

Research Material
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A Deep Dive into Guarantees, Development Finance

Introduction

Private Sector Instruments (PSIs), recognized as Official Development Assistance (ODA) since 2018, are categorized into grants, loans, mezzanines, equity investments, and guarantees. While reporting methods to determine ODA eligibility have been set for grants, loans, and equity investments, the procedures for mezzanines and guarantees are still under development. However, as the formulation of a reporting method for guarantees has become a task in priority for the OECD DAC's Working Party on Development Finance Statistics (WP-STAT), it is expected that a consensus on a method will be reached among members shortly (OECD 2022b). This effort becomes particularly relevant because, guarantees, following syndicated loans, are the second biggest mobilizer of private finance (OECD 2022a). Furthermore, donor institutions are the primary issuers of guarantee instruments (Convergence 2022). Considering the above, guarantees emerge as an apt PSI that KOICA might adopt in its future projects. As such, this brief delves into the definition, pros and cons of guarantees. It also discusses the various types of guarantees and the general procedure to access them and briefly outlines potential strategies for KOICA's effective use of the guarantee system.

What Are Guarantees

A guarantee is a legally binding commitment. In cases where a debtor cannot repay a loan or equity investment upon maturity, the guarantor is required to cover either a portion or the entire outstanding debt. At its core, a guarantee serves as an insurance policy, protecting banks and investors from potential defaults. However, guarantees also play a pivotal role in facilitating liquidity for Small-and Medium-sized Enterprises (SMEs), which often lack access to financial instruments due to the absence of collateral. This also enables banks and investors to invest in larger markets that carry higher investment risks. Especially in developing countries, guarantees often take on the characteristics of subsidies as it bolsters the credit profiles of SMEs, allowing them to secure financing at lower interest rates.(Kang, Jong-ku, Jeong, Hyung-kwon 2006). As illustrated in Table 1, guarantees can be categorized into three distinct groups based

either on the managing entity or the mechanism of operation. Notably, all three types of guarantee systems incorporate government funds as part of their financial resources. The Public Guarantee System and the Loan Guarantee System are both directly fueled by government funds. Meanwhile, the Mutual Guarantee System complements its resources with government re-guarantees or lower-rated loans. As a result, the guarantee system operates as a governmental policy, primarily serving as a financial tool designed to enhance financial backing for SMEs. In essence, it possesses a public-oriented nature.

Table 1. Categorized guarantee system based on the managing entity or the mechanism of operation

Type	Definition	Service Region
Mutual Guarantee System	A system in which an association, created through the financial contributions or investments of its members, acts as a guarantor for loans procured by member companies from financial institutions. (Indirect funding support is provided by the government via a re-guarantee mechanism.)	European region including Germany
Public Guarantee System	A system where the government initiates the establishment of an independent guarantee agency, supported by governmental contributions or investments. This agency offers guarantees under governmental oversight.	Asia region including the Republic of Korea
Loan Guarantee System	A system where the government entrusts financial institutions with the responsibility of managing the guarantee service in the absence of an independent guarantee agency (Certain guarantee conditions such as eligibility criteria and guarantee limits are predetermined). The agency guarantees loans that align with the defined criteria. The government compensates for the losses if incurred.	American region including the U.S. and Canada

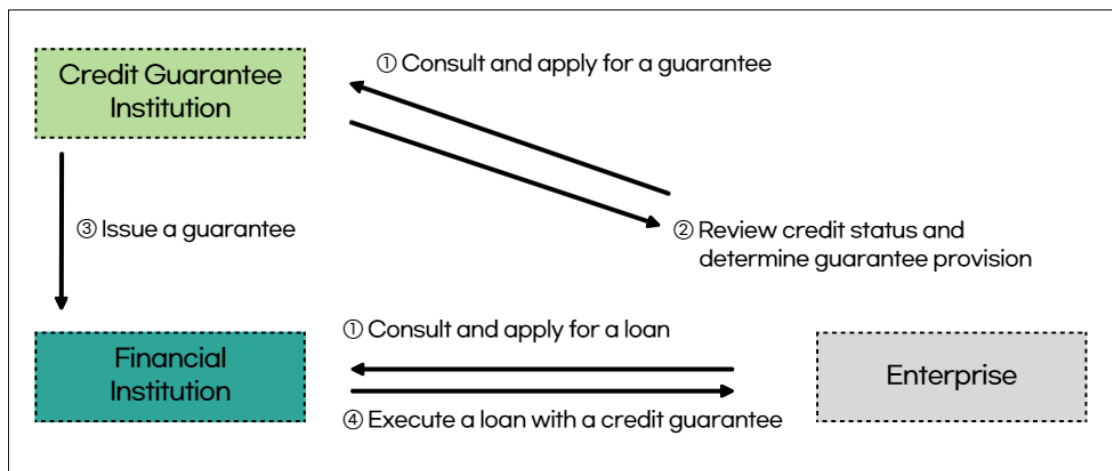
Source: Nam, Joo-ha 2005, Kang, Jong-ku, Jeong, Hyung-kwon 2006, Nam, Gi-jung 2007

How to Access Guarantee Services

In Korea, the procedure for enterprises to access guarantee services is as follows: Enterprises begin by consulting with financial institutions regarding loan applications. Simultaneously, they seek advice and apply for a loan guarantee from the Korea Credit Guarantee Fund (KODIT), a credit guarantee service institution. Once the application is made, KODIT initiates the process of gathering essential information for a

comprehensive credit review and guarantee assessment. During this phase, the applicant provides all the required documentation as stipulated by KODIT. Using the collected data and insights from on-site due diligence, KODIT evaluates the enterprise's creditworthiness and assigns its credit ratings. KODIT also cross-checks the applicant's eligibility against specific review criteria, gauges the viability of extending guarantee support, and decides on the guarantee amount. Subsequently, an informed decision is made regarding the guarantee's approval. Upon obtaining approval, KODIT issues a guarantee document to the respective financial institution. This document acts as collateral, empowering the institution to grant the loan to the applicant. Once equipped with both the guarantee and the loan, the enterprise is obligated to remit a predetermined guarantee fee to KODIT.

Figure 1. Guarantee Service Process in Korea



Source : Kang, Jong-ku, Jeong, Hyung-kwon 2006, 7

Types of Guarantees and Major Guarantee Agency in Development Cooperations

The criteria for classifying guarantees are varied, encompassing aspects such as the operational mechanism referenced earlier, types of risks, financial instruments, payment amounts, payment types, and the availability of funds. Within the realm of development cooperation, guarantees are categorized based on contractual relationships and financial instruments, as delineated in Table 2.

Table 2. Types of Guarantees

Contractual relationships	Type	Definitions
A guarantee provider and financial institution	Loan guarantees	Guarantee for a payment provided to back the repayment of the individual loan amounts that the private sector with specific conditions in developing countries obtained from financial institutions.
	Portfolio guarantees	A payment guarantee provided for the loan portfolio granted by financial institutions to groups in the private sector of developing countries with specific conditions.
	Portable guarantees	A guarantee that enables the private sector in developing countries to select and obtain loans from financial institutions offering the most advantageous terms.
A guarantee provider and investors	Bond guarantees	A payment guarantee on the entire bond issuance or on a portion of bonds with a higher risk of loss is issued by the private sector in developing countries.
	Equity guarantees	A guarantee that protects investors from losses on their equity investments in the private sector of developing countries.
	Balance sheet guarantees	A guarantee that ensures a portion of the short-term debt obligations of the private sector in developing countries experiencing temporary liquidity problems.

Source: Adapted by the author from Garbacz et al., 2021.

Institutions offering guarantees for development cooperation are divided into five categories: bilateral donor institutions, bilateral development finance institutions (DFIs), multilateral development banks (MDBs), commercial investors, and special agencies that offer guarantee services¹⁾. Among these, bilateral donor institutions, specifically USAID and Sida, account for a substantial 44% of guarantee issuance (Convergence 2022). However, it is notable that the Development Credit Authority, which managed guarantees within USAID, was transitioned to a newly established financial institution, the Development Finance Cooperation, in 2019. Conversely, while an institution for development finance, Swedfund, exists, Sida continues to oversee and broaden its role in guarantee services (Sida 2022). Sida's Technical Guarantee Unit has been crafting a strategy aimed at expanding and integrating guarantee services. The goal is for these services, which were previously exclusive to the unit, to be distributed among all regional teams (Convergence 2022). A significant portion, about 65%, of the guarantees

1) GuarantCo serves as a prime example of such institutions. It is funded by the governments of the UK, the Netherlands, Switzerland, and Australia, and is extending a guarantee of USD 800 million to 22 nations.

issued by Sida are portfolio guarantees (Convergence 2022). Moreover, Sida has been proactive in providing guarantees for diverse projects in agriculture, infrastructure, energy, healthcare, and democracy (Sida 2022). Analysis suggests that the reasons bilateral donors are permitted to manage guarantees is that if a payment is triggered, these guarantees primarily operate as grants, and funds are only required in the event of a default. Also, issuing guarantees does not exert financial pressure on the institution since they are based on the respective government's credit rating, eliminating the immediate need for the institution to hold the funds (Convergence 2022, Garbacz et al 2021).

In 1995, the Swedish government tasked Sida with proposing a new type of modality. In response, Sida introduced a guarantee in 1996. After cultivating a favorable environment and establishing the necessary policies, a pilot phase was launched from 1999 to 2005. During this pilot, four guarantees were issued (Convergence 2022, Lindal 2006). The financial commitment for these guarantees totaled 230 million Krona, with value at risk of 49 million Krona set aside as a reserve (Lindahl 2006). After the pilot phase, and following a business feasibility evaluation, the guarantee became a regular modality offering by Sida. A concise overview of Sida's guarantee provision process is as follows: Upon receiving a guarantee support request, Sida's Technical Guarantee Unit evaluates the viability of providing the guarantee for the specific case. This evaluative phase is marked by an assessment of both the financial and developmental additionalities of the project under consideration, which is conducted collaboratively with the relevant regional teams and the global economic team. This analysis entails considering the additionality²⁾ from the viewpoints of several stakeholders, including financial institutions, investors, and borrowers. Sida also assesses investment risks posed by the borrowing institutions and determines guarantee fees in cooperation with the Swedish National Export Credits Guarantee Board (EKN)³⁾ and the Swedish National Debt Office (NDO) (Sida 2016). Although EKN was a prominent collaborator in the early stages of the guarantee services, recent times have seen heightened participation from the NDO (Sida 2016, Garbacz et al 2021). An amount equal to the expected loss is earmarked within a reserve account managed by the NDO. Guarantee fees⁴⁾ collected from the borrowing institutions are deposited into this account. Should the realized losses surpass the reserves, Sida has the option to request the necessary funds from the NDO. Between 2015-2019, Sida compensated 31 claims, translating to a portfolio loss rate of 0.1% (Garbacz et al 2021). By 2021, the total guarantee sum reached 10.3 billion

2) For further details on Additionality, please refer to Policy Briefing, Issue No. 6.

3) The EKN operates under the jurisdiction of the Ministry for Foreign Affairs.

4) At times Sida subsidizes the guarantee fees, primarily for loan or portfolio guarantees (Convergence, 2022).

Krona, facilitating loan capability of 50 billion, and mobilizing an additional 27.3 billion Krona from other financial channels for development finance (Sida 2022). Lastly, while the shortest guarantee maturity period is five years and the longest is 25 years, Sida generally ensures it does not surpass 15 years. (Lindahl 2006)

Pros and Cons of Guarantees in Development Cooperation

One significant advantage of guarantees is their robust capability to mobilize private capital. As previously noted, guarantees are second only to syndicated loans in terms of rallying private capital among various financial instruments. For development aid agencies that can issue guarantees based on a country's credit rating, this mechanism offers a more efficient method to direct Official Development Assistance (ODA) towards higher-need areas. This is because the funds are only required in the event of a default. Moreover, guarantees can stimulate capital markets in developing nations, and help the financial institutions in those nations to funnel liquidity into sectors marked by elevated investment risks through risk-sharing and technological cooperation. This will ultimately boost the operational capacity of financial institutions operating in developing nations and set the stage for the birth of novel markets.

However, guarantees come with a set of disadvantages. For one, they cannot be reported as ODA at present. Additionally, involving a guarantee provider can complicate contractual relationships and inflate transaction costs. Such complications increase if the guarantee provider lacks essential expertise. The volatility inherent to developing nations makes it difficult to set precise guarantee fees. Additionally, when Development Finance Institutions (DFIs) post guarantees on their balance sheets, they frequently register the entire guarantee amount instead of the expected loss amount. Such a practice might compromise the integrity of financial statements, which underpin decisions regarding a financial institution's credit rating. Furthermore, establishing a direct causal link between issuing guarantees and achieving developmental outcomes poses a challenge. This is because cash flows would not materialize unless there's an actual default, which is cited as another limitation.

Key Preliminary Considerations to introduce a guarantee system at KOICA

The significant share of the guarantee sector held by bilateral donors, such as Sida and USAID, suggests a promising avenue for KOICA to explore. However, prior to diving into this domain, various preparatory steps must be undertaken. These encompass acquiring the necessary legal authorization to provide guarantees, drafting relevant domestic

regulations, ensuring governmental budget provisions, and establishing efficient operational frameworks for project execution. Alongside these foundational measures, it's pivotal to build expertise and devise a comprehensive guarantee assessment process. This can be achieved through collaborative agreements with KODIT. Additionally, criteria specific to extending guarantees in developing nations should be defined. This might involve establishing business partnerships with credit guarantee institutions existing in developing countries and entities such as Sida. Following the 1997 Asian Financial Crisis, KODIT suspended operations across all its international branches. However, in 2020, it reopened its branch in Hanoi, Vietnam to assist Korean companies making inroads into the Vietnamese market. Therefore, by signing up a partnership with KODIT KOICA can utilize its professionalism respect to Vietnam industries in evaluating local Vietnamese enterprises. Moreover, due to KODIT's vast collection of research on credit guarantee systems in developing nations, it is aptly equipped to offer specialist insights into pertinent sectors. It's worth highlighting that Sida, when launching its guarantee business, partnered with USAID and currently collaborates with Denmark to develop a pilot guarantee program spanning four years. Given this backdrop, KOICA should consider cultivating a similar cooperative relationship with Sida. After laying the groundwork conducive to a guarantee business, a short-term project could be envisioned, such as running a pilot guarantee project in alliance with Sida. This initiative could serve as a foundational step, potentially enabling KOICA to set up its own standalone guarantee business operations in the long run.

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