Project Finance at the World Bank

An Overview of Policies and Instruments

Philippe Benoit
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Philippe Benoit

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ABSTRACT

Private and public sector sponsors of infrastructure, industrial and other commercial projects in developing countries are looking increasingly to the project finance structure to fund these operations. The World Bank has an array of financial instruments to support these projects. This paper serves as an introductory working tool for World Bank staff and professionals outside the Bank who are interested in the role of the World Bank in this area. It provides an overview of World Bank support to these operations, and describes some of the underlying legal, structural and policy issues that affect World Bank involvement in these projects. The paper also outlines the support provided by the International Finance Corporation and the Multilateral Investment Guarantee Agency, affiliates within the World Bank Group.
FOREWORD

Like many terms used in business practice, "project financing" is not a well defined legal term; it does not always have the same meaning in the different contexts in which it is used. The World Bank's increasing involvement in project financing, as a direct or indirect lender or guarantor of the project company or the project financiers, calls for a clarification of the meaning of this term and of the implications of its use for the several parties which are often involved.

This publication by Philippe Benoit attempts to serve this purpose. Not only is it timely, it also treats the subject from the perspective of the World Bank. It is, therefore, particularly useful for the Bank staff whose work increasingly engages them in project financing issues.

Ibrahim F.I. Shihata
Senior Vice President and General Counsel

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# TABLE OF CONTENTS

| CHAPTER I. | INTRODUCTION | .......................................................... | 1 |
| CHAPTER II. | IMPORTANCE OF PROJECT FINANCE IN DEVELOPING COUNTRIES | .................. | 3 |
| CHAPTER III. | PROJECT FINANCE: BASIC STRUCTURAL ELEMENTS | .................. | 7 |
| | A. General Description | .................................................. | 7 |
| | B. Project Viability | .................................................. | 8 |
| | C. Forms of Investment | .................................................. | 8 |
| | - Equity | | |
| | - Debt | | |
| | - Quasi Equity | | |
| | - Contractors, Suppliers and Purchasers | | |
| | - Sureties | | |
| | - Insurance | | |
| | D. Participants | .................................................. | 9 |
| | - Private Participants | | |
| | - Host Countries | | |
| | - Export and Transit Countries | | |
| | - Multilateral Participation: World Bank and Other Development Banks | | |
| | E. Benefits | .................................................. | 10 |
| | F. Risks | .................................................. | 11 |
| | 1. Project Risks vs. Debtor’s Credit Risk and Sovereign Credit Risk | | |
| | 2. Commercial vs. Political Risks | .................................................. | 12 |
| | a. Commercial Risks | | |
| | b. Political Risks | | |
| | 3. Force Majeure | .................................................. | 13 |
| | G. Reallocation of Risks and Related Mechanisms | .................................................. | 14 |
| | 1. Guarantees | .................................................. | 14 |
| | - Structure | | |
| | - Payment vs. Performance Obligations | | |
| | 2. Insurance: Casualty and Political Risk | .................................................. | 15 |
| | 3. "Take-and-Pay", "Take-or-Pay" and Other Purchase/Supply Contracts | | |
| | 4. Put Options | .................................................. | 16 |
| | 5. Escrow Accounts and Other Pledges of Assets | .................................................. | 18 |
CHAPTER IV. WORLD BANK GROUP ..................................................... 19

CHAPTER V. WORLD BANK: POLICY AND LEGAL FRAMEWORKS ................. 21
   A. Development Objectives .............................................. 21
   B. Issues and Considerations ......................................... 22
      1. IBRD .......................................................... 22
         a. Legal Framework
            - Loans
            - Guarantees
         b. Developmental Aspects
            - Economic Returns
            - Financial Returns
            - Environmental and Other Socio-Economic Issues
            - Distribution of Revenues and Risks
         c. Country Context
         d. Financial Considerations
         e. IBRD Lending in "IDA-Only" Countries: "Enclave Projects"
         f. Security Interests and Negative Pledge Clause
         g. Institutional Policy Issues
            - Limitations on Financial Resources
            - Lender ‘of Last Resort’
            - Selectivity
            - IFC/MIGA Complementarity
            - Political Dimension
      2. IDA .............................................................. 32
         a. Legal Framework
            - Credits
            - Guarantees
         b. Developmental Aspects
         c. Country Context
         d. Financial Considerations
         e. Institutional Policy Issues

CHAPTER VI. WORLD BANK INSTRUMENTS IN SUPPORT OF PROJECT FINANCE .. 37
   A. Debt Financing: IBRD Loans and IDA Credits ................................ 37
      1. Basic Characteristics of Loans and Credits ................................ 37
      2. IBRD Loans ...................................................... 38
      3. IBRD Loans for "Enclave Projects" .................................. 39
      4. IDA Credits ...................................................... 42
B. Guarantees ................................................ 42
   1. Direct IBRD and IDA Guarantees .......................... 43
      a. IBRD Guarantees
         i. Partial Risk Guarantees
         ii. Partial Credit Guarantees
      b. IDA Guarantees
   2. World Bank Financed (Indirect) Guarantee Protection .......... 45
      - Country Guarantees
      - Third-Party Guarantees
      a. Form of Investment
      b. Type of Obligation
      c. Risks: Commercial vs. Political
C. Other Guarantee-Type Instruments ................................. 49
   1. Put Options ........................................... 49
   2. Political Risk Insurance ................................... 50
   3. "Take-or-Pay" and Other Purchase/Supply Contracts ............ 50
D. Equity and Quasi Equity ....................................... 51
E. Other World Bank Investment Support: Debt Refinancing and
   Investment Facilities ....................................... 52
   1. Debt Refinancing ....................................... 52
   2. Investment Facilities ..................................... 53
F. Use of Contingent Loans ......................................... 54
   - Purpose and Financial Attributes
   - Irrevocable Payment Instructions
G. Overview of World Bank Support .................................. 55
   - Debt
   - Equity
   - Guarantees
   - Put Options
   - Political Risk Insurance
   - "Take-or-Pay"/"Take-and-Pay" Contracts

CHAPTER VII. RELATIVE ADVANTAGES OF WORLD BANK SUPPORT ....... 59
A. Financial Advantages ........................................... 59
   - Resource Base
   - Catalytic Role
   - Willingness to Lend in Developing Countries
   - Willingness to Finance Government Investment
   - Favorable Terms: Maturities and Interest
B. Political Risk Protection ........................................ 61
  1. Political Risk Guarantees ........................................ 61
  2. Political Risk Comfort ........................................ 62
  3. World Bank Leverage ........................................ 62
     - Contractual Leverage
     - Leverage Regarding Future Lending
     - Leverage Regarding Other Donor Resources
C. Additional Considerations ........................................ 63
  1. Policy Conditionality ........................................ 63
  2. Risk Analysis ........................................ 64
     - Sovereign Credit Risk vs. Project Risks
     - Developmental Implications of Project Risks
  3. Other Considerations ........................................ 66
     - Procurement Policies
     - Financial Management Requirements
     - Development vs. Commercial Orientation

CHAPTER VIII. INTERNATIONAL FINANCE CORPORATION .......... 69
A. Forms of Investments ........................................ 69
   - Loans: IFC Funded and Syndicated
   - Equity
   - Quasi Equity
   - Guarantees
B. Institutional Considerations ..................................... 71
C. Relative Advantages of IFC Participation ..................... 71

CHAPTER IX. MULTILATERAL INVESTMENT GUARANTEE AGENCY .... 73
A. MIGA Financed Coverage ........................................ 73
   1. Eligibility: Investors and Investments ...................... 74
   2. Types of Coverage ........................................ 74
      - Currency Transfer (Inconvertibility)
      - Expropriation
      - War and Civil Disturbance
      - Breach of Contract
   3. Risk Assessment, Risk Mitigation, and Country/Project
      Exposure Limits ........................................ 75
   4. Terms of Insurance ........................................ 76
B. MIGA Sponsorship Trust Fund ................................... 76
C. MIGA Guarantee Administration .................................. 77
D. Relative Advantages of MIGA Participation .................... 77
<table>
<thead>
<tr>
<th>Annexes</th>
<th>Table of Contents</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-1: IBRD Loan to Project Company with Country Guarantee</td>
<td>79</td>
</tr>
<tr>
<td>A-2: IBRD Loan to Country with Onlending to Project Company</td>
<td>80</td>
</tr>
<tr>
<td>A-3: IBRD Loan for an &quot;Enclave Project&quot;</td>
<td>82</td>
</tr>
<tr>
<td>B: IDA Credit</td>
<td>84</td>
</tr>
<tr>
<td>C-1: IBRD &quot;Partial Risk&quot; Guarantee</td>
<td>86</td>
</tr>
<tr>
<td>C-2: IBRD &quot;Partial Credit&quot; Guarantee</td>
<td>88</td>
</tr>
<tr>
<td>C-3: IBRD &quot;Partial Credit&quot; Guarantee Through Put Option</td>
<td>90</td>
</tr>
<tr>
<td>D-1: World Bank Financed Country Guarantee</td>
<td>92</td>
</tr>
<tr>
<td>D-2: World Bank Financed Third-Party Guarantee</td>
<td>94</td>
</tr>
<tr>
<td>D-3: World Bank Financed Put Option</td>
<td>96</td>
</tr>
<tr>
<td>D-4: World Bank Financed &quot;Take-or-Pay&quot; and Other Contracts</td>
<td>98</td>
</tr>
<tr>
<td>E: World Bank Financed Equity</td>
<td>100</td>
</tr>
<tr>
<td>F-1: World Bank Financed Debt Refinancing</td>
<td>102</td>
</tr>
<tr>
<td>F-2: World Bank Financed Investment Facility</td>
<td>104</td>
</tr>
<tr>
<td>Selected Bibliography</td>
<td>106</td>
</tr>
</tbody>
</table>

xiii
I. INTRODUCTION

1.1. Large-scale infrastructure, industrial and other development projects have provided an essential pillar for global economic growth. Many of these projects, in both industrial and developing countries, have been financed through the medium of the project finance structure. Under this structure, sponsors raise debt financing for their proposed project on the basis of the project and its revenues, rather than the sponsors' assets. Sponsors have frequently employed the structure to mobilize private capital for discrete infrastructure, industrial and other commercial projects. This technique has also provided an important medium for commercial banks, insurance companies and other financial institutions to participate in these projects to the benefit of the host country and other project participants.

1.2. Through the early 1970s, large-scale projects in developing countries were frequently financed through official sources, such as host country governments, multilateral development institutions and the export promotion agencies of industrial countries. Recent trends, however, have reduced the availability of public sector financing for these projects, and at the same time increased the importance of private sector participation in such projects. These trends include constrained public expenditures, increasing emphasis on the role of the private sector, and a reduction in aid flows to developing countries. As a consequence, if developing countries are to continue to benefit from new large-scale infrastructure and other projects needed to support their economic development, flexible financing techniques need to be exploited and creative methods found to mobilize the private capital resources required to ensure the execution of such projects.

1.3. This evolution poses a challenge to the World Bank, which is relied upon by a significant number of developing countries to provide assistance in financing their economic development programs. To address these trends and constraints, the World Bank should enhance its strategy for supporting the execution of these large-scale infrastructure and industrial projects that are often the backbone of such economic programs. The increased use of the project finance structure and the development of new instruments to advance its use should be important elements of this strategy. The World Bank's constituent organizations, the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA), together with their affiliates within the World Bank Group, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA), can potentially provide a varied, and complementary, array of support in this regard.

1.4. The purpose of this paper is to provide an introductory working tool for World Bank staff and professionals outside the Bank who are interested in project finance operations in developing countries and the role of the World Bank in this area. The paper reviews the support for project finance operations provided by IBRD and IDA. It outlines the financial instruments employed by IBRD and IDA, and describes the principal underlying legal, structural and policy issues that affect their participation in this area. In addition, the paper identifies various benefits and constraints which may be engendered by World Bank participation in a project finance operation. The paper also includes a brief description of the support provided by the World Bank's affiliated organizations, IFC and MIGA.
Chapter II - Importance of Project Finance in Developing Countries

II: IMPORTANCE OF PROJECT FINANCE IN DEVELOPING COUNTRIES

2.1. Many developing countries have, since their independence, embarked on large-scale infrastructure and industrial projects. For numerous countries, these projects have represented an important element, and at times the cornerstone, of their economic development strategy. These projects have often involved the mining industry, as well as industrial production and processing operations targeted at export markets – enterprises that generate needed foreign exchange earnings. Other projects have centered on domestic power generation and other local infrastructure projects, operations that provide critical support to local economic activity.

2.2. These large-scale projects in developing countries often were financed primarily through public sector resources. In their quest to spur large-scale enterprises to achieve rapid economic growth, many governments played an active financial role in the development of these projects, providing financing for critical infrastructure and other project components. Although this approach presented potential monetary benefits to the country, it also engendered significant financial exposure, as the governments concerned in many cases bore many of the risks associated with their financial participation in the project. In addition, because of the need of large-scale infrastructure and industrial projects for substantial financial resources and the attendant exposure they present, these projects have historically placed a heavy burden on public finances in many developing countries.

2.3. This reliance on public sector financing, however, has not proven effective or sustainable, as reflected in numerous global developments in the late 1980s and early 1990s. These developments include deteriorating fiscal conditions for many developing countries, increasing emphasis in both industrial and developing countries on the role of the private sector, increased privatization of public sector enterprises, the recent substantial demand for aid resources from countries in Eastern Europe and Central Asia, and reduced aid flows to many developing countries. Similarly, the significance of foreign and other private sector participation has increased over the last decade as greater emphasis has been placed on private sector investment and control, and on limiting government involvement in industrial and other commercial activities. These developments have led both to a reduction in the amount of public sector financing available for large-scale projects in many developing countries, and to increased emphasis on private sector participation in these projects.

2.4. In response to these factors, a varying array of financing techniques needs to be developed and exploited to mobilize the private capital resources required to ensure the execution of new large-scale infrastructure and other projects in developing countries. The project finance structure represents such a technique -- one that provides a means for governments to substitute private investment for public expenditures.

2.5. The potential catalytic role of the project finance structure in this process was recently summarized by project finance analysts as follows:

There is enormous demand throughout Latin America for investment in basic infrastructure . . . [and] for expansion of investment in the exploration and production of traditional, export-oriented natural resources . . . . But although the major Latin
American countries have emerged from the debt crisis and again gained access to international capital, many of them have recently embraced free-market economic programs and, in an effort to curb inflation, are attempting to balance their budgets. These efforts have resulted in their reluctance to make direct governmental investment in infrastructure or to borrow for new projects on the basis of the country's balance sheet. For these nations, limited recourse project financing is a promising vehicle for attracting the capital necessary to address the demand for investment in infrastructure and natural resources.¹

The same prospects face developing countries in other regions of the world. Indeed, for many such developing countries, the need for alternatives to government financing provided by mechanisms such as project finance is often more acute because the fiscal constraints are more severe.

2.6. The relationship between these recent trends and the increasing importance of project finance is also reflected in the 1994 World Development Report on infrastructure.² The Report highlights the heavy dependence of developing countries on government financing of critical infrastructure facilities, as well as an increasing demand in many developing countries for such infrastructure projects. Recognizing the financial constraints facing governments, and the need to limit public expenditures in favor of private sector capital and control, the Report calls for the development of new approaches to promote private sector investment in these projects. It concludes that the project finance structure is an appropriate mechanism to address these constraints and concerns -- one that is within reach of all developing countries.³

2.7. Experience has demonstrated the success of the project finance structure in attracting private sector sponsors and commercial lenders. A survey published in 1993 indicates that nearly 150 private infrastructure projects had been carried out worldwide on the basis of this mechanism at a total cost of more than $60 billion; about half of these investments were made in developing countries.⁴ In addition, the World Development Report notes that: "250 [infrastructure] projects are being considered in developing countries - seventy two of them in low-income countries,"⁵ and observes that "a huge pipeline of . . . projects bears the promise of decisively shifting the channels and instruments of

¹ Mortimer and Green, Building Bridges, Tunnels and Power Plants (1993), at page S-2.
³ The World Development Report notes that in certain cases, countries may require technical assistance from the World Bank and other development agencies to effectively exploit the project finance mechanism. Another method to generate private capital is the use of bond and equity issues for these projects. This approach has the added advantage of supporting the creation of capital markets within developing countries, which can be used to attract both local and foreign investors. However, the use of bond and equity issues requires a relatively developed financial sector, which numerous developing countries currently lack. World Development Report 1994, at page 108.
infrastructure financing in the future.6 These comments and figures reflect the increasing importance7 and extensive use of the project finance structure, and point to a large portfolio of future infrastructure projects that potentially could be financed through this mechanism.

2.8. The global movement away from heavy dependence on public sector financing, and toward greater reliance on private capital and control, means that the project finance mechanism will receive greater consideration in the future. For developing countries, this mechanism will likely constitute an important tool to finance the large-scale infrastructure and other industrial projects needed to support their economic development in the 1990s and beyond.

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7 As recently described by Robert Shanks, former Vice President and General Counsel of the United States Overseas Private Investment Corporation: "Project Financing is receiving renewed attention as the primary vehicle for financing cross-border investments throughout the world." International Investors Eye Project Financing (1992), at page 30. Similarly Clarke and Martin wrote in 1980: "The role of [commercial] banks in project finance has only recently grown to a significant size on an international scale. Until the early 1970s, the main sources of finance for projects were official ones. . . . [M]ost bankers will agree that project finance looks to become the most challenging and potentially lucrative sector of international banking in the 1980s." The Big Swing to Project Finance (1980), at pages 233-234.
III: PROJECT FINANCE: BASIC STRUCTURAL ELEMENTS

3.1. Project finance transactions in developing countries are characterized by several basic structural elements, including (a) varying forms of investment, (b) diverse participants including governments, and (c) an array of benefits and risks. In addition, these transactions often involve various mechanisms designed to reallocate risks among the participants. Given these various structural elements, project finance transactions frequently present relatively complex financial structures and arrangements. This Chapter provides an overview of some of the basic structural elements generally found in such transactions in developing countries. The descriptions below emphasize classifications and distinctions of significance to the World Bank, and set out a framework for the discussion in the succeeding chapters of the World Bank’s support for project finance operations.

A. General Description

3.2. "Project finance" is a term that has been used to refer to a wide array of financial transactions. Although it is a common term in business, financial and even legal settings, it does not have a precise legal definition. Clifford Chance, an international law firm with significant expertise in project finance transactions, describes the term as follows:

The term "project finance" is used to refer to a wide range of financing structures. However, these structures have one feature in common - the financing is not primarily dependent on the credit support of the sponsors or the value of the physical assets involved. In project financing, those providing the senior debt place a substantial degree of reliance on the performance of the project itself.9

Peter Nevitt of Bank of America describes the concept in his seminal book, "Project Financing", in the following terms:

A financing of a particular economic unit in which a lender is satisfied to look initially to the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan.10

In general terms and for purposes of this paper, project finance refers to a structure through which a project sponsor attracts financers to a proposed discrete project on the basis of the project’s revenues, rather than the general assets of the sponsor. An important corollary is that the project finance structure allows a sponsor to avoid providing financers with "recourse" (that is, access) to its general assets in the

8 For a fuller discussion of project finance generally, see: (a) Nevitt, Project Financing (1983), (b) Clifford Chance, Project Finance (1991), and (c) Delaume, Legal Aspects of International Lending and Economic Development Financing (1967).

9 Clifford Chance, Project Finance, at page 1.

10 Nevitt, Project Financing, at page 3.
case of poor project performance, which in turn allows the sponsor to finance the project off its balance sheet. This "off-balance sheet financing" characteristic is for many sponsors a significant part of the appeal of the project finance structure.

3.3. By emphasizing the link between the financial resources required to execute the project and the project's revenues, this structure provides a means of funding a variety of enterprises that might otherwise not be financed. In particular, the project finance structure permits the financing of a project whose sponsors either (a) are unwilling to expose their general assets to liabilities to be incurred in connection with the project (or are seeking to limit their exposure in this regard), or (b) do not enjoy sufficient financial standing to borrow funds on the basis of their general assets. The project finance structure also provides a means for sponsors to minimize their exposure to the risks associated with the project by attracting a variety of investors (in particular, lenders) with which project risks are shared in exchange for a share of project revenues.

B. Project Viability

3.4. As indicated from the foregoing general definition of project finance, the structure centers around the viability of the proposed project, rather than the financial standing of the sponsor. The raison d'être for these projects may vary. In many cases, the purpose is to develop a country's natural resources or to generate a needed output (such as electricity). Project concepts may be put forward by professional project operators, other private investors, or governments or governmental entities. But in all instances, the project finance operation requires an underlying project that is technically and financially viable.

C. Forms of Investment

3.5. Project finance operations involve varying forms of investments. These include the following principal types, all or several of which are generally present in a particular transaction:

i. Equity: Any project finance operation begins with the equity investment. Equity typically shares in the profits of the project and any appreciation in the value of the enterprise, without limitation -- this represents the upside potential of equity. At the same time, the return on equity is generally the first to be adversely affected when the project encounters financial difficulties -- this represents the countervailing downside risk faced by equity. Equity investment in the project finance context is distinguishable into two types: (a) active (or "direct") equity investors who seek

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11 Financing which has been accorded no access to the sponsor's general assets is referred to as "non-recourse"; if limited access is provided (e.g., if the sponsor provides a guarantee of repayment but only for certain risks), the financing is referred to as "limited-recourse".

12 As explained by Clifford Chance, investors in a project finance transaction "will need to concern themselves closely with the feasibility of the project. . . . Project finance . . . requires the consideration of . . . factors relating to the technical feasibility of the project ('the technical test') and its economic viability ('the economic test')." Project Finance, at pages 1-2.
to participate in the management or operation, or both, of the project (this may often include operators), and (b) passive (or "portfolio") equity investors that provide only their funds.\(^3\)

ii. **Debt:** The critical element in a project finance operation is the provision of loans to help finance the project. The main attribute of this debt is a specified return on the investment, consistent with traditional lending returns, but with commensurate protection against losses provided principally through the project's assets. Debt financing is often provided through private placements (that is, negotiations between the sponsor and specified individual lenders). Alternatively, this financing can in certain circumstances be raised through capital markets (for example, public bond issues).

iii. **Quasi Equity:** A third class of investment frequently takes the form of debt, but enjoys many of the qualities of equity. This class of investment is commonly referred to as "quasi equity". This class includes convertible debentures, preferred stock and other investments with the attributes of both debt and equity.

iv. **Contractors, Suppliers and Purchasers:** A fourth class of investment often present in a project finance operation is that of purchasers of outputs, and of contractors and other suppliers of services and inputs. Projects are often designed to respond to the needs of specific purchasers (for example, power plants are often built to satisfy the needs of a utility distributor). Many projects are also sponsored in part by private sector companies that specialize in building or operating the proposed project facilities.

v. **Sureties:** A fifth class of investment involves sureties -- that is, resources that are allocated by a guarantor or another party to protect the investment of others against specified financial losses.

vi. **Insurance:** A sixth class of investment of financial resources consists of resources allocated to a project by insurance companies to compensate for eventual casualties (such as fire) and other insurable events.

### D. Participants

3.6. Project finance operations in developing countries typically bring together an array of participants, both domestic and foreign. The participants may be grouped into the following three general classes: (a) private sector participants, (b) governments and governmental entities, and (c) multilateral institutions. Each of these classes of participants has played a variety of roles in project finance operations.

3.7. **Private Participants.** Private sector industrial companies and other participants often play the central role in project finance operations -- for example, as the primary sponsors, or as the parties

responsible for the construction and operation of the project. Generally, private sponsors work, often with a government sponsor, to solicit the financing needed to bring the project to financial closure. Commercial banks and other private sector financial institutions also generally provide a substantial portion of the funds required to finance the project. Private participants also play a variety of other roles, including (a) as guarantors or other sureties for certain aspects of the transaction, (b) as insurers, and (c) as purchasers of the output of the project or suppliers of required input.

3.8. **Host Countries.** The country where the project will be located (the "host country"), together with its governmental entities, often play an important supporting role, most notably in large-scale transactions in developing countries. The form and extent of their participation generally varies from one project to another. The principal ones are: (a) as a contributor to equity; (b) as a provider of debt; (c) as a provider of guarantees (in particular regarding political risks); (d) as a supplier of various resources required for the operation of the project (for example, electricity and other utilities); (e) as a purchaser of output (for example, as a utility purchasing electricity); and (f) through fiscal support (for example, tax holidays and other incentives).

3.9. **Export and Transit Countries.** The home countries of potential suppliers to the project (the "export country"), as well as countries through which project goods must transit to ensure project success (the "transit country"), are often also participants in project finance operations. Many export countries have two separate windows to finance these projects, namely: (a) their national export credit agencies, which generally provide some form of supplier credit support, and (b) their foreign aid agencies, which provide funds to developing countries on concessional terms to purchase goods and services. Transit countries may participate formally in the project, seeking a specific remuneration to facilitate transit through their territories. Alternatively, the active participation of a transit country may be needed for infrastructure improvements in its territory that are required by the project (for example, improvements in its port facilities).

3.10. **Multilateral Participation: World Bank and Other Development Banks.** The World Bank and other development banks also play a complementary and often catalytic role in project finance operations in developing countries. The support provided by the World Bank is discussed in the next several chapters. Many other development banks provide the same kind of assistance as the World Bank. Often, various development banks coordinate their activities to co-finance particular operations.

E. **Benefits**

3.11. Industrial and other projects typically financed through the project finance structure yield a variety of benefits, such as: (a) project revenues, which generally constitute the principal project benefit for most investors; (b) the creation of secure markets for goods or services (for example, a plant seeking a stable supply of electricity, or a natural gas developer financing a pipeline project as a means to export its product); and (c) miscellaneous fees (such as premiums paid to insurers for their policies, and commissions provided to commercial banks for issuing letters of credit).

3.12. There are also additional potential benefits of particular relevance to host developing countries. These include: (a) the import of new technologies and the training of nationals in related
technologies; (b) employment creation, during both the construction and operation phases; (c) increased
tax revenues from the enterprise (in addition to any revenues accruing from a direct debt or equity
investment); (d) improved infrastructure required to construct or operate the project (for example,
construction of access roads to the project site); and (e) foreign exchange savings flowing, for example,
from the substitution of imported goods with domestically produced project output.

F. Risks

3.13. In connection with any proposed loan or other investment, lenders and other investors
must identify and evaluate the risks affecting their expected returns. These risks can be categorized as
follows:

(a) risks which pertain to a specific project ("project risks"), as distinguished from risks which
relate to a particular debtor (referred to in this paper as "debtor's credit risk"), including risks
relating to a particular country debtor (referred to in this paper as "sovereign credit risk")14;

(b) project risks that are commercial in nature ("commercial risks"), as distinguished from those
that are political in character or otherwise relate to the country context (referred to in this paper
as "political risks"); and

(c) risks that are within the control of project participants, as distinguished from those outside
such control (force majeure).

1. Project Risks vs. Debtor’s Credit Risk and Sovereign Credit Risk

3.14. In general terms, "project risks" are those risks which threaten the operation of a specific
project, and thereby threaten repayment of the lender's loan to the project. By comparison, debtor's
credit risk is the risk that a particular debtor company will default on its loans (for example, as a result
of bankruptcy or other deterioration in its overall financial condition). When the debtor is a country, the
risk of default is referred to in this paper as sovereign credit risk. The relative importance for a lender
of these different classes of risks will vary as a function of the sources upon which it is depending for
repayment of its loan.

3.15. Under traditional credit financing, the lender looks to the borrower's general assets. In
credit financing structures, risks affecting an individual borrower activity (such as a specific project) are

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14 This type of risk is commonly referred to as "sovereign risk". However, this term has been used in different ways,
including to refer to "political risks" (discussed below). For purposes of this paper, the term "sovereign credit risk" is used
to denote the risk of a payment default by a sovereign state in respect of a loan, indemnity, or other contract with a similar
repayment or reimbursement obligation.
usually not critical to the lender; rather, the lender focuses on the general creditworthiness of the borrower. When the borrower is a country, the lender must assess the capability and the willingness of the sovereign to repay the loan. In the archetypal project finance structure, financiers look to the project and its revenues, rather than to the general assets of the sponsors. Consequently, any discrete risk which may interfere with the operation of the project and related revenue flows to the lender must be evaluated and addressed. In this context, project risks are critical and require significant attention from investors. In practice, however, sponsors are often required in project finance transactions to provide guarantees to specified lenders or other investors (for example, against certain commercial risks). To the extent that pursuant to these guarantees the lender now also looks to the sponsor for repayment, the sponsor’s credit risk becomes significant. As a consequence, debtor/sovereign credit risk and project risks are often both important issues for financiers in project finance operations.

2. Commercial vs. Political Risks

3.16. Project risks are divisible into "commercial risks" and "political risks". Although there is some overlap between these two categories, they provide a general framework often used to address this area. In general terms: (i) commercial risks relate to technical, financial and other concerns that would face a project irrespective of its country location, and (ii) political (or country) risks relate to those risks presented by the particular country and its government. This second set of risks is generally highlighted when foreign investors are present in the project; moreover, these risks are often of particular importance to potential foreign investors in projects in developing countries.

a. Commercial Risks

3.17. The commercial risks facing any project are numerous. Below is an indicative list.

- Risks relating to completion: (a) the risk that the construction of the project will not be completed within the required time frame as a result of contractor delays; (b) the risk that the project’s completion will involve cost-overruns (for example, as a result of delays or underestimated cost projections); and (c) the risk that the project fails at its commissioning to meet the required performance specifications;

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15 However, such individual activities remain relevant to the lender as they can affect to some degree the debtor’s ability to repay the loan. There are certain exceptions to this de-emphasis of particular activities, such as in the case of a loan to a company that depends heavily on a specific business activity for the majority of its revenues.

16 As explained by Clifford Chance, financiers must "concern themselves closely with . . . [the project’s] sensitivity to the impact of potentially adverse factors." Project Finance, at p. 1. However, the general creditworthiness of the sponsor remains important since it can affect certain project risks (for example, the likelihood of sponsor abandonment of the project).

17 See, for example, Clifford Chance, Project Finance, at pages 16-23; and Nevitt, Project Financing, at pages 165-166.

18 For example, as described by Clifford Chance: "In any cross-border financing, banks take a 'political' risk . . . ." Project Finance, at page 19.

19 See also Clifford Chance, Project Finance, at pages 16-18.
- Risks relating to operation (post-completion risks): (d) the risk that the project does not operate with the desired efficiency (this may result from deficiencies in equipment or personnel); (e) the risk that project operation is significantly more costly than projected (for example, as a result of unforeseen technical hurdles); (f) unexpected legal issues arising in connection with project operation (for example, environmental liabilities); and (g) fire and other casualties;

- Risks relating to inputs and outputs: (h) inadequate or inconsistent supply of raw materials, utilities or other inputs (for example, interruptions in the supply of electricity); (i) breach of contract by purchasers or suppliers; (j) price increases regarding project inputs (for example, increase in the cost of utilities); and (k) inadequate demand for project output, either in terms of price per unit or quantity; and

- Risks relating to financing: (l) increases in interest rates; and (m) fluctuations in exchange rates (for example, between revenues received for project output and debt service payments).

b. Political Risks

3.18. Investors in projects also face a myriad of political risks that typically devolve either from political acts by the government of the host country or other country-specific conditions. These include: (a) the risk that the government will expropriate project facilities; (b) the risk that the government will unduly withhold licenses required for the construction or operation of the project, or will delay their issuance; (c) the risk that the government will breach its contractual obligations to the investors and deny them access to an adequate forum to resolve any ensuing contractual dispute; (d) the risk that the government will impose restrictions or otherwise act to limit the ability of investors to convert their local currency into foreign exchange; (e) the risk that the government will enact changes in law that adversely affect the project's operations; and (f) the risk of war or civil disturbance interfering with the project's operation.

3. Force Majeure

3.19. The third category of risks focuses on project risks that are outside the participants' control -- that is, force majeure. They include floods, earthquakes, and other natural disasters.

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20 In various instances, government breaches of contract may reflect commercial, rather than political, risks. For example, the government's failure to provide electricity may result solely from technical problems affecting its power generators. The commercial risk, however, becomes political in nature if the government denies the project company access to an appropriate forum to adjudicate its claims or the facility to enforce a favorable judgement.

21 See also Clifford Chance, Project Finance, a pages 19-21.

22 Black's Law Dictionary (Fifth Edition) (1979) describes force majeure as "causes which are outside the control of the parties and could not be avoided by exercise of due care."
(referred to as "Acts of God"), 23 and generally include war and civil disturbance. The set of risks included in force majeure will vary as a function of whether the project participants include governments. In projects with only private sector participants, expropriation and other political risks are frequently considered force majeure risks. When the host government participates, expropriation and various other political risks are viewed as falling within its control and thus would not be deemed to constitute force majeure risks. In many cases, the contractual effect of force majeure is to excuse performance or to suspend penalty provisions associated with defaults (for example, in connection with supply contracts). In contrast, lenders typically seek repayment of their loans notwithstanding events of force majeure, and otherwise seek to insulate themselves from these risks. In part as a consequence of these dynamics, the parties to a project finance operation will often carefully negotiate which risks are included in the definition of force majeure, as well as the contractual effects of force majeure events.

G. Reallocation of Risks and Related Mechanisms

3.20. As described above, project finance operations involve a myriad of risks, and each investor in the project faces the prospect that any one of these risks will interfere with its expected returns. As a consequence, project participants attempt to protect themselves from such risks, often by reallocating responsibility to another party. This reallocation of risks is generally accomplished by one party agreeing to compensate (that is, protect) another party for financial injury resulting from the occurrence of the risk. Reallocation of risks in any given transaction is made in the context of the following general underlying dynamics: (a) absent reallocation, parties face the panoply of risks with respect to their investments; (b) parties attempt to minimize the risks they will face; (c) parties seek returns at least commensurate with the risks they absorb; (d) parties seek to allocate risks to the parties best able to manage them (that is, the party most capable of reducing the particular risk), 24 and (e) parties attempt to reallocate risks to those parties capable of absorbing them or best able to evaluate them. The use of mechanisms to effect the reallocation of risks is a visible part of any transaction; it is also one where the World Bank Group plays a potentially important role. Several mechanisms frequently used to reallocate risks are described below.

1. Guarantees

3.21. Structure. Guarantees represent the most common method for reallocating responsibility for risks. Under the traditional guarantee structure, the guarantor backs the contractual obligations of one party to another party (see Box I.1). By way of illustration, a parent company (the guarantor) may issue a guarantee to creditors of its subsidiary under which the parent undertakes to pay the creditors amounts due on their loans if the subsidiary defaults. This represents a direct guarantee. In other instances, the guarantee is provided to the subsidiary’s creditors by a commercial bank or other third-

23 Black’s Law Dictionary defines 'Act of God' as "An act occasioned exclusively by violence of nature without the interference of any human agency."

24 For example, government participants may be called upon to protect other parties from risks involving government action. This principle would not apply to force majeure risks which, by definition, fall outside the control of the project’s participants.
party, at the behest of the parent company; the parent company, in turn, agrees to reimburse the bank or other third-party guarantor for all amounts paid to the creditors under the guarantee. This represents a third-party form of guarantee. The undertaking by the parent company to reimburse the third-party guarantor constitutes a form of indemnity or counter-guarantee running from the former to the latter. Guarantees may (a) cover a limited set of specified risks (for example, expropriation) -- these constitute "partial risk" guarantees; (b) protect certain payments under a loan (for example, later maturities) -- these constitute "partial credit" guarantees; or (c) provide full coverage against all risks (for example, an undertaking by a sponsor to a lender to repay the loan in full if the debtor project company fails to do so for any reason).

3.22. **Payment vs. Performance Obligations.** Guarantees protect two basic types of obligations: payment and performance. The former involves an obligation by one party to pay another. The guarantee of this obligation also would involve a payment undertaking. In the case of performance obligations, the party obligates itself to take certain actions (for example, to provide certain inputs). The guarantee of this obligation may involve an undertaking by the guarantor to perform itself (that is, to provide the inputs); generally, however, the guarantee would permit payment of financial compensation instead.

2. **Insurance: Casualty and Political Risk**

3.23. Project participants often insure themselves against various risks, such as casualties and political risks. Under the traditional insurance structure, investors purchase insurance against certain risks from an insurer; payments by the investors to the insurer are made in the form of premiums. When the casualty or political risk materializes, the insurer pays the insured investors from its resources for losses suffered (see Box I.1). In this manner, insurance serves to mitigate, through the medium of the insurer, the financial exposure that would otherwise be faced entirely by the project participants. The insurer, in turn, depends financially on the premiums generated from its entire portfolio, and relies heavily on its ability to evaluate risks and only insure acceptable ones.

6 In the area of political risk insurance, the insurer also may benefit from an additional advantage, namely the ability to exercise influence over the relevant host country to mitigate the likelihood of the risk materializing and a claim being filed.

3. "Take-and-Pay", "Take-or-Pay" and Other Purchase/Supply Contracts

3.24. Purchase and supply contracts are often employed to address market and other risks facing project sponsors and lenders. These include "take-and-pay" and "take-or-pay" contracts. Although

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25 The term "third-party" guarantor as used in this paper differs from the use of the term by Nevitt (see Project Financing, at p.163). As used herein, the concept covers any institution acting as a financial intermediary for a project sponsor. The term as used by Nevitt refers to third-parties that provide guarantees for their own account (for example, export credit agencies).

26 Given the practice within the insurance industry of evaluating risks, the ability of a project company to obtain insurance also serves for potential financiers as an endorsement by an independent party, namely the insurer, that the project company’s proposed risk mitigation measures are acceptable (for example, that the company has an adequate action plan to implement fire safety measures).
each of these terms is used in practice to refer to contracts with varying characteristics, the following general descriptions provide useful models.

a. Under the "take-and-pay" contract, a purchaser agrees to pay for what the project produces and delivers. In this way, it guarantees to investors that there will be a secure market for project outputs, but it does not guarantee the operation of the project.

b. Under the "take-or-pay" contract, the purchaser is required to pay for the outputs, whether or not it takes delivery. Often, the obligation to pay exists even if the output has not been produced. As described by Nevitt: "[This] obligation to pay by the take-or-pay obligor is absolute and not limited by total destruction of facilities, acts of God, nuclear explosion, confiscation, condemnation, etc." In this regard, the "take-or-pay" contract often provides for a minimum payment designed to protect creditors specifically. As such, it can substitute for a full guarantee (see Box I.1).

3.25. These contract structures are also used in transmission and other service projects (such as petroleum pipelines). In these service projects, the operator is guaranteed payment of its tariffs or other charges. These contracts are referred to as "through-put", "ship-and-pay" and "ship-or-pay" contracts. These structures are also applied to the supply of goods. For example, a "supply or pay" contract can be used to assure a project of delivery of required raw materials; if the supplier fails to deliver, it must compensate the project for any additional costs incurred in obtaining the raw materials from other sources. Alternatively, sponsors may enter into more informal arrangements with suppliers and purchasers designed to give comfort to project participants regarding inputs or outputs, rather than to provide the type of direct financial compensation associated with the "take-or-pay", "take-and-pay" and other similar guarantee-like contracts.

4. Put Options

3.26. Put options are also employed as an instrument to protect investors in project finance operations. Under a put option, specified parties (for example, the investors) are given the option to require another party (for example, the sponsor) to purchase certain project assets they own (for example, equity or debt instruments) at a specified price, and typically upon the occurrence of certain events (for

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27 Nevitt defines the "take-and-pay" contract as "an obligation to pay for the product or service only if it is delivered." Project Finance, at p. 184.

28 Nevitt, Project Financing, at page 183. This type of unconditional undertaking is commonly referred to as a "heli or high water" obligation. See also Bochenski, Enclave Projects, at page 25.

29 As described by Carroll in Legal Aspects of Project Finance: The Borrower's View (1992): "Reduced to its simplest terms, take-or-pay means that the purchaser is subject to an absolute and unqualified obligation to make periodic payments in a minimum amount (usually enough to cover debt service including scheduled amortisation) . . . (at page 80)."

30 See Nevitt, Project Financing, at pages 183-184 for a fuller discussion.
Chapter III - Project Finance: Basic Structural Elements

Box I.1: Comparison of Guarantees, Insurance, "Take-or-Pay" and Put Options

a. **Contractual Aspects.** Payments made under a guarantee do not extinguish the obligations of the party (the obligor) whose undertakings are being guaranteed. Rather, guarantors generally become "subrogated" to the rights of the protected investors as against the obligor (that is the guarantor steps into their shoes and now benefits from the obligor's original undertakings to the investors). In contrast, when an insurance claim is paid, no ongoing contractual relationship generally remains after such payment. Similarly, when the put option is exercised, the assets are sold for the agreed price, and no ongoing contractual relationship ties the parties to the transaction (except when the assets themselves involve a debt instrument or other contractual obligation). Under the "take-or-pay" contract, payment is made for goods provided; if the goods were not then provided, the purchaser may benefit from a credit with respect to future project output.

b. **Source of Compensation.** The insurer looks to the premiums from the particular project, together with those generated by its entire portfolio, for compensation. In contrast, the guarantee, put option and "take-or-pay" contracts are typically backed by a project sponsor, who looks to the project's success for compensation. Commercial banks and other third-party guarantors generally derive their compensation from the fees they charge for their services.

c. **Transfer of Assets Upon Payments.** Guarantees normally involve the payment of money and the receipt through subrogation of contractual rights. The put option typically involves a transfer of cash in exchange for generally recognized assets (e.g., equity or debt in the project company). An important distinction between the guarantee and the put option is that under the latter, the investor would normally be required to transfer the debt instrument or other assets, and thus forgo attendant future rights. Under the guarantee, the investor would typically continue to own the assets and attendant future rights; only the investor's underlying contractual right to receive a specific payment would be transferred to the guarantor upon its related payment under the guarantee. The "take-or-pay" contract involves payment in exchange for a right to the project's output. Payment of an insurance claim may involve the transfer of property by the insured party to the insurer (e.g., the insurer would obtain the investor's interest in the insured assets upon paying an expropriation claim).

d. **Performance and Payment Obligations.** Guarantees generally provide for payment, and at times may require performance by the guarantor. The put option, "take-or-pay" contract and insurance all involve payment, not performance.

example, after a certain period of time). This option provides the investors with comfort that they can recoup directly from the sponsor part or all of their investment under certain conditions (see Box I.1). The put option structure can take on several distinct forms. For example, the put can be used as a surrogate for a "partial risk" guarantee if it is structured to be triggered only upon the occurrence of certain defined risks; this mechanism is referred to in this paper as a "partial risk" put option. Alternatively, it can be used to guarantee certain debt payments; that is, as a surrogate for "partial credit"
guarantees. For example, an option to put debt instruments to a sponsor at their maturity can serve to guarantee to investors payment at maturity without guaranteeing earlier interest payments.

5. Escrow Accounts and Other Pledges of Assets

3.27. A project sponsor may often pledge certain assets to "secure" a guarantee or other contractual undertaking it has made to an investor or other party (the "secured" party). Under this mechanism, the sponsor provides the "secured" party with priority access to certain of its assets (the "security") to back the guarantee or other contractual undertaking. In certain instances, the security may take the form of a special dedicated account (an "escrow account"), managed by an independent trustee, into which project revenues or other moneys are deposited by the sponsor for the benefit of the secured party. The security arrangements in project finance transactions generally include the following two elements: (a) a pledge of the project's assets and revenues to lenders, and (b) the establishment of an escrow account for the benefit of the lenders into which project revenues are deposited for payment to lenders, project sponsors and other parties in accordance with priorities which have been agreed upon by the project participants.
IV. WORLD BANK GROUP

4.1. The World Bank Group plays an important and visible role in supporting project finance operations in developing countries. Over the last several decades, the World Bank Group has been among the largest, and perhaps the largest, financier in this area, providing the equivalent of billions of United States dollars for project finance operations in developing countries. At the same time, the World Bank Group represents a conglomeration of distinctive multilateral financial institutions, with a unique combination of economic and financial objectives and concerns.

4.2. The World Bank Group consists of five separate, but affiliated, organizations established primarily to promote the economic development of developing countries. The Group includes: (i) the International Bank for Reconstruction and Development (IBRD), (ii) the International Development Association (IDA), (iii) the International Finance Corporation (IFC), and (iv) the Multilateral Investment Guarantee Agency (MIGA). Each organization carries out a complementary function to support economic growth in their member developing countries.

4.3. IBRD was established in 1944. Its primary function is to promote the economic development of developing countries through the provision of financial resources and technical advice. To this end, IBRD approved over US$16.5 billion in loans during its 1995 fiscal year. It is the single largest provider of development loans to middle-income developing countries. IBRD currently has over 175 member countries. Membership is only open to countries that are members of the International Monetary Fund.

4.4. IFC was established in 1956 to complement the support provided by IBRD. Whereas IBRD and IDA, established subsequently, operate through the medium of governments, even when supporting private sector operations, IFC was established to provide direct support to the private sector in developing countries, without government financial guarantees. The purpose, however, remains the same -- that is, to promote the economic development of developing countries. IFC approved about

31 The World Bank classifies countries as developing based primarily on their per capita gross national product (GNP). Currently, the threshold is approximately US$4,900 per capita GNP (1993 dollars). In addition, certain countries with moderate per capita GNP but limited total national resources also qualify for support.

32 Actual disbursements of funds are made in various currencies, including dollars.

33 The World Bank Group also includes the International Centre for the Settlement of Investment Disputes (ICSID). This organization provides a forum to resolve disputes regarding cross-border investments. As such, it also can play a potentially important role in the implementation of project finance operations by providing a forum for the resolution of disputes. Given the focus of this paper on financial tools employed by the World Bank Group to support project financing transactions, the operations of ICSID are not addressed herein. For a fuller description of ICSID see, for example, Shihata, Towards a Greater Depoliticization of Investment Disputes: The Roles of ICSID and MIGA (1992), and Broches, Selected Essays, World Bank, ICSID and Other Subjects of Public and Private International Law (1995).

US$2.9 billion in financing during its 1995 fiscal year. IFC currently has over 160 member countries. Membership is only open to countries that are members of IBRD.

4.5. IDA was established in 1960 to provide financial support to the poorest developing countries. Its purpose is also to promote the economic development of these countries. To this end, IDA approved over US$5.5 billion in loans during its 1995 fiscal year. Given the financial constraints facing these countries, IDA provides this financing on highly concessional terms. IDA currently has over 155 member countries. Its membership is only open to countries that are members of IBRD.

4.6. MIGA was established in 1988 to encourage the flow of foreign investment to developing countries, mainly through the provision of political risk insurance. Although numerous countries have established national programs, their resources are finite and generally their coverage is restricted to investments by their nationals. MIGA has augmented the availability of political risk insurance to foreign investments in developing countries, while avoiding country-specific restrictions. Its purpose in doing so is to promote the economic development of developing countries. During its 1995 fiscal year, MIGA issued political risk coverage totaling over US$670 million. MIGA currently has over 125 member countries. Its membership is only open to IBRD members.

4.7. Although the four organizations are separate legal entities, they share, as organizations within the World Bank Group, most of the same members, the same directors (except in the case of MIGA), and a coherent set of policies. IBRD and IDA also share the same staff and virtually identical procedures; the two organizations are generally referred to collectively as the "World Bank". IFC and MIGA are each served by their own staff.

4.8. As a consequence of the differences in modalities and objectives among these organizations, each one supports project finance operations in developing countries in distinct ways. As a general proposition: (a) IBRD provides financial support to these operations in middle-income developing countries; (b) IDA provides this support in poorer developing countries; (c) IFC supports private sector investment in these operations in any developing country; and (d) MIGA provides political risk insurance to foreign investments in these operations in any such country. Taken as a group, these organizations can potentially provide substantial and varied support to project finance operations in developing countries.

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35 Countries with per capita GNP of less than $1,345 (1993 dollars) are technically eligible for IDA lending. However, under current IDA practice, virtually all IDA credits have been provided to countries with per capita GNP of less than US$835 (1993 dollars).

36 For example, the United States Overseas Private Investment Corporation.

37 IBRD is also commonly referred to separately as simply the "Bank".
V. WORLD BANK: POLICY AND LEGAL FRAMEWORKS

5.1. The manner in which IBRD and IDA participate in project finance operations is dictated by numerous constraints and considerations. These relate to: (i) the legal framework governing IBRD and IDA, (ii) developmental considerations concerning the particular proposed operation and the specific country, (iii) the financial considerations facing IBRD and IDA, and (iv) various policy considerations. These issues affect both organizations in largely identical ways. There are, however, also significant differences in their applicability to and effect on IBRD and on IDA, principally because of differences in the purposes and financial structures of each organization.

A. Development Objectives

5.2. The purpose of the World Bank as stated in its 1995 Annual Report is "to promote economic and social progress in developing nations by helping raise productivity so that their people may live a better and fuller life."\(^3\) IBRD’s Articles of Agreement provide in relevant part:

The purposes of [IBRD] are:

(i) To assist in the . . . development of territories of members by facilitating the investment of capital for productive purposes, including . . . the encouragement of the development of productive facilities and resources in less developed countries.

(ii) To promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources.

(iii) To promote the long-range balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of members, thereby assisting in raising productivity, the standard of living and conditions of labor in their territories [Article I, IBRD’s Articles of Agreement].

5.3. IDA was established to complement in largely parallel ways the functions of IBRD, with IDA focusing on relatively poorer nations. IDA’s Articles of Agreement provide:

The purposes of [IDA] are to promote economic development, increase productivity and thus raise standards of living in the less-developed areas of the world included within [IDA’s] membership, in particular by providing finance to meet their important developmental requirements on terms which are more flexible and bear less heavily on

the balance of payments than those of conventional loans, thereby furthering the development objectives of the [IBRD] and supplementing its activities [Article I, IDA’s Articles of Agreement].

5.4. Pursuant to these mandates, IBRD and IDA have provided, in practice, a wide array of financial support to their member developing countries, including loans for education, health and agriculture projects, loans to support structural adjustment of the country’s economy, and funding for debt reduction operations. IBRD and IDA also support infrastructure, industrial and other projects that promote the economic development of their member developing countries. In many instances, these projects are financed through the project finance structure.

B. Issues and Considerations

1. IBRD

a. Legal Framework

5.5. The constituent legal document governing IBRD is its Articles of Agreement (IBRD’s Articles). Pursuant to these Articles, IBRD is expressly empowered to provide loans and to issue guarantees. The Articles, however, also set out various conditions which IBRD must meet when making loans or issuing guarantees.

5.6. Loans. IBRD is empowered under its Articles to make loans to two distinct classes of borrowers. First, loans can be made to countries that are members of IBRD. Second, IBRD can make loans to any entity within the country, including any of its political subdivisions and any private company or other enterprise located in the country.

In the case of any loan that is made to any entity other than the country itself for a project in its territories, the Articles require that the country guarantee to IBRD the repayment of the loan. IBRD’s Articles thus require that for any loan for a project in a

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39 IBRD’s Articles implicitly permit IBRD to provide other forms of financing. For example, IBRD has provided grants. However, such other forms of financing have not to date been actively considered in the context of project finance operations.

40 Article III, Section 4 of the IBRD Articles provides in relevant part that “The Bank may guarantee, participate in, or make loans to any member or any political subdivision thereof and any business, industrial, and agricultural enterprise in the territories of a member . . . .”

41 Article III, Section 4(i) provides in relevant part:

When the member in whose territories the project is located is not itself the borrower, the member or the central bank or some comparable agency of the member which is acceptable to the Bank [must] fully guarantee . . . the repayment of the principal and the payment of interest and other charges on the loan.

As noted in this provision, the country’s central bank or another governmental entity could potentially substitute for the country as guarantor. However, under IBRD policy (see The World Bank Operational Manual, Operational Policies, OP 7.00, para. 3) and practice, the member itself (i.e., the country) provides the guarantee.
member country, IBRD must receive a sovereign undertaking regarding repayment, either (a) in the form of a repayment obligation from the country for loans made directly to it, or (b) in the form of a guarantee from the country, in the case of loans made to other entities for projects located in the country.

5.7. Guarantees. The Articles expressly empower IBRD to guarantee any loans made by a third-party to a member country or to any other enterprise in a member country. Pursuant to the Articles, IBRD must receive an indemnity or counter-guarantee from the relevant country for any guarantee it issues. When IBRD guarantees a loan, it must receive suitable compensation for its risk. Moreover, IBRD must also receive in connection with any guarantee the option of purchasing the guaranteed loan from the investors in the event of a default by the borrower triggering the guarantee.

5.8. Thus, IBRD is expressly empowered under its Articles to provide financial support for a proposed project finance operation either in the form of loans or guarantees of loans. The Articles also contain other prescriptions which apply to IBRD’s participation in projects. The most important are that: (a) the project must serve a productive purpose (for example, the development of its developing members); and (b) IBRD must assess the likelihood that the country will be able to repay the loan.

In carrying out the first mandate, IBRD reviews the merits of a particular proposed project, given a specific country context. The second requires an assessment of the country’s financial capability to repay given its resources and competing obligations -- that is, its creditworthiness. These issues are addressed in the succeeding sections.

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42 As quoted above, Article III, Section 4 provides, in relevant part, that "The Bank may guarantee ... loans to any member ... or ... any business in the territories of a member ... ."

43 The requirement for an indemnity flows from the provisions of Article III, Section 4(i), quoted above.

44 Article III, Section 4(vi) provides that: "In guaranteeing a loan made by other investors, the Bank receives suitable compensation for its risk."

45 Article IV, Section 5(c) provides in relevant part: "Guarantees by the Bank shall provide that the Bank may terminate its liability with respect to interest if, upon default by the borrower, the Bank offers to purchase, at par and interest accrued to a date designated in the offer, the bonds or other obligations guaranteed." This provides IBRD with the option to transform itself from a guarantor potentially having to make periodic future payments under its guarantee into a creditor awaiting payments under the loan it had originally guaranteed.

46 See Article I of IBRD’s Articles, quoted above in Part A of this Chapter.

47 Article III, Section 4(v) provides that:

In making or guaranteeing a loan, the Bank shall pay due regard to the prospects that the borrower, and, if the borrower is not a member, that the guarantor [i.e., the member country], will be in a position to meet its obligations under the loan; and the Bank shall act prudently in the interests both of the particular member in whose territories the project is located and of the members as a whole.
b. Developmental Aspects

5.9. Before IBRD undertakes to provide financial support to a proposed project, either in the form of loans or guarantees, it first must establish that the project promotes the development goals of the country. This developmental impact is the central issue addressed by IBRD with respect to any proposed project. In evaluating this impact, IBRD assesses economic and financial issues, as well as environmental and other socio-economic matters.

5.10. **Economic Returns.** Central to IBRD's evaluation of a project is an assessment of the benefits and costs of the project to the country's economy as a whole. This is referred to as the economic evaluation or analysis of a project. In this regard, the World Bank determines "whether the project creates more net benefits to the economy than other mutually exclusive options for the use of the resources in question." The World Bank calculates for this purpose the discounted present value of the project's benefits, net of its costs, as well as the expected internal rate of economic return. Under World Bank policies, "To be acceptable on economic grounds, a project must meet two conditions: (a) the expected present value of the project's net benefits must not be negative; and (b) the expected present value of the project's net benefits must be higher than or equal to the expected net present value of mutually exclusive project alternatives." As part of this analysis, the World Bank evaluates a variety of factors potentially affecting the sustainability of the project; these include financial and technical elements, but also sociological and environmental considerations.

5.11. **Financial Returns.** IBRD analyzes, like any commercial bank, expected revenue flows to ensure that the project is viable from a financial perspective (for example, that the project (a) generates sufficient revenues to meet its outstanding debt obligations and ongoing operating expenses, and (b) provides an adequate return to its investors). This financial analysis helps to determine whether the project constitutes a productive and sustainable activity for the country. For example, the financial analysis serves to assess whether the enterprise would be able to satisfy its creditors (including IBRD), procure needed supplies and otherwise function as expected -- preconditions for the sustainability of the enterprise in support of the country's developmental objectives.

5.12. **Environmental and Other Socio-Economic Issues.** IBRD also evaluates a variety of socio-economic issues with developmental implications. The most important is the expected impact of the proposed project on the environment. Many industrial, infrastructure and other projects susceptible of being supported by IBRD through the project finance structure may potentially have a significant impact on the environment. As a development organization, IBRD has instituted policies which require that appropriate mechanisms are put in place to mitigate adequately any potential adverse environmental

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effects.\textsuperscript{51} If such mechanisms are lacking, or the adverse environmental effects cannot adequately be mitigated, IBRD will not participate or otherwise support the project, irrespective of the size of its expected economic and financial returns. IBRD also evaluates a myriad of other socio-economic issues. These include (a) whether the project will require the resettlement of peoples (which is common, for example, in dam projects) and, if so, whether the country has adopted an appropriate plan to resettle and compensate people thus affected by the project, (b) the impact of the project on indigenous peoples, and (c) the impact of the project on international waterways.\textsuperscript{52}

5.13. **Distribution of Revenues and Risks.** In addition to evaluating the economic and financial returns of the project, IBRD also reviews the proposed distribution of revenues and risks among the host developing country and other project participants. Although IBRD does not seek to introduce itself into the negotiation between private sponsors and developing countries regarding this distribution, it brings its resources, expertise and influence to bear on such discussions through various means. IBRD’s involvement in this regard generally takes three possible forms. First, IBRD may provide financing to the country to enable the government to procure the services of financial, legal and other appropriate advisors to assist it in analyzing and negotiating the terms of the proposed financial transaction, and otherwise preparing the project. Second, IBRD may advise the government directly as to its assessment of the proposed transaction’s costs to and benefits for the country. Third, to the extent that IBRD is called upon to participate as a lender or guarantor in the transaction, its involvement is guided by the fundamental objective of ensuring that the operation promotes the economic development of the participating developing countries.

c. **Country Context**

5.14. IBRD also assesses the particular host country context in evaluating any proposed project. In this regard, IBRD evaluates whether the proposed operation represents a priority activity for the country’s development, given in particular the World Bank’s strategy for assistance to the country. The country context is also important in determining the potential developmental impact of any project. As noted above, the expected economic returns are central to IBRD’s evaluation of a proposed project. The actual impact of any expected project returns depends, in large part, on the economic policies in place in the country. A sound macro-economic policy framework (including such matters as fiscal policies and exchange rate regimes) serves to magnify the developmental benefits to the country of a particular project. Poor economic policies can, in contrast, undermine any expected benefits. Consequently, the country context is critical to the evaluation of the expected developmental impact of the project.

5.15. The country context is also relevant because of its impact on the IBRD/country relationship apart from the specific project. This manifests itself in several ways. First, IBRD will not, as a matter of policy, provide a new loan to any country which is significantly delinquent in making any

\textsuperscript{51} Very often these mechanisms must meet standards similar to those prevailing in the industry concerned.

\textsuperscript{52} Many of the policies followed by IBRD and IDA in these areas are set out in The World Bank Operational Manual.
payment under an outstanding IBRD or IDA loan. Second, IBRD’s general willingness to provide loans to a country depends on that country’s performance on the development front. In this regard, IBRD reviews whether the country has been implementing appropriate economic policies to support development and has been implementing other development projects with due diligence and efficiency. Third, as discussed below in the succeeding section, the country’s overall financial position is central to IBRD’s evaluation of the prospects for loan repayment, which in turn affects IBRD’s willingness to lend.

d. Financial Considerations

5.16. IBRD faces two distinct, but related, sets of financial considerations in deciding whether to support any project. The first relates to the prospects for repayment and the issue of country creditworthiness. The second concerns IBRD’s financial standing as a borrower in international markets and the effect of this standing on its lending practices.

5.17. As described above, IBRD’s Articles require that it must "pay due regard to the prospects that [the borrowing country] will be in a position to meet its obligations to [IBRD]." This legal provision renders explicit a basic requirement for any banking institution, namely that the lender ascertain that the borrower is likely to be able to repay the loan — that is, the borrower’s creditworthiness. To this end, IBRD evaluates the country’s ability to repay its loans with a view to determining the country’s aggregate borrowing capacity. In evaluating the creditworthiness of a country, IBRD assesses various factors, including the country’s economic structure, its natural resources, and its balance of payments, as well as any projected increase in the country’s financial capability expected to result from the proposed development project. Based on this evaluation, a ceiling is fixed by IBRD for global lending to the country (including both direct loans to the country and loans to other entities guaranteed by the country); this assessment is reviewed periodically. Proposed loans are evaluated within this ceiling

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53 See discussion below in Part B.1(d) of this Chapter. This practice contrasts with commercial banks which, on occasion, will lend additional funds to a defaulting borrower to improve the prospects for recovery of outstanding delinquent loans previously made to the same borrower.

54 Article III, Section 4(v) of IBRD’s Articles.

55 As described in IBRD’s Information Statement, dated as of September 20, 1994:

In making loans, the Bank must act prudently and pay due regard to the prospects of repayment. Before making a loan, the Bank studies, among other things, a country’s economic structure, and makes an assessment of the country’s natural resources, the state of its basic infrastructure, industry and agriculture, the quality of its public administration, its trade patterns and its balance of payments position. In addition, . . . the Bank estimates the country’s existing and prospective debt service obligations and assesses its ability to generate sufficient foreign exchange to meet them (at p. 11).

56 The exposure under IBRD guarantees indemnified by the country is also pertinent. IBRD also attempts to avoid excessive concentration of loans, and thus exposure, to any country.
of country creditworthiness\textsuperscript{58} (taking into account the developmental impact of the proposed project and other issues described above in Parts B.1(b) and (c) of this Chapter). Countries that are not deemed to be creditworthy for IBRD lending, however, generally would be eligible for concessional lending from IDA.\textsuperscript{59}

Box V.1: Sources of IBRD Financing

IBRD's subscribed capital totals about US$175 billion (as of June 30, 1995), of which about 6\% is paid-in and the balance is callable (if required by IBRD to meet its financial obligations). Largely on the strength of this callable capital, and of its financial practices and credit standing (see description below in Box V.2), IBRD raises much of its resources through medium and long-term borrowings on international capital markets (about US$9 billion in fiscal year 1995), as well as through short-term borrowings (about $4 billion outstanding at the end of fiscal year 1995). These resources are supplemented by funds received by IBRD as repayment on loans made to borrowing countries and revenues generated by IBRD from its investments. Most of these resources are, in turn, loaned to member countries for development projects or used by IBRD to make debt service payments under its borrowings.

5.18. IBRD's lending for developmental activities is made largely from resources raised through borrowings in international capital markets. Currently, IBRD raises about US$13 billion a year through such debt financings. The funds raised through these borrowings are then loaned to member developing countries to finance projects (see Box V.1). In addition to providing IBRD with the resources used to finance its loans, these borrowings also have a direct impact on the rate it charges on its loans to developing countries. IBRD's lending rates are set as a direct function of IBRD's cost of borrowing funds -- namely, the interest rates IBRD provides to its lenders. These rates, in turn, are a function of IBRD's credit rating, which is currently the highest possible. This rating enables IBRD to borrow at relatively low rates, the benefit of which is passed on to borrowing countries through lower interest charges on the loans it provides for development projects. Accordingly, IBRD has a strong developmental interest and serves the interests of its borrowing countries as a group by maintaining prudent financial practices to protect its premier rating, and thereby helps to keep the interest rate charged its borrowers relatively low (see Box V.2).

\textsuperscript{57} As described in IBRD's September 1994 Information Statement:

The Bank keeps under continuous review the creditworthiness of its member countries which have obligations to the Bank as borrowers and adjusts its overall country programs and lending operations to reflect the results of these reviews (at p. 11).

\textsuperscript{58} In certain projects, the country's creditworthiness can be enhanced with respect to the particular loan. See the discussion below in Part B.1(e) of this Chapter regarding "enclave projects".

\textsuperscript{59} These countries are referred to as "IDA-only" countries.
Box V.2: IBRD Lending and Borrowing Rates

**Lending Rates.** The interest charged by IBRD on its loans to any country is a direct function of the cost to IBRD of obtaining the resources it is lending. Borrowers are charged a rate which generally represents a spread (currently 50 basis points) over IBRD’s cost of borrowing money (see Box VI.1 below regarding IBRD loan terms).

**Borrowing Rates, Financial Practices and Financial Standing.** IBRD’s cost of borrowing money is the interest rate which it must offer on its borrowings in international capital markets. This rate is determined by a combination of market forces and IBRD’s financial standing. While the market generates the relevant range of interest rates in which IBRD must compete with other potential borrowers, its relative position in that range is a direct function of its standing, or rating, in the market. Currently, IBRD bonds benefit from a "AAA" rating, the highest provided by rating agencies. This rating reflects in large part IBRD’s strong record as a borrower on financial markets and its capital structure. It also reflects the preferred creditor status accorded to IBRD by its borrowers, and its conservative financial management practices. These practices include: (a) assessing the creditworthiness of borrowing countries, (b) minimizing its exposure in respect of exchange rate fluctuations, (c) limiting its exposure to delinquent borrowers through the prompt suspension of cash disbursements to such borrowers, (d) maintaining a conservative 'gearing ratio' (namely, the ratio of its exposure under loans and guarantees to its capital, reserves and surplus), and (e) managing its short-term obligations and liquid assets.

5.19. This financial framework may lead IBRD to forgo providing financial support to a particular project finance operation that would benefit the host developing country, if providing such support would undermine IBRD’s conservative financial practices and thereby adversely affect its member developing countries as a group.60 For example, in the event any payment due under a loan made to or guaranteed by a country is significantly past due, IBRD’s policy is: (a) to withhold approving or signing any new loan for a project in the country, even one with strong economic returns,61 and (b) to

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60 This approach is also mandated by IBRD’s Articles, which provide in Article III, Section 4(v) that “the Bank shall act prudently in the interests both of the particular member in whose territories the project is located and of the members as a whole.”

61 Under current policy and practice, IBRD and IDA withhold approval of new loans for any country if any payment due under a loan made to or guaranteed by the country is over 30-45 days in arrears (The World Bank Operational Manual, Operational Policies, OP 13.40, para. 3(a) and (b)).
Chapter V - World Bank: Policy and Legal Frameworks

withhold future disbursements under all its outstanding loans made to or guaranteed by the country (subject to certain exempted items). 62

5.20. IBRD also does not enter into rescheduling agreements with respect to its loans. In addition, IBRD charges the same interest rate on its loans, irrespective of varying risks of repayment. 63 This contrasts with commercial financial institutions, which make loans with different degrees of attendant risk and adjust the interest rate they charge accordingly.

e. IBRD Lending in "IDA-Only" Countries: "Enclave Projects"

5.21. In exceptional cases, IBRD has made loans to countries that are not generally creditworthy to borrow from IBRD, but rather are only eligible for IDA lending (namely, "IDA-only" countries). These cases have involved commercial projects in IDA-only countries that are expected to generate large foreign exchange revenues, but require substantial financing compared to the amount of IDA resources allocated for such countries. 64

5.22. In making these loans, IBRD must determine that the risk of non-payment is sufficiently small to satisfy the legal requirements: (a) that the Bank "pay due regard to the prospects that the borrower . . . will be in a position to meet its obligations under the loan", and (b) that the Bank act "prudently in the interests both of the particular [country] and of [its] member [countries] as a whole" 65 (for example, by ensuring that the loan does not adversely affect its financial rating). To address these requirements, IBRD has identified three basic considerations. First, because IBRD has determined that the country lacks sufficient capability absent the project to repay the loan, the project in question must generate enough foreign exchange revenues to service this debt. Second, since the country is not creditworthy for the loan in question, IBRD must benefit from various guarantee and security arrangements designed to enhance its likelihood of being repaid. Third, the project’s revenues must be capable of being segregated for purposes of servicing IBRD’s loan. Pursuant to this framework, IBRD has provided loans for several projects in IDA-only countries meeting these criteria, whose operations and revenues could be treated as a distinct activity — that is, as an "enclave" operation outside of the

62 Under current policy and practice, IBRD and IDA suspend disbursements under outstanding loans for a country if any payment due under a loan made to or guaranteed by the country is more than 60 days in arrears (The World Bank Operational Manual, Operational Policies, OP 13.40, para. 3(c)). Items exempted from this suspension would normally include payments to consultants "whose interruption would disrupt critical technical work ... (OP 13.40, para. 5(a))."

63 Although IBRD does not charge different interest rates for different borrowers or projects, its rates do vary for differing types of loans. Thus, for example, as described below in Box VI.1, the interest rate for "single currency" loans varies as a function of the currency in which the loans are denominated, not the borrower.

64 See discussion of IDA below in Part B.2(c) of this Chapter.

65 Article III, Section 4(v) of IBRD’s Articles.
country's normal economic activities. These projects in IDA-only countries are referred to as "enclave projects" (they are described in fuller detail below in Chapter VI, Part A.3).

f. Security Interests and Negative Pledge Clause

5.23. Other financial considerations that affect the structure of IBRD participation in project finance operations are its policies regarding the taking of security. As a general principle, IBRD does not seek security for its loans to countries, and would normally not seek security for loans to private borrowers. At the same time, IBRD normally prevents other lenders from obtaining a priority position in relation to its claims. To this end, every IBRD loan agreement contains a negative pledge clause that generally requires that any lien established by an IBRD borrower for the benefit of other creditors equally and ratably secure the payment due to the Bank under its loan agreement.

g. Institutional Policy Issues

5.24. In assessing whether to support a particular project finance operation, IBRD also faces a series of institutional policy issues. Many of these issues derive from its character as a development institution, as distinguished from that of a commercial financial institution. Several are described below.

5.25. Limitations on Financial Resources. Although IBRD has a very large amount of financial resources to provide through loans and guarantees, it faces numerous competing demands. Accordingly, IBRD must allocate these resources appropriately. Whereas the creditworthiness issues sets an upper bound for lending to a country, IBRD must decide how much funding it will allocate below that ceiling to specific projects in each particular country. This issue manifests itself both in terms of allocations to particular projects and aggregate allocations to countries, and may limit the amount of resources that IBRD would provide for any given project.

66 This discussion also would apply to a country which, although eligible for some IBRD lending, is not creditworthy for the full amount of the loan under consideration. This situation would engender for IBRD the same type of creditworthiness concerns it faces generally for IDA-only countries. Thus, as described in the World Bank's Operational Manual Statement, OMS 1.16: "The IBRD will occasionally seek special security for a loan to finance an 'enclave project' in a country with limited creditworthiness" (at para. 27). Similarly, the principles of the "enclave project" were applied by IBRD to several projects in poorer countries before IDA and the concept of "IDA-only" countries came into being (see, for example, Broches, Selected Essays, at page 90).


68 See Section 9.03 of the "General Conditions Applicable to Loan and Guarantee Agreements, dated January 1, 1985" (IBRD's General Conditions). Section 9.03(c) exempts certain liens (e.g., purchase money liens).
5.26. **Lender "of Last Resort".** Pursuant to its Articles, IBRD lends its resources for a project when other loans are unavailable on reasonable terms.\(^{69}\) In accordance with this requirement, IBRD assesses whether a proposed project faces a financing gap which cannot be filled through commercial loans or other financing provided on reasonable terms before it provides funding for the project. Because IBRD plays this role, it is commonly referred to as a lender "of last resort". The policy also helps IBRD to manage the demands on its resources by serving to filter loan proposals, thereby leaving more funds available to allocate to those sound development projects for which its financing is essential.

5.27. **Selectivity.** As described above, the demands for IBRD assistance are numerous, and are extremely varied, but its resources are finite. As a result, IBRD targets its support to activities "where its involvement ... is likely to make the most impact"; this is referred to as the principle of "selectivity".\(^{70}\) In application of this principle, IBRD forgoes undertaking certain activities in order to be able to maintain some degree of institutional focus and avoid excessive diffusion.

5.28. **IFC/MIGA Complementarity.** Another consideration facing IBRD is whether its sister organizations, IFC and MIGA, enjoy a comparative advantage for a proposed project. For example, MIGA specializes in political risk insurance. Consequently, to the extent that MIGA is willing to insure a particular investment, IBRD would normally defer to the institutional comparative advantages enjoyed by its specialized sister organization. IFC is expert in transactions with the private sector; to the extent it is able and willing to provide sufficient financing for a private sector transaction, IBRD would generally defer to IFC’s participation in this area. The participation of more than one of these organizations may be required for specific projects (for example, projects with large financing needs).

5.29. **Political Dimension.** Responsibility for the conduct of the general operations of IBRD is vested with its Executive Directors.\(^{71}\) These directors are appointed by IBRD’s shareholders, namely its member countries. Several member countries appoint their own director, while other directors are appointed by a group of countries. As a result of this structure, the views of countries and their governments filter into the operations of IBRD. This adds a multilateral political dimension to IBRD -- a dimension that is generally not present with commercial financial institutions.\(^{72}\)

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\(^{69}\) Article III, Section 4(ii) provides that IBRD can provide a loan if "The Bank is satisfied that in the prevailing market conditions the borrower would be unable otherwise to obtain the loan under conditions which in the opinion of the Bank are reasonable for the borrower."


\(^{71}\) Article V, Section 4(a) of IBRD’s Articles.

\(^{72}\) Commercial institutions are, however, also subject to some degree of political pressure. For example, they may face domestic political considerations in the country where their headquarters is located or other countries where they operate.
2. IDA

a. Legal Framework

5.30. The constituent legal document governing IDA is its Articles of Agreement (IDA's Articles). These Articles were drawn in large part from IBRD's Articles of Agreement, and thus there are strong similarities; there are also significant differences. Pursuant to these Articles, IDA is empowered to provide financing for development projects. Two forms of such financing are expressly provided for in IDA's Articles: loans (as the general rule) and guarantees of loans (in special cases). The Articles also contain prescriptions which IDA must follow when making loans or issuing guarantees.

5.31. Credits. As specified in its Articles, IDA is expressly empowered to make loans. To distinguish these loans from those provided by IBRD, IDA in practice refers to its loans as "credits". Like IBRD, IDA credits can be made to member countries, to political subdivisions thereof, and to any entity in the territories of a member country. In practice and as a matter of policy, however, IDA has made credits to countries (and in a few selected cases to regional organizations), and has not provided any credits directly to project companies or other corporate entities.

5.32. Guarantees. IDA's Articles expressly empower IDA to provide guarantees of loans. The Articles, however, also provide that IDA may furnish financing in forms other than loans if the

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73 See Article I of IDA's Articles, quoted above in Part A of this Chapter. Article V, Section 1(a) also provides that: "[IDA] shall provide financing to further development in the less-developed areas of the world included within [IDA's] membership."

74 IDA's Articles permit it to provide financing in other forms under certain conditions. However, to date, such other forms have not been employed.

75 Article V, Section 2(a) provides in relevant part that: "Financing by [IDA] shall take the form of loans."

76 Article V, Section 2(c) provides:

[ID] may provide financing to a member, the government of a territory included within [ID]'s membership, a political subdivision of any of the foregoing, a public or private entity in the territories of a member or members, or to a public international or regional organization.

Section 2(d) provides that "In the case of a loan to an entity other than a member, [IDA] may, in its discretion, require a suitable governmental or other guarantee or guarantees."


78 Article V, Section 5 provides in relevant part that "In addition to the operations specified elsewhere in [these Articles, IDA] may: . . . (iv) in special cases, guarantee loans from other sources for purposes not inconsistent with the provisions of these Articles . . . ."
arrangements under which its financial resources are donated authorize such financing. To date, IDA has not activated its guarantee power. Thus, although IDA has the potential power to provide guarantees, it has not yet done so.

5.33. As described in the foregoing paragraphs, IDA is legally empowered under its Articles to provide financial support for a proposed project finance operation either in the form of credits or guarantees of loans. As with IBRD, the IDA Articles also contain other provisions that govern IDA’s participation in projects; the most important requirement is that the project further the development of the less-developed areas of the world included within IDA’s membership.

b. Developmental Aspects

5.34. In evaluating whether to support a proposed project, IDA addresses the same developmental issues as IBRD. As with IBRD, the project’s expected developmental impact is the central issue addressed by IDA -- it flows from its development mandate, and is enforced by the legal requirement that IDA support the development of its poorer members. To this end, IDA follows the same policies and practices as IBRD, and its review of any proposed project includes an analysis of: (a) the economic returns, (b) the financial returns, (c) the environmental impact and contemplated mitigation plans, and (d) whether the resettlement of peoples is required and, if so, plans to assist affected peoples (see discussion above in Part B.1(b) of this Chapter).

c. Country Context

5.35. The particular country context is also considered by IDA in deciding whether to support a proposed project. First, as described above in Part B.1(c) of this Chapter, IDA evaluates whether the proposed operation represents a priority activity for the country’s development, given in particular the World Bank’s strategy for assistance to the country. Second, as also described in such Part, the actual developmental impact of any project depends, in large part, on the economic policies in place in the country. Consequently, the country context will affect the project’s expected benefits. Third, if any payment under any IDA credit or IBRD loan for the country is significantly past due, IDA follows the same policy as IBRD of withholding approval of any new credit until the country clears these arrears.

5.36. The country context can also present a potentially binding constraint on IDA’s lending posture in a particular transaction. IDA has followed a practice of allocating its relatively scare resources largely as a function of the country’s performance and need. To this end, IDA has adopted a policy of allocating its lending resources among its borrowing member countries as a function of the following country specific criteria: (a) population size, (b) per capita income, and (c) performance in economic development.
policy, poverty reduction and implementation of World Bank projects. Among these criteria, performance is becoming an increasingly dominant factor. As a practical matter, given IDA’s relatively limited resources, this framework for determining aggregate levels of support to countries may, in certain instances, limit the amount of financial resources IDA would commit to support a specific project finance operation in a particular country.

d. Financial Considerations

5.37. The principal financial consideration facing IDA is its ability to mobilize financing. In contrast to IBRD, the bulk of IDA’s resources is raised directly through financial contributions by donor countries. Every three years, IDA solicits funds from these donor countries to fund its credits to its poorest member countries; through these periodic solicitations, IDA replenishes its financial resources (see Box V.3). Often during these replenishment exercises, policy issues are raised by donors. IDA’s ability to address these issues may affect the amount of financing donors are willing to contribute as part of the replenishment exercise, which in turn affects the total amount of resources available to IDA to lend to developing countries. As a result, discrete policy issues have been injected into IDA’s general resource mobilization efforts.

Box V.3: "IDA Replenishments" and Other Sources of Financing

Since IDA’s formation, its donors have met every three years to pledge additional resources to be used by IDA over the succeeding three-year period. These resources are then paid to IDA in the form of cash over the succeeding years in accordance with an agreed "encashment" schedule. Each periodic process of pledging resources and subsequently providing the cash is referred to as an "IDA replenishment". There have been 10 replenishments since IDA was created, over thirty years ago. In the most recent replenishment, over thirty donor countries agreed to provide about US$18 billion over the 1994-1996 fiscal year period.

The resources which IDA uses to make loans derive from three principal sources: (a) the replenishments (which averaged over 4.3 billion Special Drawing Rights (SDR) per year for the 1994-1996 fiscal year period); (b) resources generated from loan repayments by borrower countries (over SDR 450 million in fiscal year 1995); and (c) periodic financial contributions from IBRD’s net income to IDA (over SDR 200 million during fiscal year 1995). IDA also generates additional income from the investment of its resources.

5.38. Although IDA faces a more acute resource mobilization constraint than IBRD, it does not face IBRD’s concerns regarding creditworthiness or financial standing issues. IDA was established with

82 IDA also targets portions of its lending to countries in Sub-Saharan Africa and to "blend" countries -- that is, countries that are eligible for both IDA credits (given their per capita income) and IBRD loans (given their financial resources and related general creditworthiness). Examples currently include China, Egypt, India, Pakistan and Zimbabwe.
the express purpose of funding development projects in its poorest member countries. In this vein, country creditworthiness is not a factor that IDA takes into account in providing its credits. Similarly, in contrast to IBRD's Articles which require an evaluation of "prospects" for repayment, IDA's Articles are silent on this issue. In addition, IDA does not raise its resources through borrowings on international financial markets, and the interest rate it charges on credits is not tied to any related borrowing rate. As a consequence, the issue of financial standing is not a significant consideration affecting the amount of funds IDA can lend to its borrowers or the interest rate they will face on IDA's credits. As a corollary to these factors, IDA's credit agreements do not contain the negative pledge clause present in IBRD loan agreements.

5.39. IDA follows many of the same practices as IBRD regarding the management of its portfolio of credits. For example, IDA: (a) suspends disbursements under its outstanding credits to countries that are significantly delinquent in making scheduled repayments under IDA credits or IBRD loans, (b) withholds new credits to such delinquent borrowers, and (c) does not enter into rescheduling agreements with respect to its credits.

e. Institutional Policy Issues

5.40. IDA faces the same issues as IBRD regarding: (a) issues of limited financial resources, (b) its function as a lender "of last resort" (including after IBRD), (c) selectivity, and (d) IFC/MIGA complementarity. Moreover, as indicated from the description in the preceding section regarding the replenishment process, IDA is often called upon to address a relatively more significant political dimension in the replenishment of its resources.

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83 Article V, Section 1(c) provides that IDA "shall not provide financing if in its opinion such financing is available from private sources on terms which are reasonable for the recipient or could be provided by a loan of the type made by [IBRD]."
VI. WORLD BANK INSTRUMENTS IN SUPPORT OF PROJECT FINANCE

6.1. The World Bank financially supports project finance operations through a variety of instruments. Historically, the World Bank has generally provided loans for these operations to finance the acquisition of goods and services required to implement the project. Recently, the World Bank has taken various steps to diversify its modes of support beyond traditional debt financing. In this regard, IBRD has undertaken a program to expand the use of its guarantee powers. In addition, the World Bank has been considering alternative ways to finance guarantees and other investments in project finance operations. These various instruments are described in this Chapter.

A. Debt Financing: IBRD Loans and IDA Credits

6.2. The predominant instrument employed by the World Bank to support project finance operations is debt financing, namely loans by IBRD and credits by IDA. IBRD provides its loans under "loan agreements" and IDA provides its credits under "development credit agreements". IBRD loans and IDA credits have many of the same attributes, but there are also important financial and structural differences between these instruments.

1. Basic Characteristics of Loans and Credits

6.3. Funds provided through IBRD loans and IDA credits are typically disbursed by the World Bank to finance the acquisition by borrowers of goods and services required to implement the project. Loans are structured to disburse over a specified period of time. In the case of project finance operations, the period would normally cover the construction phase, and perhaps some initial years of operation. The loan has a stated aggregate limit, specified at financial closure, and does not revolve. Upon the occurrence of a default, the World Bank reserves the right to suspend future disbursements until the default is cured. If the default is not cured within a further specified period, the World Bank reserves the right to cancel the undisbursed balance of the loan. The World Bank also enjoys the right to accelerate the loan upon certain defaults (although this remedy has never been exercised). In addition, loan agreements include cross-default provisions tied to other World Bank loan and guarantee agreements with the country.

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84 Unless the context requires otherwise, the term "loans" includes both loans and credits, the term "loan agreements" includes both loan agreements and development credit agreements, and the term "Bank" includes both IBRD and IDA.

85 The World Bank provides loans that are divisible into two basic categories: (a) "investment loans" which finance goods and services required for specific industrial, education and other projects; and (b) "adjustment loans" which provide balance of payment financing in support of economic reforms. Only the former are used to support project finance operations directly. The discussion in this paper addresses these "investment loans".

86 Section 6.02 of IBRD's General Conditions provides that the Bank may suspend disbursements under the relevant loan if:

(a) The Borrower shall have failed to make payment . . . of principal or interest or any other amount due

(Footnote continued)
6.4. World Bank agreements for project finance operations also generally include several financial covenants pertaining to the project company similar to those employed by commercial banking institutions. These covenants, however, are frequently not as extensive as those employed by commercial lenders. Rather, the focus of World Bank loan agreements is generally on covenants regarding implementation of the project, including undertakings from the host government on related policy issues.

2. IBRD Loans

6.5. IBRD has traditionally provided loans for the financing of specific projects in one of two ways.

a. IBRD can provide a loan directly to a project company, in which case it receives a guarantee from the relevant country (acting through its government) regarding the company's repayment obligation.\(^7\) This structure involves the following two basic agreements: (a) a loan agreement between IBRD and the project company, and (b) a guarantee agreement between the country and IBRD. The guarantee agreement covers repayment of the loan and, in cases where the country controls the project company, the guarantee may also cover performance.\(^8\)

b. Alternatively, IBRD can lend the money directly to the country (acting through its government), which in turn relends (or "onlends") the funds to the project company. In this second case, the repayment obligation to IBRD rests only with the country, not the project company. This second structure involves the following basic agreements: (a) a loan agreement between IBRD and the country, (b) an "onlending" (or "subsidiary") loan agreement between the country and the project company, and (c) very often a "project agreement" between IBRD and the project company, setting out certain obligations of the company regarding implementation of the project.

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(Footnote continued)

to the Bank or [IDA]: (i) under the Loan Agreement, or (ii) under any other loan or guarantee agreement between the Bank and the Borrower, or (iii) in consequence of any guarantee or other financial obligation of any kind extended by the Bank to any third party with the agreement of the Borrower, or (iv) under any development credit agreement between the Borrower and [IDA]. . . .

(d) The Bank or [IDA] shall have suspended . . . the right of the Borrower . . . to make withdrawals under any loan agreement with the Bank or any development credit agreement with [IDA] because of a failure by the Borrower . . . to perform any of its obligations under such agreement or any guarantee agreement with the Bank.

The "General Conditions Applicable to Development Credit Agreements, dated January 1, 1985," issued by IDA (IDA's General Conditions), contain a similar provision. See also discussion above in Chapter V, Part B.1(d).

\(^7\) As discussed above in Chapter V, Part B.1(a), this guarantee is an express requirement of IBRD's Articles.

\(^8\) The World Bank Operational Manual, Operational Policies, OP 7.00, at para. 4.
Box VI.1: IBRD Loan Terms

**Interest:** IBRD currently provides three loan products with differing interest rate structures: (a) variable-rate "currency pool loans", (b) variable-rate "single currency loans", and (c) fixed-rate "single currency loans". The rate charged for a variable-rate loan is set at 50 basis points above IBRD's cost of funding for the relevant class of loans, as determined by the Bank. For the currency pool loans, the cost of funding relates to the funding of a specified pool of currencies; for variable-rate single currency loans, it relates to the funding for the specified currency loans in question. The rates charged for fixed-rate single currency loans are set at 50 basis points above a market-determined rate, adjusted for IBRD's funding cost margin for these loans and a risk premium, both as determined by the Bank. In addition, borrowers with records of timely repayment currently benefit from a waiver of 0.25% on their interest charges.

**Commitment Charge:** IBRD's loan agreements provide for a commitment charge set at 0.75% of the undisbursed balance. Since 1989, 0.50% of the fee has been waived, producing an effective rate of 0.25%.

**Term and Amortization:** The term is generally for 15 to 20 years, including a grace period of 3 to 5 years. The specific term and grace period vary depending on the country's GNP per capita. The loan is amortized either on an annuity basis of principal and interest repayments, or on the basis of level repayments of principal.

6.6. The terms of IBRD loans are delineated in Box VI.1. The first structure is described in Annex A-1, and the second in Annex A-2. IBRD has employed both structures over the last several decades to support large-scale infrastructure and other industrial projects. However, IBRD "prefers to lend directly to the entity that will be responsible for the project's construction and operation . . .." Consequently, IBRD prefers in most industrial and similar projects to lend directly to the project company with a government guarantee. Examples of both structures are set out in Box VI.2.

3. IBRD Loans For "Enclave Projects"

6.7. As described above in Chapter V, Part B.1(e), IBRD can provide, in exceptional cases, loans for projects in IDA-only countries, notwithstanding inadequate creditworthiness of the country. These projects are referred to as "enclave projects"; they can be defined "as a project that carries its own creditworthiness by promising to produce substantial net foreign exchange earnings, which, in one way

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89 In certain instances, IBRD has also loaned funds to countries without any onlending to a project company. For example, in the Boké Project (1968), a US$64 million loan was made to the Republic of Guinea to finance rail and port infrastructure. No onlending of the funds was made to a project company.

Box VI.2: Use of IBRD Loans

1. **Nigeria Oso Condensate Field Development Project (1991).** This project involves the commercial development of Nigeria’s off-shore Oso Condensate field. The project involved a joint venture between foreign private sector investors and the Nigerian National Petroleum Corporation (NNPC), Nigeria’s parastatal oil company. The total cost of the project was US$885 million. IBRD provided a US$218 million loan to NNPC pursuant to a loan agreement between IBRD and NNPC. The loan was guaranteed by the Federal Republic of Nigeria pursuant to a guarantee agreement between the parties. IFC also provided a US$75 million loan to the private sector sponsor. Other participants included the European Investment Bank, the Export-Import Bank of Japan, and commercial banks who participated under IFC’s syndicated “B-loan” program (see discussion below in Chapter VIII, Part A).

2. **India Northern Region Transmission Project (1990).** The project involved the expansion of India’s electricity transmission and distribution system. IBRD provided a US$485 million loan to the Republic of India pursuant to a loan agreement between the parties. US$430 million was onlent by India to the power utility, the National Hydroelectric Power Corporation Limited (NHPC), which would carry out the expansion activities. IBRD entered into a project agreement with NHPC setting out the utility’s obligations regarding implementation of the expansion activities.

or another, could form the basis of security arrangements for the lender.91 These operations have two distinct sets of elements: the first relates to the project to be financed, and the second relates to the security arrangements employed to protect IBRD. Both sets are designed to ensure that the risk to IBRD of non-payment in making the loan for the project is acceptably small, notwithstanding that the country is not generally creditworthy for such loan.

6.8. The project to be financed must have the following characteristics. First, the project must generate sufficient revenues to repay the IBRD loan, as well as other financiers. Second, the project must be an export-oriented operation that generates foreign exchange off-shore. Third, the project must be capable of being treated as a separate distinct activity, with revenues that can be segregated from the country’s general resources.

6.9. To further ensure that it receives repayment of loans for these projects, IBRD has looked to security arrangements designed (a) to supplement the country’s creditworthiness, and (b) to establish a protected path for the flow of project revenues to debt service. IBRD has compensated for inadequate creditworthiness of the host country by seeking a guarantee of repayment from a creditworthy party.92


92 The guarantee may take the form of a “take-or-pay”, a “ship-or-pay” or other similar contractual arrangement which serves the same function (see discussion above in Chapter III, Part G).
Chapter VI - World Bank Instruments in Support of Project Finance

Normally, foreign private sector sponsors of the project have been required to provide these guarantees. In other instances, another country that was deemed to be creditworthy has provided the guarantee. Although IBRD relies largely on the presence of these guarantees for financial comfort, the presence of such guarantees does not obviate the need for the host country’s guarantee, which is mandated under IBRD’s Articles. To establish a protected path for the flow of project revenues to debt service, IBRD has required the presence of an off-shore trust account into which the project’s foreign exchange revenues are deposited by an off-shore purchaser. These revenues are channeled in priority to repay the IBRD loan, as well as those of other lenders.

6.10. Loans for enclave projects, like other IBRD loans, can be made either directly to the project company, with a country guarantee, or to the country which onlends the funds to the project company. The structure for loans to enclave projects involves the following basic agreements (using the IBRD loan to a project company as a model): (a) a loan agreement between IBRD and the project company, (b) a guarantee agreement between the country and IBRD, (c) a guarantee from the private sector sponsors to IBRD, and (d) an agreement establishing the off-shore trust account and establishing the priority of payments for debt service. The details of this structure are described in Annex A-3. Several examples are set out in Box VI.3. In practice, IBRD has not had frequent occasion to employ the enclave structure since the 1960’s. An important factor which has reduced the need for such IBRD financing is the establishment in 1960 of IDA, which has provided a source of funds for many such

Box VI.3: Enclave Projects

1. Botswana Shashe Project (1971). This project involved the development of an integrated scheme for the production of Botswana’s nickel and copper. The mining project was owned by a joint venture consisting of foreign private sector investors and Botswana. IBRD provided a loan to the Republic of Botswana of about US$35 million to finance infrastructure works. A portion of the proceeds of the loan was onlent to Botswana’s water and power utilities for the construction of the infrastructure facilities. The private sector sponsors provided a guarantee to IBRD covering repayment of its loan to Botswana. A trust account was also established to channel payments from the sale of minerals to repay IBRD’s loan to Botswana.

2. Dominican Republic Falconbridge Nickel Project (1969). This project involved the construction and operation of a nickel processing plant and related facilities. IBRD provided a US$25 million loan to the project company, Falconbridge Dominicana (Falcondo), to finance needed power generation infrastructure. The Dominican Republic guaranteed repayment of the loan. In addition, the foreign private sector sponsors provided a “take-or-pay” contract to fund Falcondo’s debt service obligations to IBRD and the other lenders. An escrow account was also established to channel payments under the “take-or-pay” contract to IBRD and other lenders.

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93 See discussion above in Chapter V, Part B.1(a).
projects in poorer countries. Another factor is the relative dearth of projects for which IDA resources were unavailable, but were sufficiently robust and secure to meet the strict enclave project eligibility criteria.

Box VI.4: IDA Credit Terms:

**Interest:** IDA charges a fixed rate of 0.75% on the credit's outstanding balance (referred to as a "service charge").

**Commitment Charge:** IDA’s credit agreements provide for a commitment charge on the credit’s undisbursed balance of not more than 0.50%, as set by IDA. A single fee for all credits is fixed on an annual basis by IDA’s board of directors. Over the last several years, the commitment charge has been set at 0.0%.

**Term and Amortization:** The term is 35-40 years, depending on the relative financial resources of the country (e.g., least developed countries receive the preferential 40 year term). Principal is repaid in semi-annual installments. All credits include a 10-year grace period.

4. IDA Credits

6.11. In contrast to IBRD loans, all IDA credits provided for projects are made to the country (acting through its government), never directly to a project company. The country in turn can onlend the funds to the project company. This structure involves the following three basic agreements: (a) a development credit agreement (that is, a loan agreement) between IDA and the country, (b) a subsidiary loan agreement between the country and the project company, and (c) very often a project agreement between IDA and the project company setting out certain obligations of the company regarding implementation of the project. The terms of IDA credits are delineated in Box VI.4. The details of this structure are described in Annex B. IDA credits have frequently been used to finance infrastructure and other large-scale industrial projects in poorer developing countries. Several examples are described in Box VI.5.

B. Guarantees

6.12. Recently, the World Bank has expanded its support for guarantees for investors. This World Bank support for guarantees is provided in two distinct ways. First, it issues guarantees directly to lenders to a project. Second, it can finance, through its loans to countries, guarantee coverage issued by the country (or by another party at the country's behest). The former represents a direct form of guarantee, whereas the latter involves the indirect financing of guarantees. Taken together, they permit

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94 As noted above in Chapter V, Part B.2(a), credits have been made in several exceptional circumstances directly to regional development banks.
IBRD has recently adopted a program to expand the use of its guarantees, in particular for infrastructure projects. This program is referred to as the "IBRD Guarantee Program." The program aims to provide a portion of the proceeds of the project, thereby reducing the risk for the borrower. The guarantees can be used to cover a variety of project risks, including construction delays, cost overruns, and political risks.

1. **Direct IBRD and IDA Guarantees**

   - **2. China Thermal Power Project (1996)**

Under this project, the World Bank provides guarantee coverage to participating international financial institutions in a variety of ways.

In addition to direct guarantees, the World Bank also entered into a project agreement with the World Bank Group (WBG) and the Asian Development Bank (ADB) to provide guarantees for certain projects. The guarantees cover risks associated with the project, such as political risks and currency risks. The guarantees are intended to reduce the risk for the borrower and to attract private sector investment.

Box V.1: Use of IDA Credits

Chapter VI - World Bank Instruments in Support of Project Finance
i. Partial Risk Guarantees

6.14. As described by the World Bank:

A partial risk guarantee covers risks arising from nonperformance of sovereign contractual obligations or from force majeure aspects in a project. . . . The partial risk guarantees are particularly relevant in the context of current worldwide interest in . . . private financing of infrastructure. Such guarantees cover government obligations spelled out in agreements with the project entity. They are most appropriate for "limited recourse financing," as in build-own-operate-transfer (BOOT), build-own-operate (BOO), and similar projects.96

6.15. The structure for IBRD partial risk guarantees involves the following basic agreements: (a) a loan to the borrower by commercial lenders, (b) an agreement setting out various contractual undertakings from the country in favor of the project, which serves to protect lenders against various

<table>
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<th>Box VI.6: IBRD Partial Risk Guarantee</th>
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<td><strong>Pakistan Hub River Power (1994).</strong> This project involves the construction of a power plant estimated to cost about US$1.8 billion. The financing plan provided for approximately US$680 million in internationally syndicated commercial bank loans to the project company. IBRD provided a guarantee to various commercial lenders covering US$240 million of debt. The guarantee can be called if Pakistan defaults on various undertakings made to the project company (including with respect to the performance of certain parastatal companies, as well as several events of force majeure), and such defaults results in a payment default under the guaranteed commercial debt. The Islamic Republic of Pakistan also undertook, pursuant to an indemnity agreement with IBRD, to reimburse IBRD for any amounts disbursed by IBRD to the lenders under its guarantee.</td>
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risks, (c) a guarantee issued by IBRD protecting the lenders against several or all of such various risks, and (d) an indemnity (or counter-guarantee) from the country in favor of IBRD for payments made by IBRD under its guarantee.97 The details of this guarantee structure are described in Annex C-1. As noted above, the partial risk guarantee is a potentially important tool to support project finance transactions in infrastructure, as well as potentially other areas. An example of the partial risk guarantee is provided in Box VI.6.

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96 *The World Bank's Guarantees*, at pages 3 and 5.

97 IBRD may, in addition, require an indemnity from the project company in instances where the company, rather than the country, is the borrower under the commercial loans. Alternative contractual structures are also under consideration.
ii. Partial Credit Guarantees

6.16. IBRD also provides partial credit coverage to lenders under a second window of guarantees. As described by the World Bank:

Partial credit guarantees cover all events of nonpayment for a designated part of the financing. These guarantees encourage the transformation of shorter-term to longer-term financing by covering a part of the commercial financing, usually the later maturities. In recent operations, the Bank covered late repayments, stretching the normal lending terms offered by the market.98

6.17. The structure for IBRD partial credit guarantees involves the following basic agreements: (a) a loan to the borrower by commercial lenders, (b) a guarantee issued by IBRD to the lenders covering later maturities or certain other specified payments due under the loan, and (c) an indemnity (or counter-guarantee) from the country in favor of IBRD for payments made by IBRD under its guarantee.99 The details of this guarantee structure are described in Annex C-2. IBRD has also implemented the partial credit guarantee through a put option, in lieu of a formal guarantee. Under this structure, IBRD provided a put option to holders of long-term project debt, pursuant to which they were given the option to sell their loans to IBRD after a number of years. The effect of this instrument is identical to that of a partial credit guarantee: it insulates the lenders from the credit risk posed by the debtor with respect to later maturities. The details of this put structure are described in Annex C-3.

6.18. The partial credit guarantee is, like the partial risk guarantee, a potentially important tool to support project finance operations. Although a relatively recent instrument, it has already been used in several operations. Examples are set out in Box VI.7.

b. IDA Guarantees

6.19. As discussed above in Chapter V, Part B.2(a), IDA has the potential power to issue guarantees, but has not yet exercised this power. If IDA were to issue guarantees, they would likely be structured drawing on IBRD’s experience with these instruments (see, for example, the description of the structure of the IBRD partial risk guarantee in Annex C-1).

2. World Bank Financed (Indirect) Guarantee Coverage

6.20. As an alternative to providing direct guarantees, the World Bank has been exploring mechanisms to finance coverage provided by countries and other parties. Under this approach, instead of issuing a guarantee directly to commercial lenders, the World Bank provides a loan to a country, the

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99 As with partial risk guarantees, if the borrower under the commercial loans is the project company, rather than the country, IBRD may, in addition, require an indemnity from the project company.
Box VI.7: IBRD Partial Credit Guarantees

1. China Yangzhou Thermal Power Project (1994). This project involves the construction of a thermal power plant, estimated to cost about US$1 billion. The financing plan included US$120 million in loans to China from commercial lenders for which IBRD provided a partial credit guarantee covering the later maturities of the debt. The IBRD guarantee permitted China to obtain the commercial debt on relatively favorable terms. The People's Republic of China undertook, pursuant to an indemnity agreement, to reimburse IBRD for moneys disbursed under the IBRD guarantee.

2. Philippines Leyte-Luzon Geothermal Project (1994). This project involves the expansion of the existing power plant at Leyte. The financing plan includes US$100 million in bonds issued by the National Power Corporation (NPC), the parastatal utility of the Philippines. IBRD provided to the bondholders an option to "put" (namely, sell) the bonds to IBRD at their maturity for the principal then due. This enabled NPC to place bonds with relatively longer maturities than were generally available to it at the time. The Republic of the Philippines and NPC provided an indemnity to IBRD for providing the put option to the bondholders.

proceeds from which are used to finance a guarantee issued by the country\(^\text{100}\) or by another party at the country’s behest.\(^\text{101}\) World Bank financing of guarantees may be provided for principally two distinct types of guarantees: (i) those provided by the countries themselves, and (ii) those provided by independent third-party guarantors at the behest of the country.

6.21. **Country Guarantees.** Under the first approach, the country provides the guarantee to the investors. The World Bank, in turn, agrees to lend to the country the funds to be used to pay any claims under this guarantee. This mechanism could potentially involve the following two basic agreements: (a) a guarantee (or other similar instrument), issued by the country, that protects the investors against certain defined risks, and (b) a loan agreement between the World Bank and the country, the proceeds from which are used by the country to finance payments under the guarantee. The possible structure for the

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\(^{100}\) Often, a parastatal company or other governmental entity may act on behalf of the country and government — for example, as the issuer of a guarantee. For purposes of simplicity of presentation, the illustrations presented in this Chapter do not explicitly address this variation.

\(^{101}\) The direct and indirect guarantees present different legal exposure for the World Bank. Under the former, the World Bank issues a guarantee in favor of the investor under which it explicitly obligates itself directly to the investor to provide funds upon the occurrence of specified risks. Accordingly, the investor enjoys direct recourse and access to the World Bank. In contrast, under the indirect guarantee structure, the World Bank enters into a loan agreement with the country, and the investor is provided the guarantee by the country or another party. This indirect structure would normally not involve a direct contractual relationship between the World Bank and the investor, or any related obligation from the World Bank to the investor; rather, the World Bank’s obligations would be to the country. Consequently, the investor would normally not enjoy any recourse to the World Bank, but only to the country or other guarantor.
6.22. **Third-Party Guarantees.** Under the third-party scenario, a commercial bank or other independent third-party, rather than the country, provides the guarantee to the investors. The country, in turn, agrees to reimburse or otherwise fund the guarantor. Under a slight variation, the third-party may act as administrator of the country's guarantee, rather than issuing the guarantee itself in its own name. In either case, the World Bank provides through the country the funds to be used to finance the payments under the guarantee. This mechanism would potentially involve the following three basic agreements: (a) a guarantee issued (or administered) by the commercial bank or other third-party guarantor protecting investors against certain defined risks, (b) a reimbursement, counter-guarantee or other funding agreement between the country and the third-party guarantor setting out, among other things, the obligations of the country to finance the payments made by the third-party under the guarantee, and (c) a loan agreement between the World Bank and the country, the proceeds from which would be used to finance the country's funding obligation to the third-party guarantor. The possible structure for the World Bank's financing of a third-party guarantee is described in Annex D-2. This structure is currently under consideration.102

3. **Framework for World Bank Support Through Guarantees**

6.23. The availability and form of World Bank support through either the direct or indirect guarantee mechanism depend on several factors, including: (a) the form of the investment to be protected, (b) the type of obligation to be guaranteed, and (c) the type of risks to be covered.

a. **Form of Investment**

6.24. As noted above in Chapter V, IBRD is empowered to issue guarantees of "loans".103 Consequently, determining whether the investment to be guaranteed is a "loan" is central to evaluating the potential availability of a direct IBRD guarantee. In contrast, countries, governmental entities and third-party guarantors generally do not face these same limitations on the forms of investment they can guarantee. Rather, in practice, countries are frequently called upon to guarantee equity and other non-

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102 See discussion below in Part C.2 of this Chapter regarding political risk insurance.

103 As discussed above, IDA has not yet been authorized to issue guarantees. Any eventual authorization in this regard could, potentially, permit other forms of guarantees than loan guarantees.
Project Finance at The World Bank

debt investments, as well as loans. The World Bank can provide loans to countries to enable them to provide or otherwise finance these guarantees, including guarantees protecting equity, as well as debt.

b. Type of Obligation

6.25. As described above in Chapter III, Part G.1, guarantees may cover payment or performance obligations, and may also require payment or performance on the part of the guarantor. The World Bank provides direct guarantees for loans and, in this regard, only covers payment obligations; it also only undertakes to make payments under its guarantees. In contrast, country guarantees may involve payment or performance obligations (for example, an undertaking to maintain a free currency transfer regime). To the extent that countries seek World Bank financing to fund their guarantees, such guarantees would need to include provisions converting any performance obligation therein into a payment one (that is, "monetizing" the obligation).

c. Risks: Commercial vs. Political

6.26. Project finance operations typically present a variety of risks. Some of these risks are considered to be commercial in nature, whereas others are deemed to devolve from the country context and attendant political aspects (see discussion above in Chapter III, Part F.2). IBRD's and IDA's respective Articles providing for the issuance of guarantees do not distinguish between types of risks. In practice, however, the World Bank has focused its attention on political risks and risks relating to government undertakings provided in support of the project, and has been hesitant to provide specific coverage for general commercial risks. Thus, for example, the IBRD partial risk guarantee covers government breaches of its contractual undertakings to the project. In a similar vein, the World Bank has demonstrated a willingness to support country-sponsored guarantees covering specified political risks and government undertakings. It should be noted that IBRD has provided coverage against commercial risks, but primarily in cases in which it provides a general guarantee of payment (such as under its partial credit guarantees) and on occasion where such risks have been subsumed into government undertakings to the project.

6.27. The World Bank's relative willingness to support guarantees covering political risks and risks relating to government performance, as opposed to general commercial risks, appears to devolve in part from several factors which provide it with a comparative advantage in managing this first set of risks.

First, the World Bank is a multilateral institution owned by a large number of countries, including the host country of the project. As a development institution working with countries, it enjoys a close and extensive relationship with host governments, and is in continual consultation with them on policy and other issues. Moreover, developing countries often rely on continued financial support from the World Bank to support their development strategies. These factors place the Bank in a relatively strong position to address and resolve with host governments disputes regarding government actions which might adversely affect the project.
Second, a country faces financial exposure to the World Bank for any payments made by the Bank in respect of any guarantee. This exposure flows either from: (a) the country’s indemnity agreement with the Bank, in the case of a direct Bank guarantee, or (b) under the loan agreement between the Bank and the country, in the case of Bank financing of a country-sponsored guarantee. This exposure serves as a financial disincentive to the host country to take any governmental action triggering payments by the World Bank.

Third, because the World Bank is a development organization and not a commercial financial institution, it does not have the same commercial orientation as private commercial entities.

As a result of these factors, the World Bank is in a relatively stronger position than many private sector parties to mitigate political risks and the risk of government defaults. At the same time, private investors are in a relatively stronger position than the Bank, or the country, to evaluate commercial risks; private investors are also in the business of doing so and being compensated for it. These factors tend to engender distributions of risks in which the World Bank finances coverage for political risks and government performance more willingly than general commercial risks.

C. Other Guarantee-Type Instruments

6.28. As described in Chapter III, Part G, put options, political risk insurance and "take-or-pay"/"take-and-pay" contracts also provide guarantee-type protection for investors. These instruments may, in the same vein, serve as alternative vehicles for World Bank support of guarantee protection in a particular project finance operation.

1. Put Options

6.29. As described above in Part B.1 of this Chapter, the World Bank has provided a direct put option to debt holders in lieu of a partial credit guarantee. The structure of a put option provided directly by the World Bank is described in that Part and detailed in Annex D-3.

6.30. In addition, the World Bank can also finance put options provided by countries, or by other parties at the country’s behest. Under this structure, the country could, for example, provide a put option to the investors, and the World Bank would provide a loan to the country to finance the country’s obligation to purchase the relevant assets if the investors exercise their put. The structure involves the following two basic agreements: (a) the put option provided by the country in favor of the investors, and (b) a loan agreement between the World Bank and the country, the proceeds from which are used to finance the country’s obligations to purchase the investors’ assets under the put. The structure for the
Project Finance at The World Bank

Box VI.9: World Bank Financed Put Option

Argentina Capital Market Development Project (1994). In this project, Argentina established a facility (the "Backstop Facility") that provides options to commercial banks to "put" (namely, sell) specified eligible bank bonds to the facility. IBRD provided a US$500 million loan to the Argentine Republic to be used by the country to finance payments due under the put options provided by the Backstop Facility.

World Bank’s financing of a put option is described in Annex D-3; an example of such financing is set out in Box VI.9.

6.31. The form and availability of put options are likely to depend on the same factors affecting guarantees and described above in Part B.3 of this Chapter. Thus, for example, direct put options -- which, as noted above, can serve as surrogates for IBRD partial credit guarantees -- would be limited to debt instruments. Similarly, the World Bank would, as with guarantees, generally not issue or finance a partial risk put option covering commercial risks specifically.

2. Political Risk Insurance

6.32. The World Bank does not issue political risk insurance coverage solely on the basis of its corporate resources (as is the case with MIGA, described below in Chapter IX, and other political risk insurers); IBRD does, however, issue similar guarantee coverage, but with the financial backing of the host country for the project. The Bank also been exploring ways to financially assist member developing countries to access such insurance from political risk insurers to support foreign investments in their territory. In this vein, the World Bank and MIGA are exploring mechanisms for the Bank to provide financing to a country to fund political risk insurance for a specified foreign investment in the country (see also discussion below in Chapter IX). Such a mechanism would potentially involve the following three basic agreements: (a) insurance coverage issued, or administered, by MIGA in favor of the investors, (b) a funding agreement between the country and MIGA regarding the modalities for the country to finance the payment of claims under the coverage, and (c) a loan agreement between the World Bank and the country, the proceeds from which would be used to finance the country's obligations to MIGA under the aforementioned funding agreement. This structure is detailed in Annex D-2. This mechanism represents a specific illustration of the third-party guarantee structure described above in Part B.2 of this Chapter. To date, this structure has not been employed, but is currently under consideration by IDA.105

3. "Take-or-Pay" and Other Purchase/Supply Contracts

6.33. To the extent that the World Bank supports project finance operations through guarantees, and through guarantee-like instruments such as the put option and political risk insurance, the World Bank would likely also support these operations through "take-or-pay" or "take-and-pay" contracts that provide

105 The World Bank is considering using this type of structure to finance political risk insurance to protect foreign investors against currency transfer risk. However, no definitive decision has to date been taken in this regard.
similar guarantee-type protection. Although the Bank would not enter into such contracts directly, since they involve an obligation to purchase project output, the Bank could potentially finance a country's obligations under any such contract that serves as a surrogate for a guarantee. World Bank financing of these contracts would potentially involve the following two basic agreements: (a) the "take-or-pay"/"take-and-pay" or similar contract provided by the country in favor of the project company, and (b) a loan agreement between the World Bank and the country, the proceeds from which would be used to finance the country's financial obligations to the project company under the contract. The potential structure for the World Bank's financing of these contracts is described in Annex D-4.

6.34. As noted above, "take-or-pay" and "take-and-pay" contracts provide guarantee-type protection. The applicability of the analysis above regarding the World Bank's support for guarantees probably varies with respect to each of these distinct types of contracts. The "take-and-pay" contract essentially involves a firm obligation to procure goods and services that are provided. This is very much akin to the traditional World Bank practice of financing, through its loans, the borrower's acquisition of goods and services. Given this use of Bank funds to acquire specified goods and services, the analysis of proposals for the World Bank to finance a "take-and-pay" contract would likely involve an evaluation of the utility of the goods or services to be procured, as well as an assessment of the contract's financial character (that is, as a guarantee to investors against market risks). The treatment of the "take-or-pay" contract is less clear since the contract can involve payments for goods or services provided, and yet in other circumstances require payment like a guarantee even when no goods or services are provided. In this manner, the "take-or-pay" serves both as a purchase contract and a guarantee, and may need to be assessed in this dual light. Thus, for example, the Bank's financing of country payments under the "take or pay" contract where there are no goods or services provided (that is, where it serves as a guarantee) might be limited to situations where the failure to deliver the goods or services resulted from political, rather than commercial, risks.

D. Equity and Quasi Equity

6.35. Neither IDA nor IBRD makes equity investments in enterprises. The World Bank, however, has financed equity stakes in project companies through its loans to countries. Historically, the World Bank has provided numerous loans to development finance companies under which equity investments funded from the loan were permitted (described in fuller detail below in Part E.2 of this Chapter). World Bank financing of equity would potentially involve the following two basic agreements: (a) a loan agreement between the World Bank and the country, and (b) an agreement among the country, the project company and possibly other shareholders in the project company regarding the country's equity participation (for example, setting out modalities for the issue of shares in exchange for

106 See discussion above in Chapter III, Part G.

107 This financing of equity through development finance companies and other financial intermediaries is provided for in The World Bank Operational Manual, Operational Directive, OD 8.30, which states in relevant part that: "[Financial intermediary loans] can be used to make ... investments in share capital ... (at para. 86)."
the contribution of goods and services financed under the loan). The structure is described in Annex E. An example is set out in Box VI.10.

6.36. The World Bank also does not acquire quasi-equity investments, but can finance such investments by countries. The financing of quasi equity is relatively straightforward to the extent that it consists of a debt instrument that is convertible into equity. As described above in Part A of this Chapter, IBRD and IDA financing often involves the onlending of World Bank funds by the country to the project company. Although the country typically receives a traditional debt instrument in these transactions, alternatively it could receive one that is convertible into equity -- namely, quasi equity. World Bank financing of such quasi-equity debt instruments would normally be structured along the same lines as the loan and credit onlending mechanisms described above in Part A of this Chapter. It would involve two basic agreements: (a) a loan agreement between the World Bank and the country, and (b) a subsidiary loan agreement between the country and the project company, pursuant to which the country receives a quasi-equity debt instrument rather than a traditional loan instrument.

E. Other World Bank Investment Support: Debt Refinancing and Investment Facilities

6.37. The World Bank has also diversified the ways in which it provides debt financing for a project beyond the traditional route of providing loans to finance directly the acquisition of goods and services for a specified approved project. To date, this diversified approach has included: (a) refinancing shorter-term debt, and (b) financing debt investment facilities. This latter structure has also often included a window for equity financing.

1. Debt Refinancing

6.38. IBRD can provide a loan to a country to finance the government’s undertaking to refinance shorter-term loans incurred by the project company, so as to roll over the debt into longer-term maturities. This, in turn, provides to project sponsors the flexibility of locating shorter-term debt, with attendant fiscal and other benefits, while in effect incurring only longer-term maturities. The proceeds of the IBRD loan are used in effect to refinance the procurement of the goods and services originally acquired through the shorter-term loans.

6.39. This refinancing arrangement would potentially involve the following three basic agreements: (a) a loan from commercial lenders to the project company, (b) an understanding between the country and the project company that the former will refinance the commercial loans with longer-term debt, and (c) a loan agreement between the country and the World Bank, the proceeds from which would
be used by the country to effect the refinancing of the project company's commercial debt. The structure is described in Annex F-1. An illustration is set out in Box VI.11.

2. Investment Facilities

6.40. The World Bank can also provide loans to a country to finance a country-sponsored investment facility for project finance operations. Under this approach, the government establishes a facility to finance projects yet to be specified. IBRD provides a loan to the country, the proceeds from which would be used to fund this facility. The government can then use this facility and IBRD's commitment to provide moneys under the loan to attract other potential investors, thereby leveraging Bank resources. Subsequently, to the extent that projects are identified which meet agreed eligibility criteria, IBRD disburse moneys to the facility, but only as and when needed to finance the specified eligible enterprises. The facility would then use these moneys to provide debt financing to, or potentially make equity investments in, the eligible enterprises. The World Bank has frequently provided this financing through the medium of a development finance company established within the country, which in turn provides financing to eligible enterprises in its own name and for its own account using the proceeds of the IBRD loan.

6.41. The investment facility structure involves the following basic agreements: (a) a loan agreement between the country and the World Bank pursuant to which the Bank makes moneys available to the country to finance the facility, (b) a memorandum of understanding regarding the funding and operational modalities of the facility, and (c) an investment agreement between the facility and the specified enterprise to be financed. In the context of development finance company transactions, the finance company in essence operates the facility, and the World Bank typically enters into an agreement with the company regarding the operating modalities of the facility. The structure for operations involving Bank financing of investment facilities is described in Annex F-2. An example of this form of Bank support is set out in Box VI.12.

Box VI.11: World Bank Debt Refinancing

Jamaica Energy Sector Deregulation and Privatization Project (1992) -- Rockfort Private Power Plant. The project involves the construction of a power plant to be financed under a build-own-operate structure, and requiring about US$145 million in financing. The sponsors were able to access about $80 million in medium-term commercial loans. Jamaica has provided a commitment to "take-out", and thereby refinance, such medium-term debt at its maturity. Jamaica will partially fund this "take-out" through a US$40 million loan provided by IBRD for such purpose.

Box VI.12: World Bank Financing of Investment Facilities

Argentina Oil and Gas Project (1981). As described in Box VI.10 above, IBRD provided a US$100 million dollar loan to Argentina's Banco Nacional de Desarrollo (BANADE) to finance oil and gas exploration projects. The loan was guaranteed by the Argentine Republic. Following signature of the loan agreement, specific oil and gas projects were identified and appraised by BANADE, and submitted to IBRD for approval for financing from the IBRD loan.
F. Use of Contingent Loans

6.42. **Purpose and Financial Attributes.** As described above in this Chapter, the World Bank can finance, through its loans to countries, various instruments which serve to provide guarantee-type protection for investors in project finance operations. These instruments include country and third-party guarantees, political risk insurance and partial risk put options (referred to collectively in this Part as "guarantees"). The World Bank could potentially finance these various guarantees in different ways, including (a) by providing the borrower "up-front" with the total amount of funds potentially required under the guarantee (that is, by disbursing the loan in full to the borrower at the beginning of the transaction), or alternatively (b) by disbursing the loan proceeds to the borrower only if and when needed to pay actual claims under the guarantee. Given, among other things, the uncertain nature of claims under guarantees and the related inefficiency for the World Bank of disbursing its funds "up-front" to be warehoused by its borrowers, the World Bank has currently rejected "up-front" funding in favor of loans that disburse only if and when needed to pay claims under the guarantees. To the extent that payment under guarantees is normally uncertain and questionable -- that is, "contingent" -- disbursement of the loan is also contingent in nature. Accordingly, these loans have been referred to as "contingent" loans (or "contingent" credits, in the case of IDA).

6.43. Under the contingent loan structure, the World Bank ostensibly makes funds available to the borrower, but the moneys are provided to the investors (or alternatively, to the third-party guarantor issuing the guarantee at the behest of the country). Although the proceeds of the loans are not disbursed to the country, it remains obligated to the World Bank to repay these amounts. Thus, the contingent loan has many of the attributes of a standard World Bank loan and certain qualities of a guarantee (but with certain salient distinctions). In essence, it functions like a loan as between the World Bank and the country, but it produces the financial effect for the investor of a guarantee. This instrument has to date only been employed in a few instances; an example is set out in Box VI.13.

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108 Under the "up-front" funding approach, the World Bank would disburse its funds at the beginning of the transaction into a dedicated trust account back-stopping the guarantee. Given the inherently uncertain nature of claims under guarantees, such funds may remain in the account for an extended period of time. This warehousing of funds by borrowers in an escrow account represents a relatively inefficient use of the World Bank's finite resources.

109 This discussion does not apply to the "take-or-pay" or "take-and-pay" contracts. Payment under these contracts is generally neither uncertain nor questionable; rather, the contracts are designed to result in payments thereunder to the project company. Accordingly, these contracts would generally not be financed through a contingent loan or credit.

110 Differences between the contingent and standard loans include the following: (a) disbursements under the contingent loan are generally not desired by either the World Bank or the country since it would imply that the guarantee has been called; in contrast, standard loans are designed to finance a series of activities which the country works diligently to implement with the support of the World Bank (e.g., the construction of a power plant); and (b) the proceeds of the standard World Bank loan are normally used to finance the capital costs of the project directly; in contrast, the investor finances these capital costs itself in the context of a contingent loan. Contingent loans also differ from direct World Bank guarantees in several respects. For example, a contingent loan generally does not involve a direct contractual relationship between the investor and the World Bank that characterizes direct World Bank guarantees; consequently, the investor in the contingent loan context would not enjoy the direct recourse to the World Bank present with Bank-issued guarantees.
6.44. **Irrevocable Payment Instructions.** The contingent loan is employed to finance guarantee coverage for investors that is generally irrevocable. Accordingly, the financing of such coverage through the contingent loan potentially must also be irrevocable in nature. In contrast, the availability of financing under Bank loans is generally subject to an array of events of suspension, including country payment and other defaults. To condition in this manner the availability of funds under a contingent loan that finances a guarantee would, in certain instances, undermine the utility of the guarantee for investors. Recognizing this concern, the Bank has provided for the issuance of irrevocable payment instructions for its contingent loans that are designed to ensure the continued availability of funds under the loan to finance the guarantee protection, notwithstanding country or other defaults. This approach expands upon the Bank’s practice to issue irrevocable "special commitments" to pay for specified expenditures, used by borrowers to finance, among other things, their obligation to reimburse letter of credit banks. IBRD has offered the irrevocable payment option for contingent loans for a premium. The borrowing country must determine for any proposed contingent loan whether this payment instruction from the World Bank serves the country's development objectives and is needed by investors. In the World Bank’s limited experience to date, the demand in this regard has varied.

G. **Overview of World Bank Support**

6.45. The principal conclusions regarding the modalities for World Bank support to project finance operations are as follows:

a. **Debt:**

- IBRD and IDA can provide debt financing for project companies.

- IBRD can provide these loans either directly to project companies, or indirectly through the country.

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111 See, for example, Section 5.02 of IBRD’s General Conditions.

112 IDA has not yet developed a policy or practice in this regard.
- IDA has to date only provided loans to project companies indirectly through the country.

- IBRD and IDA loans to countries could be used by the countries to finance a wide variety of financial instruments, such as equity investments and guarantees.

b. **Equity:**

- Neither IBRD nor IDA makes equity investments in project companies.

- Both IBRD and IDA could make a loan to a country to be used by the country to finance its equity in the project company.

c. **Guarantees:**

- IBRD can issue guarantees to lenders to the project.

- IDA also is empowered to issue guarantees for lenders, but has not yet exercised this power.

- Neither IBRD nor IDA issues direct guarantees for equity or other non-debt investments in a project.

- Both IBRD and IDA could make a loan to a country to be used by the country to finance its guarantee in favor of debt and equity investors. Such financing would likely be provided by the World Bank through the contingent loan structure.

- Partial risk guarantees issued directly or financed by the World Bank would generally be limited to specified non-commercial risks.

d. **Put Options:**

- Neither IBRD nor IDA issue put options, except for debt instruments.

- Both IBRD and IDA could make a loan to a country to be used by the country to finance a put option provided by the country covering either equity or debt investors. Such financing for a partial risk put option would likely be provided by the World Bank through the contingent loan structure.

- Partial risk put options financed by the World Bank would generally be limited to specified non-commercial risks.
e. **Political Risk Insurance:**

- IBRD can issue political risk guarantees for lenders with the same effect as insurance; IDA has not yet been authorized to issue such guarantees.

- Both IBRD and IDA could make a loan to a country to be used by the country to finance political risk insurance covering either debt or equity investors. Such financing would likely be provided by the World Bank through the contingent loan structure.

f. **"Take-or-Pay"/"Take-and-Pay" Contracts:**

- Neither IBRD nor IDA enters into "take-or-pay", "take-and-pay" or similar contracts.

- Both IBRD and IDA could make a loan to a country to be used by the country to finance a "take-or-pay", "take-and-pay" or similar contracts entered into by the country. Such financing would likely be provided by the World Bank through the standard (as opposed to contingent) loan structure.
VII. RELATIVE ADVANTAGES OF WORLD BANK SUPPORT

7.1. The World Bank often supports project finance operations in developing countries in a manner largely similar to that of commercial lenders: that is, by providing financial resources for the project. World Bank participation, however, also potentially brings a variety of other advantages to an operation. Several such advantages are set out below, as well as some additional considerations raised by World Bank involvement in a project.

A. Financial Advantages

7.2. The principal advantage which the World Bank generally brings to a project finance operation is financial resources. Perhaps of greater significance are the ways in which the World Bank's financial support differs from, and thus can complement, that traditionally available from commercial financial institutions for projects in developing countries. There are several salient aspects of such World Bank support, namely: (a) the amount of resources which it has available to lend; (b) the Bank's ability to catalyze other lending; (c) the Bank's willingness to lend in developing countries; (d) the Bank's willingness to finance government investment in a project; and (e) relatively favorable financing terms.

7.3. Resource Base. As previously noted, the World Bank lends the equivalent of billions of dollars every year for projects in developing countries. Although most of these loans are not made for project finance operations, the World Bank does enjoy the ability to draw upon an extremely large pool of funds to finance these operations. The World Bank is, in particular, well placed to provide financing for very large projects. IBRD is better placed than IDA to provide such financing since its annual lending portfolio is about three times larger.

7.4. Catalytic Role. In addition to providing its own financing to a project, the World Bank also often plays an important catalytic role for other donor agencies. This results from several factors. First, the World Bank and donors coordinate their activities. In this regard, donors often look to the Bank's analysis of the country's prospects and its willingness to provide financial support to a project in deciding whether to provide funds to a specific country or a specific project. Second, because many donor agencies often do not have the staff resources to evaluate the myriad of development projects they would potentially be interested in financing, they frequently rely on the Bank's evaluation of particular projects. In this regard, World Bank endorsement and support for a proposed project provides significant comfort to the donor agencies as to the viability of the project. Third, certain projects of interest to donors require large financial resources, and the World Bank is often in a position to provide a significant portion of these funds. Without such World Bank financing, the project's sponsors may be unable to obtain all the funding required to construct the project. In these cases, World Bank funds provide a critical complement to the donor's financing which allows the project to move forward financially.

7.5. Willingness to Lend in Developing Countries. The World Bank is also frequently relatively more willing to lend for projects in developing countries than commercial financiers. This results from several factors. First, one of the main purposes of the World Bank is to lend to developing countries specifically. Second, the World Bank has decades of experience in lending to developing countries. Third, because of the international character of the World Bank, its governmental membership
structure, and its extensive relationship with the governments of developing countries (both contractual and other), the World Bank is in a relatively stronger position than many commercial lenders to manage, and thus more willing to accept, risks associated with transactions in these countries. As a result, the World Bank is often the largest single financier for many projects in developing countries, particularly projects in poorer ones.

7.6. **Willingness to Finance Government Investment.** In addition to its willingness to provide funds, the World Bank is also often willing to direct its funds to finance the government's investment in a project. Whereas commercial lenders frequently prefer to provide financing directly to the project company, as the revenue generating entity, rather than to lend funds to a government, the World Bank lends much of its resources to countries acting through their governments. In addition, as discussed below in Part B.3 of this Chapter, the World Bank enjoys substantial leverage over borrowing countries to ensure repayment of its loans -- leverage that commercial lenders generally lack. As a result, the World Bank at times may be willing to provide a critical final piece of the project's financing puzzle which would otherwise be difficult to find: namely, financing for the government's investment in the project.

7.7. **Favorable Terms: Maturities and Interest.** The World Bank provides financing for transactions on relatively more favorable terms than is generally available from commercial lenders. The advantages relate to both the term of the lending and the interest rate, although these elements differ for IBRD and IDA.

7.8. **IBRD.** As noted above in Chapter VI, Part A.2, IBRD loans are provided with relatively long maturities of 15-20 years. This allows a project company to complement shorter term maturities provided by commercial banks with longer term IBRD loans, thereby spreading debt service payments over an extended period of time. The interest rate provided is also relatively favorable. As noted above, IBRD rates are generally set at 50 basis points above the rate applied to IBRD as a lender. Since IBRD benefits from a AAA rating, its loans are provided at a slight mark-up above that applicable to a AAA rated borrower. Generally, this rate would be lower than that charged by commercial lenders to the project company, which would normally not enjoy such a high rating.

7.9. **IDA.** In the case of IDA, the terms are extremely concessional. As described above in Chapter VI, Part A.4, the rate charged on outstanding balances is 0.75% per year. The term is 35-40 years, with a 10-year grace period. It is important, however, to distinguish between the terms under which IDA funds are provided to a borrowing country, and the terms under which they would be onlent by the country to the project company. As described above, IDA provides its loans directly to countries, acting through their respective governments, which typically onlend the loaned funds to the project companies. Pursuant to IDA's policies, the countries, rather than commercial project companies, should benefit from the concessional nature of IDA's credits. In accordance with this policy, IDA funds are to be onlent by the countries to commercial project companies on commercial terms.

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113 See discussion below in Part B.3 of this Chapter.
7.10. There are, however, two aspects of the IDA credit structure which still produce relatively favorable terms for the transaction taken as whole. First, the commercial-like terms of the onlending arrangement tend to be relatively favorable; the interest rate is pegged to IBRD’s terms and may be lower than that likely to be charged by commercial lenders, and the loan has a relatively long maturity (for example, 15-20 years). Second, the fact that the country benefits from the spread in rates between the concessional IDA credit and commercial-like onlending terms should augment the amount of direct revenues the government expects to receive from the project, and thus increase the project’s financial appeal to the government. At the same time, IDA also encourages governments to ensure that this spread is not factored into the distribution of revenues by other project participants since this would undermine the purpose of the concessional terms, which is to provide financial support to these poorer developing countries.

B. Political Risk Protection

7.11. One of the important advantages that the World Bank can bring to a project finance transaction is protection against political risks, in particular those within the control of the host government. As described above, political risks are an important consideration for private sector sponsors and financiers in any international project finance transaction -- particularly for projects in many developing countries. Arguably, the World Bank, together with the other members of the World Bank Group (see discussion of IFC and MIGA below), are in a unique position to provide a relatively high degree of comfort in this regard. The World Bank provides this comfort in two distinct ways: (a) through guarantee coverage against such risks, and (b) through its financial participation in the project.

1. Political Risk Guarantees

7.12. As described above in Chapter VI, Part B, the World Bank can financially protect investors against political risks through the medium of guarantees, either through an IBRD guarantee, or by providing a loan to finance a country-sponsored guarantee. Under either mechanism, lenders are guaranteed that political risks will not interfere with the repayment of their loans. If these risks materialize and prevent such repayment, the World Bank will effect the required repayments to the lenders from its own resources. The World Bank thus can provide to lenders (and potentially to other investors) financial protection against political risks.

7.13. The presence of either the IBRD guarantee, or a country-sponsored guarantee financed by the World Bank under a loan, also often serves to reduce the likelihood of political risks materializing. This results from two distinct dynamics. First, the World Bank has an interest in preventing claims from being filed and its funds drawn upon. To this end, the Bank exercises its leverage with countries to discourage government action that would allow the investor to make a claim under the guarantee. As described below in Section 3 of this Part, the World Bank enjoys considerable leverage in this regard. Second, to the extent that a guaranteed loan is not repaid as a result of political risks, and the World Bank is required to pay the lender, the country will be obligated to reimburse the Bank either (a) under its indemnity, in the case of an IBRD guarantee, or (b) under the relevant loan agreement, in the case of a country-sponsored guarantee financed by the World Bank. As a consequence, a claim by a lender under the guarantee creates financial exposure for the country to the World Bank, which serves to create a
financial disincentive for the country against taking actions that would interfere with repayment of the guaranteed loan.

2. Political Risk Comfort

7.14. World Bank financial participation in a project also provides political risk comfort to investors, even without any direct or indirect World Bank guarantee running in favor of such financiers. When the World Bank participates in a project, it acts to ensure that the specific project will be executed as contemplated, and that the host government provides the necessary reasonable support in this regard. To this end, the World Bank solicits from the project company and the host government a variety of contractual undertakings designed to protect the project and to otherwise ensure the project’s proper operation. The World Bank exercises its attendant contractual rights, and it calls upon its country relationship, to ensure that these undertakings are respected. To the extent that these undertakings support the operation of the project, they also generally protect the interest of investors.114

7.15. In addition to the World Bank’s interest in a particular project which it is financing, the Bank also has a broader interest in the government’s treatment of investments in the country generally. The equitable treatment of investors is critical to creating a favorable environment for investment — an important element in promoting the country’s economic development. To this end, the World Bank may bring its influence to bear on the government to comply with its undertakings to investors in a specific project finance transaction in support of the country’s general economic development.

3. World Bank Leverage

7.16. The ability of the World Bank to mitigate political risks flows in large part from its substantial leverage over its member developing countries. This leverage is the product of two distinct factors: (a) its contractual rights under outstanding loans, and (b) its general country dialogue and influence over potential future loans to the country.

7.17. Contractual Leverage. As described above in Chapter VI, Part A, every loan agreement signed by IBRD and IDA permits the World Bank to suspend and eventually to terminate disbursements under the loan if the country breaches its undertakings to the Bank.115 This remedy is supplemented by a right to accelerate repayment of the loan (although the Bank has never exercised this right). Of greater potential significance is the cross-default provision provided for in the Bank’s loan agreements. Pursuant to this provision, the World Bank can suspend disbursements under all loans made to or guaranteed by the country if it has suspended disbursements under any single such loan as a result of a default thereunder.116 For most developing countries, the World Bank provides a significant portion

114 See Walser, Compensation or Deterrence (1983), and Nevitt, Project Financing, at page 177.

115 See, for example, discussion above in Chapter VI, Part A.1.

116 See Section 6.02(d) of IBRD’s General Conditions and Section 6.02(c) of IDA’s General Conditions.
of the country's development financing. In this context, the possible suspension of World Bank financing under all loans through the operation of this cross-default provision provides to the Bank substantial leverage to ensure that the country complies with its contractual undertakings to the Bank under a particular loan. However, given the potential impact of this remedy on a country, the World Bank exercises this right circumspectly.117

7.18. **Leverage Regarding Future Lending.** Another source of leverage for the World Bank is the potential for future Bank lending to the country. The Bank has, for every country, a series of projects under preparation. Government action under ongoing projects is evaluated by the Bank in determining whether to provide new loans for future projects in the country. The possibility that these future projects may be delayed or canceled as a result of government breaches under existing projects is often a serious issue for many countries. This leverage is particularly acute for those developing countries for whom the World Bank constitutes the single most important lender and, in certain instances, the only meaningful source of significant external financial resources.

7.19. **Leverage Regarding Other Donor Resources.** The World Bank's leverage is magnified by the fact that in addition to a potential loss of Bank resources, the country might also lose access to the resources of other donors, both with respect to ongoing and future projects. First, as concerns ongoing projects, donor agreements for a particular project often include cross-default provisions tied to the Bank's loans for such project. Consequently, a default by a country under a loan agreement with the World Bank for a specific project not only may lead to the suspension of Bank loans, but also to the suspension of loans provided by other donors for the particular project. Second, as described above in Section A of this Chapter, many donors look to the Bank's program of assistance for a country in deciding whether to provide financing for a specific future project in that country. If the Bank delays or eliminates proposed future projects, some other donors may also delay or eliminate contemplated financial support for certain projects in the country.

C. **Additional Considerations**

7.20. Although World Bank participation potentially brings important advantages to a project finance operation, it also raises additional considerations, some of which flow from the Bank's character as a development institution. Some of these may be perceived as constraints by private sector sponsors and commercial financiers.

1. **Policy Conditionality**

7.21. The most salient additional consideration infused by World Bank participation in a project finance transaction is the Bank's emphasis on policy reforms. Given its development mandate, the World Bank focuses on the macro-economic framework of the host country, and policies in the relevant sector

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117 It is important to distinguish these performance related defaults from payment defaults. In the latter case, the Bank in practice moves aggressively to suspend its entire portfolio for a country, as described above in Chapter V, Part B.1(d) and Part B.2(d).
of the proposed project (for example, electricity, petroleum or transportation), to ensure that they are conducive to economic development. In this regard, to the extent that the World Bank identifies policies which may undermine either the expected economic benefits of the project or efficiencies within the sector, the World Bank will generally require changes in these policies as a condition of providing its financing. These conditions are referred to as "policy conditionality".

7.22. The policy conditionality may pertain to issues relating to the project specifically, broader issues affecting the relevant sector as a whole, or overall structural issues in the country’s economy. At times, these issues may not directly affect the project’s operation or its financial revenues and may be of relative unimportance for commercial lenders and other private investors, who tend to focus their attention on those regulatory, tax and other provisions which will govern the operation of the project and materially affect their ability to receive the expected returns on their investment. To the extent that World Bank financial support is conditioned on these policy reforms being addressed by the country, this adds uncertainty regarding the proposed project financing plan. As a result, policy conditionalities may represent a burden to private investors because they create preconditions to the participation of a financier (a) that the investors are not used to facing, (b) on subjects with which they may be relatively unfamiliar, and (c) whose prospects of being satisfied they are often not well placed to assess.

7.23. In numerous cases, however, changes in policy sought by the Bank may, in fact, have a beneficial effect on the project and the project’s investors. In these instances, the investors’ appreciation of the policy conditionality likely will depend on the weight they accord to the benefits they would derive from the proposed reforms as against the uncertainty such conditionality brings to the World Bank’s eventual participation in the operation.

2. Risk Analysis

7.24. The World Bank, like commercial financiers, must analyze the risks present in a proposed project finance operation. The World Bank’s risk analysis, however, differs in certain respects from that of commercial financial institutions.

7.25. Sovereign Credit Risk vs. Project Risks. Although the World Bank participates in project finance operations, it generally does not do so in reliance on the project’s revenues, but rather in reliance on the country. As noted above, the central element of the project finance structure is its ability to attract financing on the basis of the project and its revenues, which approach has permitted many project

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118 By way of illustration, private sponsors of a proposed power plant project often will focus their attention on the price charged under the power purchase agreement with the parastatal utility, tax holidays and duty exemptions accorded the sponsors, and other issues which affect the project, either through the application of generalized provisions or project-specific exemptions. In contrast, the World Bank will address sectoral issues such as the country's general tariff structure for the supply of electricity to all consumers. In addition, the World Bank will analyze the overall macro-economic context to ensure that it is conducive to economic growth; in this regard it looks at such varied areas as public expenditures, currency exchange regulations and trade barriers.
Chapter VII - Relative Advantages of World Bank Support

sponsors to raise non-recourse financing. By comparison, World Bank financing for a project finance operation or any other project is always backed by a country repayment obligation: (a) in the case of its loans (whether standard or contingent), the World Bank always benefits from either (i) a direct repayment obligation from the country, for loans made to the country, or (ii) a guarantee of repayment from the country, for loans made to other parties within the country; and (b) in the case of World Bank issued guarantees, it receives an indemnity from the country.

7.26. It is upon this country obligation that IBRD relies financially in making loans or issuing guarantees; this reliance is reflected in the central importance attached by IBRD to the creditworthiness of the country. Thus, for IBRD, sovereign credit risk, rather than project risks, is of particular significance in any loan. The analysis for IDA differs. Under IDA's financial structure, issues of exposure and standing do not have the same direct impact on IDA's activities as they do on those of IBRD. Thus, even though IDA benefits from an undertaking from the country to repay its credits and faces attendant sovereign credit risk, this issue is not as central to IDA's operations as it is for IBRD -- although sovereign credit issues do remain relevant for IDA.

7.27. In contrast to the World Bank, commercial lenders frequently hesitate to lend to developing country governments, and may often participate in project finance operations without the benefit of a country payment obligation or guarantee. Moreover, even when such an undertaking is provided by the country to a commercial lender, its value may be uncertain, since the commercial lender generally lacks the World Bank's substantial leverage over countries to ensure payment thereunder by the sovereign. These two factors tend to limit the usefulness of sovereign payment undertakings for commercial lenders. By comparison, project risks are generally critical to these lenders, which look to the project's revenues for repayment of their loans; accordingly, project risks are also of substantially greater importance to their risk analysis than to that undertaken by the World Bank. In instances where the commercial lenders also receive a guarantee of repayment from a project sponsor (some partial

199 See discussion above in Chapter III, Part A.

200 See discussion above in Chapter VI.

210 See discussion above in Chapter V, Part B.1(d).

212 See discussion above in Chapter V, Part B.2(d).

213 For example, the criteria used by IDA in allocating its resources for credits to countries emphasizes population, per capita income and policy performance; the concept of sovereign credit risk does not appear to play a significant role in this regard (see discussion above in Chapter V, Part B.2(c)). By comparison, IBRD's use of a country's creditworthiness in deciding whether to make loans accords significant importance to the capacity of the country to repay, a central component of sovereign credit risk (see discussion above in Chapter V, Part B.1(d)).

214 For example, sovereign payment defaults affect IDA's willingness to lend to the country (see discussion of IDA's policy regarding borrower payment defaults above in Chapter V, Part B.2(d)). In addition, such defaults also adversely affect the amount of revenues IDA receives through the repayment of its credits, and thus have a direct impact on IDA's resource base (see Box V.3 above).
guarantee from a sponsor, in fact, is common in practice), the sponsor’s credit risk takes on importance commensurate with the lenders’ reliance thereon(7,487),(992,993).

7.28. **Developmental Implications of Project Risks.** Although project risks generally do not have a direct financial impact on the World Bank, they remain important to the Bank because of their relevance from a developmental perspective. Project risks by their nature pose a threat to the sustainability of the project itself, and thus the ability of the country to reap the expected developmental benefits of the proposed project. As a consequence, the World Bank ensures that the project participants design strategies to mitigate these risks. In addition, the Bank must conclude before supporting a proposed project that the attendant risks do not, in fact, seriously threaten the sustainability of the project and the achievement of its developmental objectives.

3. Other Considerations

7.29. **Procurement Policies.** Borrowers under any World Bank loan must follow the Bank’s procurement procedures when purchasing goods and services with the loan’s proceeds. These procedures are designed to promote economy and efficiency in procurement; they are also intended to provide nationals of the Bank’s numerous member countries with an opportunity to bid on Bank-financed contracts. The Bank’s procurement procedures are generally more cumbersome than those typically employed by the private sector, and are more prescriptive than requirements imposed by commercial lenders. The World Bank’s procurement guidelines also apply to the procurement of goods and services financed with the proceeds of a loan to be guaranteed by IBRD. They also require in this case due attention to economy and efficiency, but otherwise are substantially less prescriptive than those relating to procurement under World Bank loans.

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125 Project risks can directly threaten the operation of the project. In other instances, they threaten the participation of an investor, and thus the financial structure and sustainability of the project.


127 Article III, Section 5(b) of IBRD’s Articles provides that "The Bank shall make arrangements to ensure that the proceeds of any loan are used . . . with due attention to considerations of economy and efficiency . . .," IDA’s Articles set out similar requirements in Article V, Section 1(g).

128 The World Bank’s procurement guidelines list as a guiding consideration "the Bank’s interest, as a cooperative institution, in giving all eligible bidders from developed and developing countries an opportunity to compete in providing goods and works financed by the Bank . . . (at para. 1.2(b))."

129 Commercial lenders generally do not impose any requirements on their borrowers in this regard. However, domestic legislation may impose limitations on the use of their loans (e.g., in connection with commercial embargoes of specific foreign countries).

130 See paragraph 3.14 of the World Bank’s procurement guidelines.
7.30. **Financial Management Requirements.** Recipients of World Bank funds are required to comply with a variety of financial management requirements regarding their accounting, reporting and auditing practices. These requirements are frequently more prescriptive than those sought by commercial lenders. They include periodic audits of the records and reports regarding the use of Bank funds. The Bank's requirements apply to direct borrowers under loans or credits, and may also be mandated for indirect recipients (for example, project companies that receive IDA funds from a country under an on-lending arrangement).

7.31. **Development vs. Commercial Orientation.** As described above in Chapter V, Part B, the World Bank evaluates in detail a wide variety of elements that go beyond traditional commercial issues. In this regard, the Bank evaluates, among other things, the project's impact on the host country's environment, infrastructure, indigenous peoples and other affected populations. In addition, as illustrated by the foregoing discussion regarding analysis of project risks, the World Bank also addresses various commercial issues from a distinctly developmental perspective. As a consequence of this orientation and approach, World Bank participation will frequently bring additional elements to the complex process of developing and evaluating a proposed project finance operation.

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VIII. INTERNATIONAL FINANCE CORPORATION

8.1. The International Finance Corporation (IFC) is the organization within the World Bank Group supporting economic development through direct financial support to the private sector. IFC is empowered under its Articles to make investments in "productive private enterprises" which contribute to the development of its member countries. As stated in its Articles of Agreement:

The purpose of [IFC] is to further economic development by encouraging the growth of productive private enterprise in member countries, particularly in less developed areas, thus supplementing the activities of the International Bank for Reconstruction and Development . . . In carrying out this purpose, [IFC] shall [among other things]: (i) in association with private investors, assist in financing the establishment, improvement and expansion of productive private enterprises which would contribute to the development of its member countries by making investments, without guarantee of repayment by the member government concerned, in cases where sufficient private capital is not available on reasonable terms . . . [Article I, IFC's Articles of Agreement.]

In contrast to the World Bank, IFC is not limited to making loans or issuing guarantees of loans. Rather, it can make investments in any form it deems appropriate, including equity, loans, other debt instruments convertible into equity, and guarantees. Also in contrast to the World Bank, IFC: (a) does not provide financing to governments, and (b) as provided in Article I quoted above, can not receive repayment guarantees from governments. In its 1995 fiscal year, IFC approved about US$2.9 billion in financing for 213 projects. This included loans in the amount of US$2 billion, equity and quasi-equity investments of US$822 million, and US$82 million in guarantees, swaps and standby arrangements.

A. Forms of Investment

8.2. Loans: IFC Funded and Syndicated. As indicated above, the principal manner in which IFC finances projects is through loans. These loans are always provided directly to a private sector entity. The terms are essentially commercial, without the concessionality of IDA credits or the relatively

132 For a fuller discussion, see, for example, International Finance Corporation, Annual Report 1995.

133 Article III, Section 2 of IFC's Articles provides that it "may make investments of its funds in such form or forms as it may deem appropriate in the circumstances." This formulation results from a 1961 amendment to IFC's Articles. The original text of this Article explicitly precluded IFC from providing financing in "the form of investments in capital stock."

134 Article I, quoted above, and Article III, Section 1 provide for IFC investments to be made in "private enterprises" only. An enterprise, however, may qualify for financing even if it includes a government participation (Article III, Section 1).
favorable terms of IBRD loans. This reflects in part the prescription in IFC's Articles of Agreement that its financing reflect, among other things, the terms that would be charged by a private investor.

8.3. In addition to the loans IFC provides from its own resources (referred to as "A-loans"), IFC also syndicates loans (referred to as "B-Loans"). These B-loans are funded by other financial institutions through the acquisition of participations. Under this program, IFC remains the lender-of-record for the borrower, and the commercial lenders benefit from IFC's umbrella of protection. As described by IFC:

The primary means by which IFC mobilizes third-party funds for projects in developing countries is syndicated loans, in which IFC shares the commercial risks of projects with cofinancing partners and provides its lender-of-record umbrella. As a result, IFC has successfully secured financing for many borrowers that would not otherwise have had access to long-term project funds on reasonable terms from the international financial markets.

In fiscal year 1995, financing provided by banks and other financial institutions through IFC syndication totaled about US$2.6 billion. Over the last several years, IFC has mobilized more debt financing through its loan syndication program than it has provided from its own resources.

8.4. Equity. IFC makes substantial equity investments in enterprises. In this regard, it is the unique institution within the World Bank Group which participates in project finance operations as an equity holder. However, it generally assumes the role of a passive, rather than active, equity holder. In this regard, it is prohibited by its Articles from assuming responsibility for the management of any enterprise in which it has invested, or exercising its voting rights to such end, absent exceptional circumstances.

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135 As described in the International Finance Corporation, Annual Report 1994:

All of IFC's loans were made at market rates, with maturities ranging from 3 to 15 years, including grace periods of 1 to 12 years. Interest rates ranged from 88 to 400 basis points over six-month LIBOR for variable-rate loans or the swap-based equivalent for fixed-rate loans (at p. 5).

136 Article III, Section 3(v) provides that:

[IFC] shall undertake its financing on terms and conditions which it considers appropriate, taking into account the requirements of the enterprise, the risks being undertaken by [IFC] and the terms and conditions normally obtained by private investors for similar financing . . . .


138 Article III, Section 3(iv) provides that:

[IFC] shall not assume responsibility for managing any enterprise in which it has invested and shall not (Footnote continued)
8.5. **Quasi Equity.** IFC also makes investments in the form of quasi equity. These include: (a) participatory loans in which IFC benefits from a variable interest rate tied to the debtor’s financial or other performance, (b) convertible debentures, and (c) preferred stock.\(^{139}\)

8.6. **Guarantees.** IFC also provides guarantees to lenders. This activity, however, represents a relatively small part of its investment portfolio.

### B. Institutional Considerations

8.7. Although IFC enjoys relatively greater flexibility than either IBRD or IDA with respect to the types of investments it can make, it faces many of the same institutional considerations. Thus, for example, issues regarding the environmental soundness of projects are central to IFC’s evaluation of projects, as they are to IBRD’s and IDA’s. In addition, IFC also functions as a lender/investor “of last resort”.\(^{140}\)

### C. Relative Advantages of IFC Participation

8.8. IFC provides a variety of possible advantages to a project finance transaction, several of which distinguish it from IBRD and IDA.

*First, as a member of the World Bank Group, it brings a degree of political risk mitigation to a transaction in two distinct ways: (a) directly through its relationship with host country governments, which are members of IFC; and (b) indirectly through its close relationship with IBRD and IDA, its sister organizations, which in turn often can exercise considerable influence over countries in support of sound investments (see discussion above in Chapter VII). IFC does not, however, receive any repayment guarantees from host countries for its investments (in contrast to IBRD and IDA).*

(Footnote continued)

exercise voting rights for such purpose or for any other purpose which, in its opinion, properly is within the scope of managerial control . . .

This restriction is subject to the exception provided in Article III, Section 4 that:

Nothing in [these Articles] shall prevent [IFC], in the event of actual or threatened default on any of its investments, actual or threatened insolvency of the enterprise in which such investment shall have been made, or other situations which, in the opinion of [IFC], threaten to jeopardize such investment, from taking such action and exercising such rights as it may deem necessary for the protection of its interests.


\(^{140}\) Article III, Section 3(i) provides that IFC “shall not undertake any financing for which in its opinion sufficient private capital could be obtained on reasonable terms.”
Second, as an investor "of last resort", IFC makes investments in sound projects in developing countries that otherwise would face insufficient private capital. In this manner, it provides critical financial support that allows these operations to be financed.

Third, IFC can provide investments through modalities not open to either IBRD or IDA, notably:

(a) IFC participation can be made directly to a private sector enterprise, without government involvement, whereas the World Bank requires a country undertaking to repay any loans. This allows IFC to support transactions in which the government is unwilling to provide any repayment guarantee, or in which the private sector sponsors would prefer to avoid active government financial participation.

(b) IFC can participate in a project in a variety of ways, such as equity, quasi equity, debt, and guarantees, whereas the World Bank is limited to loans and guarantees of loans. This provides IFC with the flexibility to match the form of its participation to the financial needs and constraints of the particular project, as distinguished from IBRD and IDA which are more limited in their instruments. Arguably, this is of particular significance for project finance operations, which often involve equity, quasi-equity and other layers of investment.

8.9. As a general proposition, IFC functions more like a commercial financial institution than the World Bank. In this vein, IFC does not impose the policy conditionality that often accompanies World Bank financing. At the same time, because IFC relies on the project’s expected revenue flows for returns on its investment, rather than on country guarantees, it often faces greater difficulty than the World Bank in identifying appropriate projects in poorer developing countries.

8.10. As illustrated by the foregoing discussion, IFC and the World Bank serve largely complementary functions with the common objective of promoting economic growth in developing countries. For many proposed projects, either IFC or World Bank financing might be more appropriate. For other operations, the participation of both IFC and the World Bank may be desirable.
IX. MULTILATERAL INVESTMENT GUARANTEE AGENCY

9.1. As implied by its name, the Multilateral Investment Guarantee Agency (MIGA) is the World Bank Group organization that specializes in the provision of political risk coverage for investments in project finance and other operations.\(^{141}\) Pursuant to the convention establishing MIGA (the MIGA Convention),\(^{142}\) the agency's mandate is to:

encourage the flow of investments for productive purposes among member countries, and in particular to developing member countries, thus supplementing the activities of the International Bank for Reconstruction and Development . . ., the International Finance Corporation and other international development finance institutions.\(^{143}\)

To this end, MIGA is empowered by its Convention to "issue guarantees, including coinsurance and reinsurance, against non-commercial risks";\(^{144}\) pursuant to this power, it provides political risk coverage for investments. MIGA has, since its inception, issued guarantees (that is, insurance) against political risks in a global amount of over US$1.6 billion. In its 1995 fiscal year, MIGA issued 54 policies representing over US$670 million in coverage. To date, MIGA has issued all its policies on the basis of its corporate financial resources.

9.2. MIGA can potentially support political risk coverage in two additional ways that draw directly on individual member, rather than MIGA, financial resources. First, pursuant to the Sponsorship Trust Fund mechanism provided for in the MIGA Convention, MIGA can issue insurance underwritten by earmarked funds provided by particular member countries. Second, MIGA has flexibility to undertake other activities to promote investment flows in member countries, and, to this end, could potentially administer guarantees provided by individual member countries. MIGA has not yet exercised either of these powers.

A. MIGA Financed Coverage

9.3. The availability of MIGA political risk coverage for a particular proposed operation depends principally upon an evaluation of four distinct elements: (a) the type of investor and investment, (b) the type of risk to be insured, (c) the likelihood of such risk occurring, and (d) the amount of coverage being solicited given country and project exposure limits.

\(^{141}\) For a detailed discussion of MIGA's corporate structure and history, see Shihata, *MIGA and Foreign Investment*.

\(^{142}\) The Multilateral Investment Guarantee Agency was established pursuant to the Convention Establishing the Multilateral Investment Guarantee Agency, dated October 11, 1985.

\(^{143}\) Article 2 of the MIGA Convention.

\(^{144}\) Article 2(a).
1. Eligibility: Investors and Investments

9.4. MIGA only provides insurance for investors and investments meeting certain eligibility criteria. The investor can be a national, or incorporated or owned by nationals, of any MIGA member country other than that of the host country. The investment to be insured must be made in a country which is both a member of MIGA and a "developing country", as defined in the MIGA Convention. The investment must also originate outside of the host country (that is, it must be a foreign investment). Moreover, the investment must be consistent with MIGA's general policies (for example, consistent with its policies regarding the environment). In this regard and as provided in its Convention, MIGA must satisfy itself as to: (i) the economic soundness of the investment and its contribution to the development of the host country; (ii) compliance of the investment with the host country’s laws and regulations; (iii) consistency of the investment with the declared development objectives and priorities of the host country; and (iv) the investment conditions in the host country, including the availability of fair and equitable treatment and legal protection for the investment. MIGA insurance covers equity investments; it can also cover (a) medium- and long-term debt made or guaranteed by an equity investor, (b) medium- and long-term debt provided by other commercial lenders provided that it is related to an investment covered by MIGA, and (c) other forms of direct investment, as determined by its board of directors.

2. Types of Coverage

9.5. MIGA is authorized by its Convention to guarantee investments against losses resulting from the following four types of risk:

a. Currency Transfer (Inconvertibility). MIGA guarantees investors that they will be able to repatriate in foreign exchange the local currency earnings (for example, dividends or loan payments) generated by their investment. This coverage protects against both (a) the investor’s inability to convert local currency into foreign exchange and (b) the investor’s inability to export foreign exchange from the host country.

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145 Article 13.

146 Article 14 restricts eligible investments to those made "in the territory of a developing member country." Article 3(c) provides that: "A 'developing member country' means a member which is listed as such in Schedule A hereto as this Schedule may be amended from time to time by [MIGA's] Council of Governors . . . ."

147 Article 2(a).

148 Article 12(d).

149 Articles 12(a) and 12(b).

150 Article 11(a).
Chapter IX - Multilateral Investment Guarantee Agency

b. **Expropriation.** MIGA insures investors against the risk that they will be deprived of their property as a result of host government action directed at the investors, or as a result of a series of such actions producing a similar cumulative effect.

c. **War and Civil Disturbance.** MIGA insures investors against losses resulting from military action or civil disturbance in the host country.

d. **Breach of Contract.** MIGA can insure investors against host government breach of contract if the investor also (i) is denied access to an appropriate forum to adjudicate its claim regarding the breach within a reasonable period, or (ii) is otherwise denied the right to enforce a favorable judgement or award regarding the breach.

In addition, MIGA may, upon the joint application of the investor and host country, approve the extension of coverage to other specific non-commercial risks (as approved by its board of directors), other than the risk of devaluation or depreciation of currency.\(^\text{151}\)

3. **Risk Assessment, Risk Mitigation, and Country/Project Exposure Limits**

9.6. MIGA, like any insurer, applies prudent rules regarding diversification of exposure and risk management. Central to MIGA’s determination of whether to insure a particular investment is an evaluation of the likelihood of a loss occurring and claims being filed under its insurance coverage. MIGA’s premiums are set to reflect the possibility of the loss occurring in the future.\(^\text{152}\)

9.7. MIGA also sets coverage limits per project and aggregate limits per country.\(^\text{153}\) These limits can be exceeded through insurance techniques, such as reinsurance, or through the operation of the MIGA Sponsorship Trust Fund (described below) under which one or more member countries finance the underwriting of MIGA’s insurance policy for a specific project.

9.8. Also central to MIGA’s portfolio management is its ability to mitigate risks through its relationship with host governments. As noted above, MIGA only insures investments in countries which are members of MIGA. In addition, MIGA obtains the consent of the host government before issuing any insurance for an investment in the country.\(^\text{154}\) Through this MIGA/country relationship, the organization attempts to mitigate the likelihood of risks maturing into actual insurance claims.

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\(^\text{151}\) Article 11(b).


\(^\text{153}\) The project limit is currently US$50 million and the country limit US$175 million.

\(^\text{154}\) Article 15.
4. Terms of Insurance

9.9. MIGA applies a variety of traditional insurance practices and techniques to the insurance it provides. These include: (a) co-insurance, under which the insured investor must assume responsibility for a portion of its losses (for example, 10%); and (b) waiting periods, which require the insured investor to wait a specified period of time following a loss before it can file a claim (this period provides to MIGA, among other things, an opportunity before a claim is filed to discuss with the host government means to remedy the problem creating the potential loss).

B. MIGA Sponsorship Trust Fund

9.10. The MIGA Convention also permits member countries to sponsor a fund to finance MIGA insurance coverage for specified investments, rather than having MIGA finance such coverage from its own resources; this mechanism is referred to as the Sponsorship Trust Fund (STF). The STF enables MIGA member countries to provide selected investments access to insurance, while providing a vehicle for MIGA to insure investments that meet its eligibility criteria, but for which it could not otherwise issue coverage (for example, because of project or country limits).

9.11. Under the STF, one or more MIGA member countries (the Sponsors) undertake to finance a trust fund. MIGA, in turn, uses the trust fund to finance insurance coverage for investments specified by the Sponsors. A host country could potentially serve as a Sponsor of an STF. As with MIGA-funded insurance, the investment must be made in a member country. However, the eligibility criteria for the investors are slightly broader as nationals of any country are eligible. The amount of coverage to be issued essentially depends on the amount of funds provided by the Sponsors. In other respects, MIGA's operational regulations generally would apply to the STF-financed insurance in the same manner as they do to other MIGA-financed insurance. Thus, for example, the insurance only would cover those risks which MIGA insures from its own resources.

9.12. The STF mechanism would potentially involve the following two basic agreements: (a) the STF funding agreement between the Sponsor countries and MIGA regarding the establishment and financing of the trust fund, and (b) the MIGA insurance contract issued in favor of the investors. The STF could also potentially be financed by a Sponsor host country using a World Bank loan. This

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155 Article 24 and Annex I to the MIGA Convention set out the modalities for the STF.

156 Article 1(c) of Annex I to the MIGA Convention provides in relevant part that MIGA "shall give priority to investments which are co-sponsored by the host countries concerned."

157 Article 6(i) of Annex I to the MIGA Convention.

158 Article 1(a) of Annex I to the MIGA Convention.

159 Article 6 of Annex I to the MIGA Convention.
approach represents a form of third-party guarantee; it is described above in Chapter VI, Part B.2, and detailed in Annex D-2.

C. MIGA Guarantee Administration

9.13. In accordance with its general mandate to support investments, MIGA potentially can also administer guarantees issued or otherwise funded by countries -- in particular, host countries. This mechanism would provide MIGA with another vehicle to support project finance operations, in addition to issuing insurance funded from MIGA’s corporate financial resources or financed by sponsoring countries through an STF. The structure would likely involve the following basic agreements: (a) a guarantee for the benefit of the investors issued by the country, or by MIGA acting as administrator on behalf of the country, and (b) an administration agreement between MIGA and the country specifying, among other things, the administrative obligations of MIGA, and the obligations of the country to finance the guarantee coverage and pay any MIGA administrative fees. MIGA would likely establish a trust fund to hold moneys provided by the country to pay for claims under the guarantee. The MIGA-administered guarantee could potentially be financed by a host country using a World Bank loan. This approach represents another illustration of a third-party guarantee; it is described above in Chapter VI, Part B.2 and detailed in Annex D-2. This mechanism to date has not been employed, but is currently under consideration.

D. Relative Advantages of MIGA Participation

9.14. MIGA brings a variety of possible advantages to a project finance operation.

First, as a provider of political risk insurance, it protects specified investors and investments against financial losses up to specified amounts.

Second, MIGA acts to mitigate political risks potentially facing a project, in two distinct ways: (a) directly through its relationship with host countries and their governments; and (b) indirectly through its close relationship with IBRD and IDA, its sister organizations, who in turn often can exercise considerable influence over countries (see discussion above in Chapter VII.B). In many cases, MIGA’s actions also serve to protect uninsured investments and investors in the project.161

Third, the STF mechanism and MIGA’s administration of country guarantees provide possible vehicles for member developing countries to support financially a specific investment in their country, without incurring the commercial exposure present when countries obtain loans.

160 Articles 2 and 23.

161 Certain risks affect an entire investment at once, not simply the portion which is insured. For example, expropriation often affects an entire power plant, not merely the portion of the equity that has been insured. In part recognizing the beneficial spillover effect of MIGA insurance on uninsured investments in the same project, investors have purchased MIGA insurance coverage for projects in which their total investment has been many times larger than MIGA’s project limit.
Fourth, MIGA represents a source of expertise for countries to assist them in promoting investments.

9.15. As illustrated by the foregoing discussion, MIGA provides a specialized form of support to project finance operations in developing countries. Political risks are frequently identified by potential foreign investors as major impediments to their willingness to invest in these operations. MIGA’s insurance provides a tool to address these risks. This specialization and the related expertise provide an important complement to the support provided by the other World Bank Group organizations.
ANNEXES
IBRD Loan to a Project Company with Country Guarantee

IBRD can provide a loan directly to a project company as follows:

a. IBRD lends funds to the project company under a loan agreement, pursuant to which the company is obligated to repay the funds to IBRD. The loan agreement also typically contains other undertakings of the project company to IBRD regarding implementation of the project.

b. The country guarantees repayment of the IBRD loan pursuant to a guarantee agreement entered into with IBRD. The guarantee agreement may contain other undertakings of the country to IBRD regarding implementation of the project.
IBRD Loan to Project Company with Country Guarantee

IBRD

Loan

Loan Repayment

Guarantee of Loan Repayment

COUNTRY

PROJECT COMPANY

Project Revenues

Output

Purchaser

Equity Investment

Shareholders
IBRD Loan to Country with Onlending to Project Company

IBRD can provide loans to project companies through the intermediary of the country under the following structure:

a. IBRD lends funds to the country under a loan agreement, pursuant to which the country is obligated to repay the funds to IBRD. The loan agreement also typically contains other undertakings of the country to IBRD regarding implementation of the project.

b. The country onlends the funds (the "subsidiary" loan or "sub-loan") to the project company under a subsidiary loan agreement.

c. IBRD often also enters into a direct contractual relationship with the project company (pursuant to a "project agreement") establishing various obligations of the company with respect to implementation of the project.
IBRD Loan To Country with Onlending to Project Company

IBRD

Loan

Project Agreement

COUNTRY

Loan Repayment

Sub-Loan

Sub-Loan Repayment

PROJECT COMPANY

Project Revenues

Output

Equity Investment

Shareholders

Purchaser
IBRD Loan for an "Enclave" Project

The "typical" structure of an IBRD loan for an enclave project with private sector sponsors (the Sponsors) is as follows:¹

a. IBRD lends funds directly to the project company pursuant to a loan agreement. The loan agreement also typically contains other undertakings of the project company to IBRD regarding implementation of the project. [Alternatively, IBRD can lend the funds to the country, which onlends them to the project company (see Annex A-2) or uses the funds directly to finance project activities.]

b. IBRD receives a guarantee of repayment from the country. [Alternatively, in cases where the loan is made directly to the country, IBRD benefits from a country undertaking to repay the loan.] The guarantee [or loan agreement] also includes certain undertakings of the country regarding the project.

c. Repayment of the IBRD loan is guaranteed by the Sponsors. This guarantee may also take other forms, such as a "take or pay" contract under which the Sponsors agree, for the benefit of IBRD and other lenders, to make predetermined payments (sufficient to cover debt service requirements) to the project company for the project’s output, whether or not any output is in fact produced and delivered.

d. The foreign exchange revenues generated by the project are deposited directly by the purchaser of the project’s output into an off-shore trust account, from which debt service payments are made directly to IBRD and other lenders according to a pre-arranged priority.

e. A reserve is created within the trust account for the purpose of financing IBRD and other debt service payments (for example, 12-18 months of debt service payments) -- this reserve provides a cushion which allows debt service payments to be made in a timely manner notwithstanding short-term interruptions in the project’s revenue flows.

f. In instances where the project company pledges project assets to other financiers, IBRD generally insists on being ratably secured.

¹ Enclave projects have in practice varied from this "typical" structure.
IBRD Loan for "Enclave" Project
IDA Credit

IDA provides loans to project companies through the intermediary of the country under the following structure:

a. IDA lends funds to the country under a loan agreement (the "development credit agreement"), pursuant to which the country is obligated to repay the funds to IDA. The development credit agreement also typically contains other undertakings of the country to IDA regarding implementation of the project.

b. The country onlends the funds (the "subsidary" loan or "sub-loan") to the project company under a subsidiary loan agreement.

c. IDA often also enters into a direct contractual relationship with the project company (pursuant to a "project agreement") establishing various obligations of the company with respect to implementation of the project.
IDA Credit

- **IDA Credit Repayment Project Agreement**
- **Country**
  - **Sub-Loan**
  - **Sub-Loan Repayment**
- **Project Company**
  - **Project Revenues**
  - **Output**
- **Purchaser**
  - **Equity Investment**
- **Shareholders**
IBRD "Partial Risk" Guarantee

IBRD "partial risk" guarantees can be provided under the following structure:

a. Commercial lenders provide loans to the project company.

b. The country provides certain contractual undertakings to the project company for the benefit of the commercial lenders (for example, not to interfere with the project).

c. IBRD issues to the commercial lenders a guarantee against defined risks covering their loans. The guarantee is callable if the project company defaults on repayment of the loans as a result of the failure of the country to comply with certain specified undertakings provided to the project company under the agreement described in the preceding paragraph (for example, in the case of governmental interference).

d. The country provides an indemnity (or counter-guarantee) to IBRD pursuant to which the country agrees to reimburse IBRD for any payments IBRD makes to the commercial lenders under IBRD's guarantee.²

e. IBRD would, upon paying on its guarantee to the commercial lenders, generally enjoy, through subrogation, rights as against the project company (that is, it would step into the shoes of the commercial lenders, with the attendant rights of a creditor of the project company).

f. IBRD might also enter into a direct contractual relationship with the project company (pursuant to a "project agreement") establishing various obligations of the company regarding implementation of the project.

² In instances where the borrower under the commercial loan is the project company, not the country, IBRD could also potentially enter into an indemnity agreement with the borrower project company.
IBRD "Partial Risk" Guarantee

Project Agreement

IBRD

Indemnity
(or Counter-Guarantee)

Guarantee

Commercial Lenders

Loan

Loan Repayment

PROJECT COMPANY

Equity Investment

Shareholders

Purchaser

Project Revenues

Output

Undertakings to
Project Company
for Commercial
Lenders
IBRD "Partial Credit" Guarantee

IBRD "partial credit" guarantees can be provided under the following structure:

a. Commercial lenders provide loans to the project company.

b. IBRD issues to the commercial lenders a guarantee covering specified payments due under their loans.

c. The country provides an indemnity (or counter-guarantee) to IBRD pursuant to which the country agrees to reimburse IBRD for any payments IBRD makes to the commercial lenders under IBRD’s guarantee.3

d. IBRD would, upon paying on its guarantee to the commercial lenders, generally enjoy, through subrogation, rights as against the project company (that is, it would step into the shoes of the commercial lenders, with the attendant rights of a creditor of the project company).

e. IBRD might also enter into a direct contractual relationship with the project company (pursuant to a "project agreement") establishing various obligations of the company regarding implementation of the project.

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3 In instances where the borrower under the commercial loan is the project company, not the country, IBRD could also potentially enter into an indemnity agreement with the borrower project company.
IBRD "Partial Credit" Guarantee

IBRD

Guarantee

Project Agreement

Commercial Lenders

Loan

Loan Repayment

PROJECT COMPANY

Equity Investment

Shareholders

Indemnity
(or Counter-Guarantee)

COUNTRY

Purchaser

Project Revenues

Output

Equity Investment

Commercial Lenders

Purchaser

Project Revenues

Output

Equity Investment

Commercial Lenders
IBRD "Partial Credit" Guarantee through a Put Option

IBRD can provide put options designed to serve as "partial credit" guarantees under the following structure:

a. Commercial lenders provide loans to the project company.

b. IBRD provides to the commercial lenders an option to put (that is, sell) their debt instruments to IBRD at their maturity for the principal amount of such loans then outstanding.

c. IBRD would, upon paying the commercial lenders pursuant to the put, acquire the underlying debt instrument and benefit from the project company's obligations thereunder.

d. The country provides an indemnity to IBRD pursuant to which the country agrees to reimburse IBRD for any payments IBRD makes to the commercial lenders under the put. This indemnity may take the form of a "counter-put option agreement" pursuant to which the country undertakes to repurchase from IBRD, at IBRD's option, the debt instruments acquired from the commercial lenders.

e. IBRD might also enter into a direct contractual relationship with the project company (pursuant to a "project agreement") establishing various obligations of the company regarding implementation of the project.
IBRD "Partial Credit" Guarantee Through A Put Option

**Diagram Description:**
- **IBRD** provides a guarantee through a put option.
- **COUNTRY** receives indemnity (or counter-put option).
- **Commercial Lenders** provide loans.
- **PROJECT COMPANY** receives loan repayment.
- **Purchaser** receives output.
- **Equity Investment** is shared by shareholders.
- **Project Revenues** flow between the company and the purchaser.
- **Loan** and **Loan Repayment** are directed to and from commercial lenders.

---

**Textual Description:**
A Project Agreement is established between IBRD and COUNTRY, with IBRD providing a put option.

The Commercial Lenders provide a loan to the Project Company, which repays the loan.

The Project Company generates revenues that are shared with the Purchaser.

Equity Investment is made by shareholders into the Project Company.

The project relies on indemnity (or counter-put option) from IBRD to guarantee the credit to the Commercial Lenders.
World Bank Financed Country Guarantee

World Bank (namely, IBRD or IDA) financing for country guarantees could be provided under the following structure:

a. The country issues a guarantee to financiers of the project company.

b. The World Bank enters into a "contingent" loan agreement with the country, pursuant to which (i) it agrees to lend funds to the country to finance the latter's liabilities under its guarantee, and (ii) the country undertakes to repay to the World Bank any moneys disbursed under the loan. The World Bank would disburse funds under the contingent loan only if and when needed by the country to finance payments under the country's guarantee.

c. The World Bank might also enter into a direct contractual relationship with the project company (pursuant to a "project agreement") establishing various obligations of the company regarding implementation of the project.
World Bank Financed Country Guarantee

WORLD BANK

Contingent Loan

Contingent Loan Repayment

COUNTRY

Loan Proceeds

Guarantee

Project Agreement

Project Financier

Financing

Repayment/Returns

PROJECT COMPANY

Project Revenues

Output

Purchaser
World Bank Financed Third-Party Guarantee

World Bank (namely, IBRD or IDA) financing of a third-party guarantee -- for example, coverage administered by MIGA -- could potentially be provided under the following structure:

a. The country and a third-party guarantor (for example, MIGA) enter into an agreement establishing the modalities under which the country will finance political risk coverage for the benefit of specified investors in the project company.

b. The third-party guarantor issues political risk coverage to the specified investors.

c. The World Bank provides a "contingent" loan to the country to fund its obligations to the third-party guarantor. The World Bank would disburse funds under the contingent loan only if and when needed by the third-party guarantor to finance payments in respect of claims by the investors. The country would be obligated to repay to the World Bank all amounts withdrawn under the "contingent" loan to finance payments to the investors.

d. The World Bank might also enter into a direct contractual relationship with the project company (pursuant to a "project agreement") establishing various obligations of the company regarding implementation of the project.
World Bank Financed Third-Party Guarantee

Annex D-2
World Bank Financed Put Option

World Bank (namely, IBRD or IDA) financing for put options provided by the country could be provided under the following structure:

a. Commercial lenders provide loans to the project company.

b. The country provides a put option to the commercial lenders (for example, a "partial risk" or a "partial credit" put option).

c. The World Bank enters into a loan agreement with the country, pursuant to which (i) the World Bank agrees to lend funds to the country to finance the latter's liabilities under the put option, and (ii) the country undertakes to repay to the World Bank any moneys disbursed under the loan. In the case of a partial risk put option, the financing would likely be provided through a "contingent" loan, and the World Bank would disburse funds under the contingent loan only if and when needed by the country to finance payments under the put.

d. The World Bank might also enter into a direct contractual relationship with the project company (pursuant to a "project agreement") establishing various obligations of the company regarding implementation of the project.
World Bank Financed Put Option

WORLD BANK

COUNTRY

Government Agency

Project Financier

PROJECT COMPANY

Purchaser

Contingent Loan

Contingent Loan Repayment

Project Agreement

Loan Proceeds

Put Option

Financing

Repayment/Returns

Project Revenues

Output
World Bank Financed "Take-or-Pay" and Other Contracts

The World Bank (namely, IBRD or IDA) could potentially finance a "take-or-pay", "take-and-pay" or similar contract entered into by the country with the project company under the following structure:

a. The country enters into a "take-or-pay" or "take-and-pay" contract with the project company. These payments are generally (in the former) and necessarily (in the latter case) made to procure goods or services from the project company.

b. The World Bank lends funds to the country under a loan agreement, pursuant to which (i) it agrees to provide funds to the country to finance the latter's financial obligations under the "take-or-pay" or "take-and-pay" contract, and (ii) the country undertakes to repay to the World Bank moneys disbursed under the loan.

c. The World Bank might also enter into a direct contractual relationship with the project company (pursuant to a "project agreement") establishing various obligations of the company regarding implementation of the project.
World Bank Financed "Take-or-Pay" and Other Contracts

- **WORLD BANK**
  - Loan
  - Loan Repayment
  - Project Agreement

- **COUNTRY**
  - Loan Proceeds

- **GOVERNMENT PURCHASER**
  - Payments under "Take-or-Pay"/
    "Take-and-Pay" Contract

- **PROJECT COMPANY**
  - Output
  - Equity Investment

- **Shareholders**
World Bank Financed Equity

The World Bank (namely, IBRD or IDA) can finance the equity investment of the country in the project company under the following structure:

a. The World Bank lends funds to the country under a loan agreement, pursuant to which the country is obligated to repay to the World Bank moneys disbursed under its loan.

b. The country receives equity in exchange for contributing the loan proceeds to the project company for the acquisition of identified goods and services.

c. The World Bank might also enter into a direct contractual relationship with the project company (pursuant to a "project agreement") establishing various obligations of the company regarding implementation of the project.
World Bank Financed Equity
World Bank Financed Debt Refinancing

The World Bank (namely, IBRD or IDA) could provide funds to enable a country to refinance debt incurred by a project company under the following structure:

a. Commercial lenders provide loans to the project company.

b. The country undertakes to refinance at a later date the project company's outstanding commercial loans through the provision at such later date of new loans.

c. The World Bank enters into a loan agreement with the country, pursuant to which (i) it agrees to lend funds to the country to finance the latter's obligation to refinance the project company's debt, and (ii) the country undertakes to repay to the World Bank moneys disbursed under the loan.

d. The World Bank might also enter into a direct contractual relationship with the project company (pursuant to a "project agreement") establishing various obligations of the company regarding implementation of the project.
World Bank Financed Debt Refinancing

- WORLD BANK
- COUNTRY

- Commercial Lenders
  - Commercial Loan
  - Commercial Loan Repayment

- PROJECT COMPANY
  - Project Revenues
  - Output
  - Equity Investment
  - Shareholders

- Purchaser

- Loan
- Loan Repayment

Project Agreement

Refinancing of Commercial Loans
World Bank Financed Investment Facility

World Bank (namely, IBRD or IDA) financing for an investment facility can be provided under the following structure:

a. The World Bank lends funds to the country under a loan agreement, pursuant to which the country is obligated to repay to the World Bank moneys disbursed under the loan. The World Bank would also benefit from undertakings regarding the operation of the investment facility. The loan proceeds would be disbursed as and when needed to finance eligible enterprises.

b. The country would provide the loan proceeds to the investment facility as and when needed by such facility to finance investments in specified project companies for eligible enterprises.

c. The investment facility would make loans to (and possibly equity and/or quasi equity investments in) the specified project companies for the eligible enterprises. The project companies would be obligated to repay these loans to the investment facility.

d. In circumstances where the investment facility is operated by a development finance company or other financial institution, the World Bank would also enter into a direct contractual relationship with the project company (pursuant to a "project agreement") regarding the operation of the facility.
World Bank Financed Investment Facility

Diagram:

- **WORLD BANK**
  - Loan to **COUNTRY**
  - Loan Repayment from **COUNTRY**
  - Project Agreement to **Investment Facility**

- **Investment Facility** (Development Finance Company)
  - Loans/Investments to **PROJECT COMPANY A** and **PROJECT COMPANY B**
  - Repayments/Returns from **PROJECT COMPANY A** and **PROJECT COMPANY B**
  - Loan Proceeds to **COUNTRY**
  - Loan Repayment from **COUNTRY**

- **PROJECT COMPANY A**

- **PROJECT COMPANY B**
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