount may vary over the life of the transaction and may be used to cover any debt-servicing shortfall that occurs."[9]

Figure 4.15: Credit Risk Guarantee Offerings

	Coverage	
Institutions	**Debt/Equity Coverage**	**Default**
Sovereign Guarantee Requirement		
IBRD PCG	Debt	?
AsDB PCG (Public Sector)	Debt	?
IsDB Bank Master Insurance	Debt	?
AfDB (Public Sector)	Debt	?
Sovereign Guarantee Unnecessary		
IFC PCG	Debt	?
IADB CGG (Private)	Debt	?
AsDB PCG (Private Sector)	Debt	?
AfDB PSG/ Enclave Projects/ MIC	Debt	?

As shown in *Figure 4.15*, six of nine IFIs provide some form of Credit Risk Coverage. Of these the IBRD Partial Credit Guarantee, AsDB Public Sector Window Partial Risk Guarantee, the IsDB Bank Master Insurance Policy, and the AfDB (Public Sector window) require a sovereign guarantee. Conversely, IFC Partial Credit Guarantee, IADB (Credit Guarantee), AsDB Private Sector Window (Partial Credit Guarantee), and AfDB comprehensive risk coverage through its Private Sector Window (PSG/ Enclave Project/ MIC) do not require a sovereign guarantee.

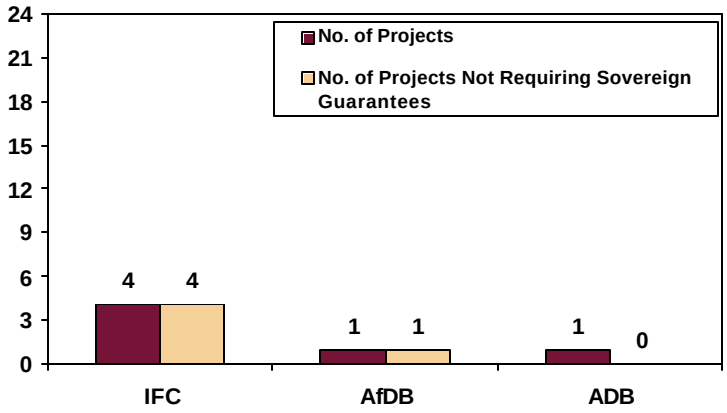
[9] See http://www2.ifc.org/proserv/products/guarantees/guarantees.html.

The level of coverage varies by institution and its specific sub-product. Rolling guarantees tend to cover a single payment, while more comprehensive guarantees, such as IADB's "guarantor of record[10]" or AfDB's private sector and public sector programs cover 100% of the credit risk. Other IFIs, such as IBRD, AsDB, and EBRD may cover certain latter maturities of the debt repayment stream. IFC's Partial Credit Guarantee, while not covering 100% of the credit risk, is flexible, allowing each guarantee to be tailored to meet the needs of both the borrower and the targeted creditors. EBRD is now exploring credit enhancement to enable extension of domestic bond tenors in the rouble bond market by municipal issues (without sovereign guarantee).

Level of Activity 2001-2003

The total value of all guarantees issued was nearly $800 million, but this figure includes a partial credit guarantee issued by AsDB to PSALM in the Philippines (backed by a sovereign counter-guarantee) for a value of $500m. While six IFIs provide credit guarantees, IFC alone accounted for the majority of credit guarantees issued between 2001 and 2003 for infrastructure projects. As depicted in *Figure 4.16*, out of 6 guarantees, 4 were issued by IFC.

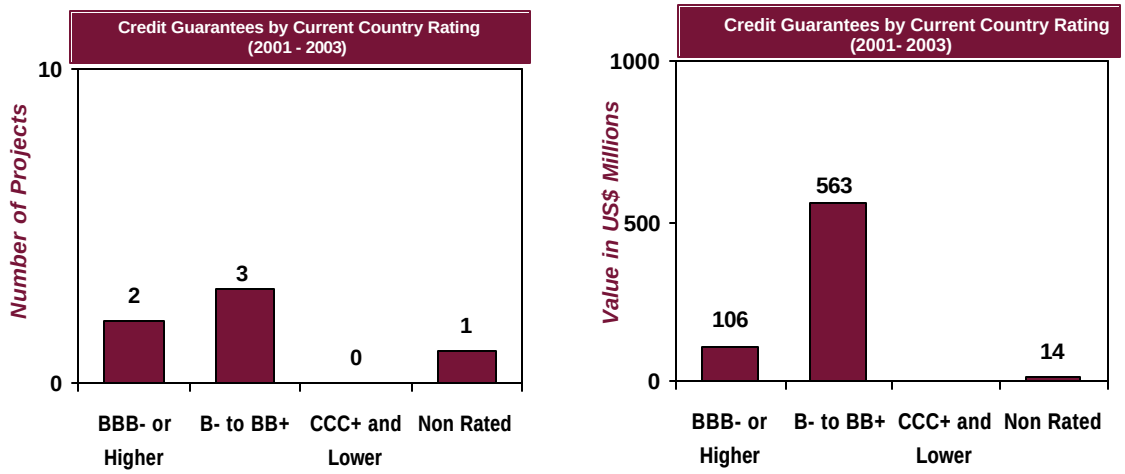
Figure 4.16: Number of Credit Guarantees Issued 2001-2003 by IFI for infrastructure projects



The IFC made rapid and successful use of the Partial Credit Guarantee (PCG) in two WSS projects. One in Mexico, a BBB, investment grade country and one in Columbia, a BB rated country. (More detail on the Tlalnepantla project in Mexico, which was covered by the new IFC's Municipal Fund Unit and covered a municipal credit risk without sovereign guarantee, is found below).

[10] IADB offers a "guarantor of record" product which is being drawn on by monoline insurers. IADB is the guarantor of record, but pools the participation of one or more monolines to underwrite the cover. IADB may take only 25% of the deal with the other monoline(s) taking the balance. Other IFIs are introducing similar products.

Figure 4.17: Number and Value of Credit Guarantees (2001-2003)



Four guarantees were issued in non-investment grade countries for some $577 million. Two guarantees were issued in investment grade countries totaling $106 million in value (*Figure 4.17*). Notable, however, is the overall higher quality of country credit where these instruments have been used—in comparison with the other instruments. Given the comprehensive risk coverage nature of these products, it is not surprising that they have had greater use in countries with stronger credit traditions. As is demonstrated from the Tlalnapantla project, Mexico, these instruments can be very useful in mobilizing domestic credit and in enhancing the credit-worthiness of sub-sovereign borrowers, but this utility appears to be more limited to countries with more established credit histories.

Market Perceptions of Product:

Due their comprehensive risk coverage, credit risk guarantees are a desired product by lenders. Compared to the more complicated contractual/regulatory risk instruments these instruments pay upon the occurrence of default for any reason. Thus, there is no question of cure periods or covered risks (except for carve-outs). Depending on the level of risk coverage available for a specific instrument, of course, the lender bears some risk of only partial repayment from the guarantee.

Like traditional political risk instruments, these guarantees are more easily valued and understood by the foreign capital markets. They carry the full faith and credit of the IFI underwriter with clearly defined events of default and understood claims and payment processes. They may be less understood in domestic capital markets, simply due to their recent introduction. Most IFIs offering these instruments are actively engaged in expanding their use into domestic capital markets.

Application in WSS:

Credit risk instruments are well suited for WSS sector investments. Properly structured they have mobilized domestic capital, reducing foreign exchange risk, and backed even sub-sovereign borrowers. However, given the fact that they underwrite bank loans and bonds, they require the presence in the deal of reasonably sound financial institutions and

they require the IFI to be able to conduct full credit risk due diligence (as a bank would) given that they are also covering commercial risks.

Used in combination with risk instruments that can cover investor equity, credit risk instruments would offer guarantees with a very significant ability to mobilize capital.

Internal and External Constraints to Use of these Instruments:

The critical constraints to greater use of these instruments include:

- **Lack of credit-worthy WSS sector projects.** Like the other instruments, the demand for these guarantees is constrained by the limited number of bankable water projects available. This is as much an upstream problem in terms of adequately prepared projects as it is one of investor demand.

- **Need for suitable domestic financial/capital markets institutions.** To achieve a successful guarantee-enhanced domestic financing, it is essential that the IFI underwriter be comfortable with the local financial institution extending the loan or the trust structure being established for a bond financing. The higher credit quality of countries utilizing this cover suggests that the instrument may have more limited use in the poorer countries, particularly for domestic financing.

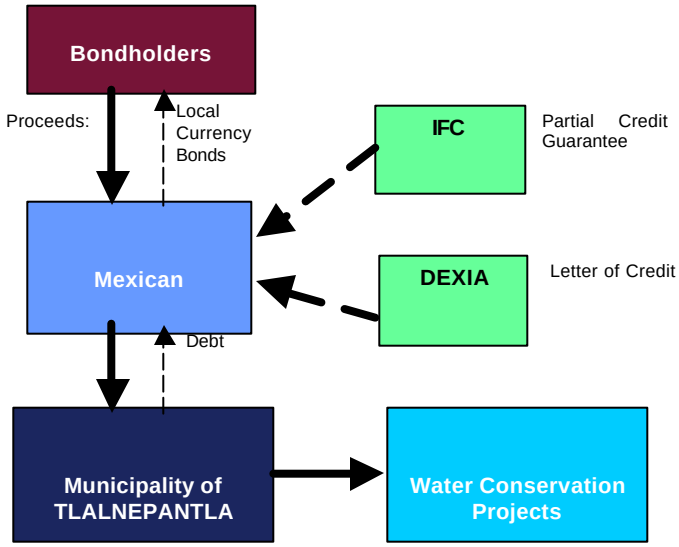
- **Ability of IFI to evaluate full credit risk.** Unlike other coverages which apply to political, contractual and regulatory risks, credit risk instruments cover commercial risks as well. Therefore, a full commercial risk evaluation of the borrower and the project is often required before issuing the guarantee. Some IFIs may be better equipped at present to undertake this analysis than others.

- **Internal constraints.** The general internal constraints to use of guarantee instruments have been noted in the previous sections. Also noted, is the efficiency of MIGA's traditional political risk instrument program. The IFC's credit risk instruments program appears to offer similar efficiencies with minimal internal constraints. The private sector nature of IFC operations (and other IFIs' private sector window operations) may make them more expedient in addressing credit risk issues and programs.

Notable Water Projects: Tlalnepantla (Mexico)

The International Finance Corporation (IFC) provided a local currency partial credit guarantee (PCG) to a Mexican Trust established by the Municipality of Tlalnepantla

Figure 4.18: Tlalnepantla (Mexico)



Rated AA by S&P's national scale rating) to issue local currency bonds in the amount of $8.8 million in the domestic capital markets. *Figure 4.18* demonstrates the project's cash flows and coverage. The proceeds of the bond issue were on-lent to the Municipality of Tlalnepantla and the municipal water utility, which pledged future water revenues, to finance water conservation projects. The size of IFC's guarantee was $3 million, which was provided alongside Dexia's $5.3 million letter of credit.

This Project, closed in early 2003, was the result of the new IFC/IBRD Municipal Fund Pilot Unit and represents a path breaking transaction by allowing a municipality to access local capital markets at affordable prices.

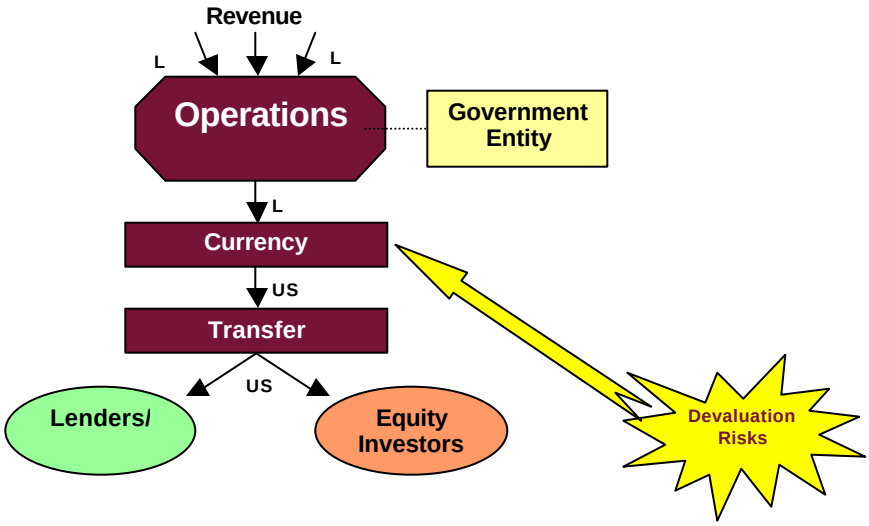
4.4 Foreign Exchange Risk Instruments

In the wake of the Asian, Russian and Argentinean financial crises, currency devaluation has become perhaps the foremost risk concern for investors in emerging markets infrastructure. Currency crises have demonstrated the limits even of well constructed contractual agreements, where despite provisions to the contrary, currency devaluation was not offset by commensurable tariff increases. In many instances, such tariff increases would have been politically and socially impossible to effect (irrespective of ability to pay) and therefore were not.

In such crises, debt service cannot be met, and tariffs may be insufficient to meet even the costs of operations and maintenance (particularly where foreign exchange may be needed

for expatriate salaries, expenses and imported equipment). Capital investment programs must be suspended and investors, lenders and governments enter into extensive renegotiation of or exit from their contracts.

Figure 4.19: Foreign Exchange Risk and the Project Cash Flow



No meaningful (widespread and affordable) foreign exchange risk coverage exists today either in the commercial markets or among the IFIs. While the scope of this study did not include review of foreign exchange cover, given its importance to the success of investment in the WSS, the team reviewed current efforts by the IFIs to address this critical area of investment risk.

In this review, IFIs reported efforts in two specific areas to address foreign exchange risk. These are:

- Options for local currency financing, and
- Specialized forex cover such as devaluation backstop facilities.

These options are reviewed at a high level below. For more detailed information on many of these options please refer to "Foreign Exchange Risk Mitigation for Power and Water Projects in Developing Countries," by J. Wright, T. Matsukawa & R. Sheppard. [11]

Local Currency Financing Options

The foremost area of focus for most IFIs is improving access to local currency financing and in support of this, access to local currency credit risk instruments. With revenues denominated in local currency, the ability to finance the majority of capital improvements in local currency would significantly reduce exposure to foreign exchange risk.

[11] Energy & Mining Sector Board, Water and Sanitation Sector Board Discussion Paper, Unpublished Final Draft, IBRD.

As noted in Section 4.3, for a number of countries local currency bank or capital markets financing is a real possibility. A number of IFIs are concentrating efforts on improving local capital markets to enable greater local currency financing—backed, as needed, by credit risk guarantees. A second area of effort regards direct provision by IFIs of local currency loans. However, due to many IFIs' internal risk management requirements, such direct local currency loans are most likely to be available only: (i) when the IFI can raise funds in the same currency in order to match its exposure; or (ii) in currencies where cross currency swaps can be made to hedge the IFI's exposure.

AsDB, AfDB, EBRD and EIB are venturing into direct local currency financing, where the funds are raised through local bond issues (EBRD is sourcing rouble funding for 4 Russian WSS projects signed in 2002-03 for US$90m equivalent and anticipates an annual program of this order). IFC, AfDB, and AsDB are lending in local currency to projects in developing countries where they can fully hedge their foreign exchange exposure back to hard currency in the currency swap market. IBRD also offers local currency financing where there is a viable swap market.

Both IFC and IADB have had experience in providing guarantees to local capital markets issues. IFC's experience in the Tlalnepantla project is an example of a successful local capital market issue enhanced with an IFI guarantee.

These efforts are likely to increase the immediate availability of funds, but most IFIs have recognized that they must be accompanied by technical assistance or other efforts designed to strengthen and deepen local capital markets—as this is the only long term solution to meeting local financing needs.

Devaluation backstop facility

The Camdessus Panel recommended further evaluation and testing of a proposed "devaluation backstop facility." Such a facility would "prevent the disruption of water services due to the impact of a devaluation, by rescheduling the debt over a time period that is politically and socially feasible."[12]

In simplest terms, a devaluation backstop facility would be comprised of a fund or a contingent commitment of funds to be provided by IFIs (and potentially the government and the project developer) which could be drawn on in the event of a significant currency devaluation. In this event, rather than triggering an unsustainable tariff increase, the funds would be used to offset shortfalls for necessary debt service payments (and possibly dividend payments) while tariffs were increased gradually. Overtime, tariff increases would be expected to be sufficient to recoup funds drawn on from the facility. To date, only OPIC has established such a facility for the *AES Tietê* power project in Brazil.

[12] "Financing Water For All", page 41

Devaluation risk coverage was discussed at some length in the September 8, 2003 meeting of IFI risk mitigation officials held in Washington, DC. It was agreed at that meeting that devaluation risk could be broken down into three groups (normal exchange rate fluctuations, shock devaluations and catastrophic devaluations), which may need different solutions. It is not clear at this point what role the IFIs could play.

The first category is "normal" exchange rate fluctuation—a band within which, based on past performance and future assessments a currency may be expected to fluctuate. Such "normal" fluctuation risk is normally borne by the investors who may be able to hedge against this risk in a number of ways.

The second category could be called "shock" devaluation, where a relatively sudden, unexpected and significant devaluation of the currency takes place. Such a devaluation could be the result of contagion from devaluation in neighboring countries, or a sudden flight of investment caused by domestic or international events. A key characteristic of "shock" devaluation would be the belief, based on economic fundamentals, that the currency will recover (or nearly recover) over a reasonable period of time from the shock. A devaluation backstop facility would be a useful instrument for this category of risk as it offers the prospect of sufficient economic growth and currency appreciation to repay the facility. The challenge is to attempt to distinguish between "shock" devaluation and "catastrophic" devaluation, the third category of devaluation risk.

"Catastrophic" devaluation would be a sudden, unexpected and significant devaluation where the prospect of exchange rates returning to previous levels are remote over the foreseeable future (10+ years). In such a devaluation, the ability to repay a devaluation backstop facility could be significantly compromised. Six years since the financial crisis in Thailand, exchange rates remain at almost half their pre-crisis level. Are Argentina, Brazil, and Russia shock or catastrophic devaluations? Would a devaluation backstop facility be able to be viable today if it was in place prior to those devaluations? Does such a facility guarantee debt service or a limited availability of funds? Who contributes to such a facility, and what are the risks and returns to their investment? A devaluation backstop facility may be a useful instrument for this category of risk. The issues that would need to be resolved in developing such a facility include the distinction between "shock" and "catastrophic" devaluations.

4.5 Conclusions

4.5.1. Guarantees: Catalysts for Increased Investment Flows to WSS?

In the wake of the financial crises of the late 1990s and early 2000s, and in response to the Millenium Development Goals of increasing financial flows to the WSS sector to $30 billion per annum through 2015, all IFIs reported efforts to expand and adapt the use of their risk mitigation instruments.

Risk mitigation instruments can bridge the gap between a potentially interested investor and a possibly bankable project. Their primary purpose is to provide cover against risks over which the investor has little control—such as expropriation, contract abrogation or

(potentially) massive devaluation. Despite the fundamentally non-commercial nature of risk coverage (other than credit risk guarantees), these instruments act to protect an expected cash flow from material harm.

Investor interest in WSS sector projects begins with identification of projects which could have sufficient cash flow to service debt and equity requirements. This typically involves an assessment of whether there is an acceptance of cost recovery principles by the municipal and national governments, and whether they will adhere to these principles (and the related regulatory regime and tariff increases required) over time (or whether they will maintain a necessary subsidy flow based on cost recovery principles). Projects located in countries or cities where governments demonstrate limited understanding or commitment to these goals are least likely to be considered by investors.

Projects which are small in scale are also less likely to be considered by international investors, as the transaction costs of due diligence, financing, legal structuring (and, as needed, guarantee provision) can make such investments prohibitive. Local investors will have greater capability to act on a smaller scale. Nevertheless, investment attractiveness is correlated to project scale and degree of acceptance (and enforcement) of market principles.

The supply of potentially bankable projects is therefore a key consideration in looking at means to stimulate investment flows to the sector. Guarantees are not presently designed and should not in the future be designed to make fundamentally uneconomic projects, economic. However, IFIs have traditionally played a critical role in sector and regulatory reform and in preparing projects for potential private participation. Where guarantees can be used to bolster confidence in these reform efforts, they are likely to have a catalytic effect, encouraging further investment in the sector and the country.

Improvements to and expansion of current risk mitigation instruments have the potential therefore to stimulate greater investment flows to the sector—but within the bounds just described. To meet the funding need identified in the MDG, risk mitigation instruments are part, but not all of the solution.

4.5.2 Constraints in the use of guarantees

The Study identified a series of constraints to the greater use of current risk mitigation instruments as reported by both IFIs and market participants. These constraints can be classified as:

- Client Government Issues
- Internal Process Issues
- Product Understanding and Acceptance Issues

This section summarizes these constraints and actions IFIs are taking to address them.

Client Government Issues

While in principle supportive of instruments that facilitate investment, it is understandable that most governments will choose a loan over a guarantee facility if they are offered on a one to one basis (e.g., a $100m loan to the government vs a $100m guarantee for a foreign investment). Moreover, where sovereign counter-guarantees are required, the preparation and administration of this guarantee can require the same effort as a loan product, with less direct tangible benefit to the government.

IFI Actions

A number of IFIs reported efforts to rescore guarantees so that they were only a fraction of par to a loan. Changes to sovereign counter-guarantee requirements at most IFIs are difficult, but similar products may be offered through private sector windows.

Additional Recommendations

Certain products (contractual/regulatory cover and possible devaluation cover) appear to benefit significantly from the presence of a sovereign counter-guarantee. Other products, such as traditional political risk instruments are now being offered successfully without such guarantees. IFIs should continue to consider the need for a counter-guarantee and offer, through their private sector windows, the option of the instrument without the sovereign-counter guarantee. Where a sovereign counter guarantee is needed and useful, IFIs should consider means to expedite processing and procedures for host governments.

Internal Processes

Many IFIs reported that internal constraints posed an obstacle to more widespread use of their instruments. These constraints, detailed in previous sections, include the scoring of guarantees on par with loans; and related to this, internal management resistance to use of guarantees in lieu of loans. Guarantee programs face the dual challenge of needing to be considered in the CAS/policy planning of the IFI for a specific country, and also to be sufficiently flexible as to be readily available for investors when needed. Some IFIs reported the need to bundle guarantees with other IFI products.

IFI Response

Almost uniformly, IFIs reported an ongoing or planned review of these policies within their institutions. IBRD is considering increasing the incentive to use guarantees by allowing, within some constraints, countries' lending envelopes to be increased by 75% of the face value of guarantee commitments. AsDB has recently undergone a review of the processing and use of its instruments. IADB reported increased priority for use of its instruments (particularly in the local capital markets). EIB reported that it has recently approved the broader development and use of guarantee instruments and plans to roll them out in 2004. During the September 8 meetings, most IFIs reported management and board efforts to streamline access to guarantees.

Additional Recommendations

The challenges in the WSS sector go deeper than guarantees alone can address. There was broad recognition in the September 8 meeting that better sector planning, to include WSS legal, regulatory and institutional reforms, should also include anticipation of the use of guarantees. Such instruments can help to solidify sector reforms and bolster confidence in them. Guarantees can be an effective instrument in this capacity and should be more fully considered in sector plans.

Product Understanding

IFIs and market participants (sponsors, lenders, credit rating agencies) both reported constraints to understanding and use of IFI certain risk mitigation products (particularly contractual/regulatory risk products). These constraints included a lack of understanding of the structure of these instruments (how they could be used), perceived constraints in the application and acceptance process for use of these instruments, perceived delays/constraints in the claims and payment processes of the instruments and uncertainty over the ability of some of these instruments to effectively lower the cost of debt service.

The table below provides an indicative ranking of market understanding and acceptance of risk mitigation instruments against the market's indicated priority for those instruments. For market acceptance, a high ranking indicates that the market has strong familiarity with that instrument and its use. For Indicated Need in the WSS Sector, a high ranking means that feedback received from market participants indicates strong interest in and demand for such instruments.

Instrument	**Market Acceptance**	**Indicated Need in WSS Sector**
Traditional Political Risk Instruments	High	Medium
Contractual/Regulatory Instruments	Low	High
Credit Risk Instruments	Medium	Medium to High
Devaluation Risk Instruments	Low	High

These results should be corroborated with a more detailed market survey, but they highlight the fact that those instruments in apparent greatest demand are least understood or available in the market.

IFI Response

IFIs reported that they were increasingly aware of such concerns in the market place and have begun to take efforts to disseminate greater information to market participants on the instruments available and how to access them. Moreover, a number of IFIs were working actively to streamline availability of their instruments and clarify claims payment processes. These efforts included "road shows" to investors, lenders and credit rating agencies, and new publications and website information.

Additional Recommendations

A number of useful lessons may be learned from the experience of MIGA in promoting the use of traditional political risk instruments and IFC in credit risk instruments. In both these cases, a structured unit with substantial market interface has been able to increase the efficiency of use of instruments and their broader acceptance in the marketplace. The strengthening of such units within IFIs, and their regular interaction with the capital markets and investor community may speed the improvement and acceptance of new instruments as they are developed and tested, and of existing instruments as well.

Sponsor/Investor Issues

A final note on Sponsor/Investor issues. With some exception, the majority of instruments available cover the risks of lenders. Sponsors, and their equity investment, are the basis for initiating and structuring the project. A number of market participants noted the limited coverage available for equity participants. It is recommended that the follow-on market survey test sentiment for an expansion of equity coverage under IFI instruments.

4.5.3 Conclusion

Guarantee instruments serve an important purpose in facilitating emerging markets investment. They give investors comfort that their projected cash flows will not be disrupted by events beyond their control, or if they are, that the costs of such disruption will be partially or wholly offset by a guarantee. Fundamental to this formula is that the underlying cash flow of the project is sufficient to attract and retain their interest. To stimulate greater investment flows to the sector, a supply of bankable or potentially bankable projects is needed.

IFIs can play a critical role in stimulating further WSS sector investment. Foremost, is the need to help countries prepare appropriate regulatory and legal frameworks and to adopt cost recovery principles for the WSS sector, even if subsidy streams are required for some time. IFIs can also assist in preparing specific projects for private participation. IFIs should pursue the changes to and expansion of risk mitigation instruments (particularly contractual/regulatory and devaluation instruments) noted previously. And then use the instruments to bolster confidence in the regulatory and sector reforms being implemented.

Taken together these reforms have the potential to make a material difference in investment flows to the sector. However, it is unlikely that private sector investment alone will be sufficient to meet the funding needs of the sector through 2015.

5. Direct Sub-Sovereign Lending (without Sovereign Guarantee)

As shown in Section 2, the WSS sector has attracted limited financial flows from the private sector. Even with expanded use and improvements in risk mitigation instruments, including those that effectively address contractual/regulatory risks and foreign exchange risks, the private sector is unlikely by itself to meet the financing needs in the sector. Public sector sources of financing are likely to remain important, even dominant, for many years to come.

Concurrent with the increased recognition of the need for public sector financing in the water sector, many emerging market governments have embarked on efforts to decentralize public administration and management, giving greater accountability to local authorities for the services they render.

Thus as central governments shift their focus to funding requirements at the national level, municipal governments and services are being increasingly called upon to help meet their own financing needs. The transition to partial or complete self-financing by sub-sovereigns will take many years and will vary by country, city and locality.

To meet the MDG in the water sector, however, it is imperative to increase the flow of funds to sub-sovereign water utilities and to increase the efficiency in use of those funds. IFIs have traditionally relied on a number of mechanisms to provide funding at the sub-sovereign level. These include:

- On-lending or transfers from the central government to sub-sovereigns;
- Lending or transfers via public sector financial intermediaries, such as national or regional development banks, rediscount facilities and state infrastructure revolving funds;
- Direct IFI lending to sub-sovereigns, counter-guaranteed by the sovereign.

Given MDG needs and increasing decentralization in many countries, the Camdessus Panel and the G8 recommended that IFIs evaluate the possibility to expand direct lending to sub-sovereigns, without a sovereign counter-guarantee (hereafter, direct sub-sovereign lending).

The Study reviewed the current direct sub-sovereign lending programs of the participating IFIs, the current constraints to expanded use of direct sub-sovereign lending and measures IFIs are undertaking to expand use of these instruments.

Of the nine IFIs in the Study, only 2 (EBRD and IsDB) currently have direct sub-sovereign lending programs. Virtually all of the remaining IFIs reported either charter or policy constraints to providing non-sovereign backed loans to sub-sovereign entities through their public sector windows. *Figure 5.1* shows these constraints, but also highlights which IFIs are planning to or have launched programs to provide this lending.

Notably, IFIs' private sector windows have the capacity to make loans without sovereign guarantees, but these loans are typically restricted to private sector controlled entities. Thus charter or policy restrictions on private sector window lending can pose as much a constraint as in the public sector windows.

Figure 5.1: Direct Sub-Sovereign Lending

IFI	IFI Ability to Lend	
	By Charter	**by Policy**
AfDB	Yes	No, plans underway
AsDB	Yes	No
EBRD	Yes	Yes
EIB	Yes, as of Spring 2003	In the Pipeline
IaDB	Yes	Under Consideration
IBRD	No	N/A
IDA	Yes	No
IFC	Yes	In the Pipeline
IsDB	Yes	Yes
MIGA	N/A	N/A

Level of Activity 2001-2003

Both EBRD and IsDB have been highly active, and EBRD particularly so even in the WSS sector. In the WSS sector during this time period, EBRD made 12 direct sub-sovereign loans to either water companies owned by cities or counties, or directly to the municipalities, totaling more than EUR 180 million, with additional sub-sovereign lending to solid waste and urban transport sectors.

Only 4 of the 12 projects financed by EBRD in the WSS sector were in EU accession countries, and 7 of them were in non-investment grade countries. Russia, a BB rated country, accounted for 4 loans and Romania, a BB- rated country, accounted for 3 loans. *Figure 5.2* below highlights EBRD's activity in the water sector by country.

Figure 5.2: Values of EBRD's Water Sector Transaction by Country

Country	GNI per Capita (2001)	Sovereign Rating	No of Water Projects	Total Loans in Euros (th)
Poland	$4,230	BBB+	3	56,532
Lithuania	$3,350	BBB+	1	14,700
Croatia	$4,550	BBB-	1	600
Russia	$1,750	BB	4	76,672
Romania	$1,720	BB-	3	32,200

In the same period, the IsDB funded 5 projects for an amount of $197 million. While none of these projects was in the water sector, in 1997 IsDB extended a direct sub-sovereign loan of $30 million to ONEP (Office National de l'Eau Potable) for the Taza Water Supply Project in Morocco.

Notable Water Projects: Yaroslavl Municipal Water Services Development Programme, Russia

In 2002 the EBRD provided a corporate loan to Yaroslavl Vodokanal, a 100% municipally-owned company responsible for operating water and wastewater services in the city of Yaroslavl. The project consisted of the improvement of the water supply system by focusing on priority investments to reduce operating costs. Total project costs amounted to an equivalent of $21 million, with EBRD extending rouble-denominated loan equivalent to $15.5 million. The project had a guarantee from the city of Yaroslavl. Furthermore, the EBRD and Yaroslavl Oblast entered into a Project Support Agreement.

Constraints to Direct Sub-Sovereign Lending

IBRD's charter does not permit direct sub-sovereign lending. In addition to policy constraints, other IFIs report a variety of constraints to broader use of direct sub-sovereign lending. These include:

- Lack of credit-worthy borrowers. Many potential sub-sovereign borrowers have little to no credit history, lack essential book keeping capabilities and operate inefficient utilities where revenues may not meet even the costs of operations and maintenance.

- Potential conflicts with sovereign's investment program. Direct lending to sub-sovereigns may put sovereign and sub-sovereign entities in competition for limited funds available. The implied or explicit responsibility of sovereigns to cover debt service shortfalls of a municipality must be defined. And the implication of sub-sovereign debt service requirements on utilization of transfers from the national level also needs to be defined.

- Lack of skilled staff in municipal credit analysis. At present, most IFIs do not have staff skilled in municipal credit analysis and therefore are not in a position to effectively evaluate credit risks the IFI would be undertaking.

- Lack of independent opinions on the credit-worthiness of sub-sovereign borrowers. Similarly, most countries presently lack credit rating agencies who can evaluate municipal risk and most sub-sovereigns lack audited financial statements.

EBRD's approach to addressing some of these constraints is outlined below.

Characteristics of the EBRD's Sub-Sovereign Lending Program

EBRD's direct sub-sovereign lending program stands in contrast to most other IFI's efforts in this area, and the structure and function of its operations provide a useful reference for other IFIs considering expansion into this area of lending. Early in its history, EBRD identified direct sub-sovereign lending as an area of activity for the bank. Overtime, it has built a dedicated municipal finance department of 25 to 30, staffed by municipal credit analysts both at headquarters and in-country. The in-country specialists play a critical role in helping to identify and screen opportunities for Bank consideration. These are then reviewed and negotiated by a combination of headquarters and in-country staff.

EBRD reports a number of factors as important to successfully arranging this financing. These include:

- Ability to evaluate municipal credit risk. EBRD has recruited and trained specialists in municipal credit risk assessment. These individuals are able to evaluate the quality of revenue streams to a municipality, the transparency of its accounts and its ability and willingness to repay debt.

- Cooperative interaction with the sovereign. EBRD reports that it is essential to ensure that the national or central government is supportive of the loan and program, even if they are not directly involved. Central government support is important to ensuring that country lending limits are borne in mind and that allocation of external resources are generally consistent with national level plans.

- Grant and technical assistance support to the sub-sovereign entity. Much of EBRD's lending is blended with sizeable grant funding from the European Union or bi-lateral donors. These grant amounts can be as high as 60% of the loan. These amounts are used both as direct capital grants and for technical assistance to improve enterprise accounts, operations and maintenance and other factors important to the ability of the sub-sovereign to repay its obligations and raise capital on its own.

EBRD reports considerable success in this lending program, with no defaults, and a number of municipal borrowers moving on to raise financing on their own as a result of EBRD intervention.

EBRD's experience suggests that where a dedicated unit can be focused on Municipal Finance, considerable progress can be made in extending direct sub-sovereign lending.

Efforts by IFIs to Expand Direct Sub-Sovereign Lending

While to-date only EBRD and IsDB have established experience in direct sub-sovereign lending, a number of IFIs are now focused on these programs.

In the spring of 2003, IFC and IBRD formed a joint Municipal Fund Unit to provide financing and guarantees to sub-sovereign entities. It was this unit that issued the innovative partial credit guarantee for the Tlalnepantla project, and which has recruited municipal finance specialists from inside and outside the host institutions.

Recent changes at the EIB now enable this institution to make direct sub-sovereign loans, and efforts are currently underway to build internal institutional capacity to evaluate and lend in this sector. Also, changes at AfDB will allow this institution to lend to commercially oriented Public Sector Enterprises in Middle Income Countries without requiring sovereign guarantees. Even institutions that have not changed their charter or policies are exploring new sub-sovereign financing schemes. IADB, for instance, is exploring new sub-sovereign financing schemes involving both partial and no sovereign counter guarantees.

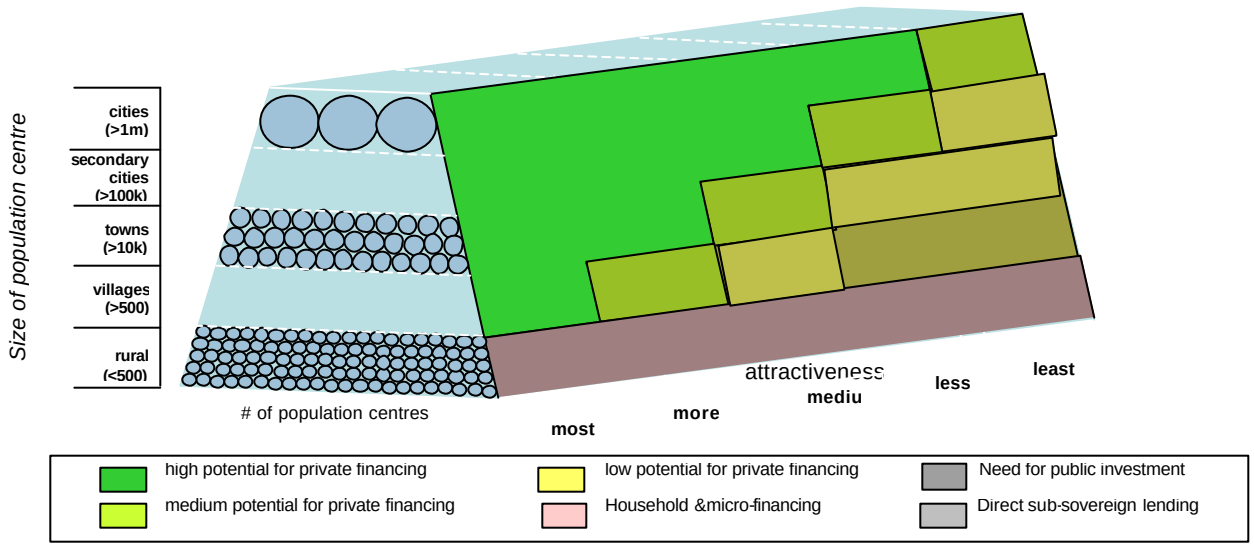
Additional Considerations in Direct Sub-Sovereign Lending Programs

Given the constraints on private sector financing and the decentralization of national government responsibilities, direct sub-sovereign lending may become a critical component toward meeting the MDG in the WSS sector. Ideally, this lending and concurrent technical assistance provides a basis for sub-sovereigns to raise funding on their own in the domestic capital markets, or it helps to create a utility sufficiently attractive to the private sector to become a candidate for a public private partnership.

One of the risks in IFI direct sub-sovereign lending programs is that the sub-sovereign never graduates to private sector financing (either through the capital markets or direct investment) or that IFI financing crowds out potential private sector financing. IFIs have faced these risks in other lending programs and should be able to address them in these programs as well.

Nevertheless, even with large grant and technical assistance components, direct sub-sovereign lending is likely appropriate only for a limited group of municipal borrowers. Adapting the water sector investment attractiveness framework from Section 2 above, immediate prospects for direct sub-sovereign programs are very likely utilities with emerging prospects for private sector participation (Figure 5.3). These utilities are depicted in Figure 5.3 by the upward sloping hash marks.

Figure 5.3: Prospects for Direct Sub-Sovereign Lending



One of the issues explored in the September 8 meeting was the combination of direct sub-sovereign lending with private sector participation. Given the reluctance of equity investors to risk their capital in the WSS sector at present and given the limited availability of bankable WSS sector projects, combining direct sub-sovereign lending with a management contract structure (which includes as its performance criteria improved efficiencies, accountability and transparency) could provide a basis for achieving rapid gains in financial flows to the WSS sector and in introducing private sector participants to potential investment opportunities.

At a minimum, with the use of risk mitigation instruments, private participation in management, and an established credit history built on direct sub-sovereign lending, dozens of municipal water utilities serving potentially millions of customers could be much better placed to access domestic and international capital markets, and to repay that debt in a timely manner.

This will require changes in current policies regarding use of risk mitigation instruments; development of non-equity private participation contracts; and technical assistance, training and direct loan funds for municipal WSS utilities. This Study found that efforts are currently underway by the IFIs toward this end, including efforts at increased cooperation and product combinations. However, to achieve the full benefit potential from these efforts, continued focus on improvements in and expansion of risk mitigation and direct sub-sovereign lending programs will be needed. These efforts should be paired with ongoing efforts to improve private participation instruments/vehicles. A series of pilot projects could test these instruments and their combinations and set precedents for more expanded programs around the world.

While such efforts will not fully meet the funding needs in the WSS sector, they would contribute to improving needed financial flows and bringing private sector investors back to the market.