# ISSUE BRIEF

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## Guarantees to finance developing cities: a promising tool for donors?

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In an overridingly urban world, cities are key sites and crucial actors for sustainable development. Yet, in developing countries, they still often lack the resources that would enable them to tackle the challenges posed by sustainability. This has prompted an increasing level of advocacy in favour of bolstering their financing capacities (New Urban Agenda 2016, §139).

In tandem, the new paradigm of international development financing is emerging. Geared to attracting the private sector to actors that are reputedly financially fragile or little-known, this shift is driving an interest in instruments, such as guarantees, that can both mitigate risk and leverage private funds (Addis Ababa Action Agenda, 2015, §34).

At the crossroads of these two logics, guarantees that back developing city financing seem to offer a promising way forward. They have been in use since the 1980s to support the financing of states and companies, but it was only a few years ago that donors envisaged using them to finance municipalities. These initiatives, however, are still few and far between and the lessons they offer have not been sufficiently exploited to enable their real potential to be assessed.

The purpose of this *Issue Brief,* written as part of the Transformative Investment for Sustainable Development project, is to inform official development assistance (ODA) actors on the implications of using this instrument. A review of the literature and interviews with experts[1] have helped us to identify some key points to bear in mind for developing guarantees as a financing tool scaled to sustainable urban development.

1. A multi-partner project, coordinated by Iddri on sustainable development finance within the framework of the 2030 Agenda for sustainable development.

### KEY MESSAGES

- In theory, guarantees can offset market failings inasmuch as they help to mitigate risks and leverage private sector funds, which makes a strong case for their potential to respond to the needs of developing cities.
- Yet, guarantees are only a downstream financial tool and cannot replace the need for financially viable projects, local government autonomy, sound local financial management, and sustainable urban development policies.
- The extension and financial sustainability of the tool supposes strengthening the capacity of local governments to contain their level of debt, and also that donors learn and adapt in view of limiting transaction costs, which are currently considerably higher than those incurred by traditional loan and grant instruments.
- Today, the terms of the guarantee debate are defined by the donors and thus framed from the supply-side perspective of providing financial products. Yet, more benefit would be gained were they more focussed on an understanding of the needs and actual demands of cities and private-sector financiers.
- Guarantees do not eliminate the risks linked to financing developing cities: they transfer the risk to a third party (i.e. the donors). Their capacity to reduce this risk depends on political will, on the mobilisation of operational arrangements able to assume this risk, and on the donors' role in taking on the financial risk to attract private investors.

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## FINANCIAL POTENTIAL

“Development guarantees” are those proposed by international public donors or philanthropic donors to support the sustainable development of the Global South (Mirabile *et al.*, 2013). This brief focuses on “subnational” guarantees for developing cities.

### Definition and operation

A guarantee is a financial instrument for mitigating risk: should a debtor default, the guarantor takes over the related obligations and protects the lender or investor against loss.

Guarantees insure against all types of risk, ranging from political risks (the non-convertibility of national currencies, restrictions on the movement of capital, war and terrorism, local authority deficiencies) through to commercial risks (non-repayment of loans, liquidity shortfalls, non-compliance with contractual obligations, etc.).

Guarantees can cover equity investments (bond issues) or loan financing (loan repayments); guarantees covering default on payment for services rendered also exist. These may cover the totality or only part of the losses incurred.

All these elements (commercial or political risk, loan financing or equity investment, total or partial cover) can be combined and mixed depending on the needs of the beneficiaries and the donor’s capacities.

The main difference between guarantees and the traditional development aid tools (loans and grants) lies not only in the fact that they involve a tripartite arrangement mobilising private-sector partners (investors, creditors), but also that, for the time being, they are not reportable as ODA.

### Expected impacts on financing

On the whole, developing cities struggle to attract institutional investors and/or obtain commercial loans. The risk of default is deemed too high by the potential financiers (Kehew *et al.*, 2005), in part because the actors do not really know one another. A vicious circle exists: the absence of a track record of municipal credit (meaning the little is known about the real risk involved) leads to the absence of credit itself, given that private financiers only grant loans or invest on the basis of a quantified risk.

Three key effects are expected from guarantees (Kehew *et al.*, 2005; Winpenny, 2005):

- a reduction of uncertainly inasmuch as guarantees facilitate a more effective assessment of risks and thus the ability to control or even cover them, thereby mitigating them,
- a leveraging effect or the mobilisation of additional sources of private finance for development; with a multiplying effect on public-sector funds,
- the emergence of a domestic ecosystem able to connect up local public and private actors and thus foster financing channels in local currency.

Yet, guarantees themselves entail risks and perverse effects (Gordon, 2008; Winpenny, 2005):

- moral hazard, whereby borrowers may be disincentivised from meeting their financial obligations,
- - market distortion, by attracting unreliable investors, providing cover for insolvent actors or encouraging finance for projects that are hardly bankable,
- deadweight effect, when the investment risk is taken on by public donors in cases where private investment alone would have sufficed.

### Risk mitigation and uncertainty

Situations in which developing cities find themselves underfinanced are characterised by market failings: the social optimum would be for the cities to have a level of self-financing that could cover their investment needs. Here, donors have a role to play given their solvency, their objective (here, we assume that this is to supply public goods) and their financial expertise. To serve as effective guarantors able to reduce uncertainty and the associated risks, the donors need to fulfil three functions:

- identify the demand: a donor’s offer of a guarantee points up a financing need that might well have remained invisible had the donor not intervened. Additionally, due diligence and risk analysis procedures provide reassurance as to the project’s viability or the beneficiary’s solvency; the donors mitigate the perceived risk by reducing uncertainty (Matsukawa & Habeck, 2007). All told, guarantees send a positive signal to private financiers.
- mitigate a real risk not only by acting as an intermediary in case of disagreement or litigation, but also by supporting efforts to strengthen capacities and implement effective management and financial systems.
- assume a real risk in case of default, agreeing to play the public-sector/philanthropic role of taking on such risk in order to facilitate and accompany the financing of sustainable urban development.

### What guarantees cannot do

Far from being an end in themselves, guarantees are simply a financial instrument: they do not make a city solvent, they cannot offset deficient budget programming, nor can they stand in for the absence of "good" projects. Moreover, financial decentralisation in developing countries is still limited. The capacity of local government to access direct financing, independently of the state, depends on national regulations, and is thus a question beyond that of introducing a new financial tool.

## IMPLEMENTING CONDITIONS

### Responding to "small" needs

Arguments in favour of municipal guarantees usually refer to experiments with large emerging cities in middle-income countries that are able to access international markets, and/or to major infrastructure projects (Mirabile *et al.*, 2013). What still needs to be explored, however, is the relevance and feasibility of applying guarantees to financing municipal functioning or public services in small cities and/or less advanced countries. Very often, these cities' needs are too small or sporadic to be eligible for ODA, while on the donors' side the process for appraising requests tends to involve criteria that require a minimal project size.

The donors can then choose either to offer small-sized guarantees for small actors, which incurs costs for the donor, or to use intermediaries (the cities' national development banks, inter-city pooling of financing requests, etc.), which may further increase costs for the beneficiaries.

Ultimately, if donors wish to respond the "small needs" of developing cities, they will need to strike a balance between taking on this cost themselves or having the beneficiaries assume it.

### Support for indebtedness

Alternatively, supposing that the beneficiary is financially independent, guarantees are used to cover loans or bonds, in other words, they support the contracting of debt. While this is not in itself a problem, the viability of the debt must be controlled and thus accompanied by measures to improve financial management: training experts in municipal finance, budget programming, the capacity to mobilise fiscal resources…

As a result, donors need to take responsibility for these upstream measures and supportive steps to ensure that the guarantees do not expose developing cities to an unsustainable debt burden (Winpenny, 2005). The addition of technical assistance or grants to cover this capacity-building is an extra cost. It nonetheless represents an advantage for donors, as it reduces the likelihood of a guarantee being called in the event of default, and also a condition of sustainability for this method of financing.

### Being attractive to meet the demand

Setting up a guarantee involves a twofold requirement: a demand from the cities and a demand from private financiers. Yet, today, neither of these is self-evident or well-known.

For cities, the appeal of guarantees is not immediately obvious. The fact that guarantees involve tripartite arrangements automatically makes the financing circuits more complex and lengthier. The procedures for obtaining a guarantee, the complexity of having to find an additional financier and the additional negotiating costs all increase transaction costs. This means that guarantees are not *a priori* more attractive than loans; donors thus need to price the instrument competitively.

For financiers, the donors' procedures involve dissuasive timeframes and learning curves, and do not fit with the requirements of private-sector actors (Matsukawa & Habeck, 2007). What they need are attractive procedures and conditions when it comes to guarantees.

For the donors, the cost of appraising guarantees is at least equivalent to that of appraising loans. When the costs of human resources, of keeping competitive pricing for cities and of simplifying procedures for private financiers are all added together, a marginal cost remains for the donors, which constitutes another type of "hidden" cost that needs to be factored into the financing schemes.

**Box 1. Private-sector reticence and needs**

Beyond the case of developing cities, the expectations expressed by the private sector for guarantees have been little addressed by the donors. For example:

- One risk in developing countries is that of default of payment for services rendered. With their scant and irregular resources, cities represent a good example of this risk, which may discourage investment in public-private partnerships for basic urban services, for instance. Dedicated guarantees could lift this reticence and attract financiers (Kehew et al., 2005), but donors are focussing more on guarantees for loans and bond issuances.
- Private-sector actors argue that only guarantees covering the entire risk can make a difference to their unwillingness to take on risk (Matsukawa & Habeck, 2007), and thus change the situation for developing cities. Guarantors tend to prefer partial guarantees in order to limit moral hazard and the risk of loss in the event of default.

### Adapting donors' structures and strategies

By bringing on board new types of actors, guarantees introduce market-based logics into development financing. This is what makes them attractive. But it also induces a change in the relationships between beneficiaries, private financiers and donors, which brings into play new interests and needs that cannot be overlooked.

From this perspective, the donor's role will become that of facilitator rather than funder. Having served for many decades as providers of direct financing, donors are now caught up in their own path dependence in terms of competences and procedures. Many changes, such as stepping beyond the loan–grant alternative, factoring in the immobilisation of capital, and shifting professional cultures and practices, have been underestimated and their cost has been little understood. It is not simply a matter of introducing an innovative financing instrument – but, in fact, means redefining the donors' strategic role, institutional organisation and in-house operational modalities.

Bringing in a new financial instrument is not neutral and thus supposes important strategic choices that may prove costly in terms of in-house reorganisation (Gordon, 2008; Humphrey & Prizzon, 2014).

Finally, although there is hope that guarantees will unblock new funds for developing cities, they do carry hidden costs (opportunity costs, transaction costs and learning costs) that need to be factored in upstream of projects.

The way in which financial products are designed will be decisive, but this implies commitments and thus political choices: introducing a new financial tool upsets operational functioning and political balances. Given the challenges of implementing guarantees, it is likely that the tool will only have a significant impact if it triggers a leveraging effect to crowd in private money, and if donors firmly reorient their strategies towards becoming "experts" in risk and agree to shoulder some of it.

The need to correct the market failings that restrict developing cities' access to financing argues the case for a new role for donors. The use of guarantees thus raises fundamental questions about risk-taking: who should bear the burden? Is it the role of ODA to assume developing cities' financing risks? All told, only financial innovation can provide an answer.

## CONCLUSION

This *Issue Brief* highlights the questions underpinning the setting-up of guarantees for developing cities: this tool certainly offers a promising way forward, but adapting it to the municipal context not only means that the tool itself must be overhauled, but also and more generally, that the donors need to make some strategic choices.

Current advances in the field are still strongly oriented towards a product offering by the donors. As development financing is heading towards market-based instruments, donors now need to integrate market considerations and rationales into their institutional logics.

Tailoring guarantees to municipalities for and in developing cities not only means co-building this tool with the target beneficiaries, but also shoring it up with significant measures to strengthen local capacities and lastingly improve the financial soundness of developing cities.

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