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# A Partial Credit Guarantee: Enhancing Access to Credit Markets during Constrained Times

***To Croatia, the ripples of the European financial crisis felt more like large waves! The challenging market conditions limited the ability of the Croatian Bank for Reconstruction and Development (HBOR) to raise funds efficiently without credit enhancement. This in turn impeded a steady flow of credit to the private sector, which was necessary to enhance competitiveness ahead of Croatia's entry to the European Union in July 2013. In response to a request from the Croatian government, the World Bank decided that a Partial Credit Guarantee (PCG) would be the ideal instrument to assist HBOR.***

## *Background*

The global financial crisis has had a significant impact on the ability of the Croatian private sector to obtain financing. Foreign direct investment in the first three quarters of 2012 amounted only to €0.5 billion, half as much as during the same period of 2011—and far from the €4.2 billion registered in 2008 and the pre-crisis average of €2.4 billion. In addition, unfavorable domestic financing conditions are accompanied by a slowdown in external corporate financing, as foreign creditors are holding back on-lending because of uncertainty in global financial markets and pessimistic expectations. Real private sector credit declined by 10.3 percent in 2012 (one of the highest contractions among EU member states), despite measures the Croatian National Bank took to boost lending growth.

Reduced foreign investment and access to finance—particularly long-term funding—made economic recovery and private sector-led growth more difficult. Only half of foreign investments are related to new projects (concentrated in real estate, tourism, and trade), while investments in production activities are significantly less. Moreover, lending to the private sector has focused on loan refinancing and provision of working-capital funding, shifting the maturity structure of the loan portfolio of banks toward the shorter term (80 percent of all new loans are short-term). These features have contributed to the lasting recession in the Croatian economy, which contracted by 2 percent in 2012 alone, driven by weak industrial production and construction.

In an environment of constrained access to long-term funding, the Croatian Bank for Reconstruction and Development is increasingly becoming an important provider of financing to the private sector. HBOR is a development and export bank—100 percent owned by the Republic of Croatia—established with the objective of financing the reconstruction and development of the Croatian economy. Using loans from international financing institutions, HBOR has been able to extend to the market long-term funds that were critical to sustain a minimum level of economic activity. In 2012, HBOR on-lent close to €800 million to exporters and to small and medium companies and had a total lending volume of €1.36 billion. However, the spread of HBOR, albeit lower than the levels shown in early 2012, remained higher than those of comparable subsovereign issues, possibly reflecting the market's perception of Croatia as a relatively higher-risk sovereign borrower, particularly after it was downgraded to below investment-grade status.

At the time of project design, HBOR did not raise any money in the capital markets for the past four years and has relied solely on funding provided by commercial banks and international financing institutions. Therefore, HBOR needed an innovative product that would expand its funding base, catalyze new interest among foreign financial institutions, improve borrowing conditions, and help reduce transactions risks in a volatile market environment—all with the ultimate objective of maintaining a steady flow of credit to the private sector and helping to enhance competitiveness ahead of Croatia's entry to the EU.

## *World Bank response: A Partial Credit Guarantee*

The government of Croatia approached the World Bank with a request for financial resources to support HBOR. The significant role of HBOR in an environment of financial crisis, combined with the need to continue supplying long-term funds to Croatian companies, was a key motive for the authorities to approach the Bank, and it was consistent with the government's strategic goal to foster growth. In particular, the authorities had in mind a support scheme for exporters and foreign-exchange-earning enterprises to ensure that these companies remain competitive.

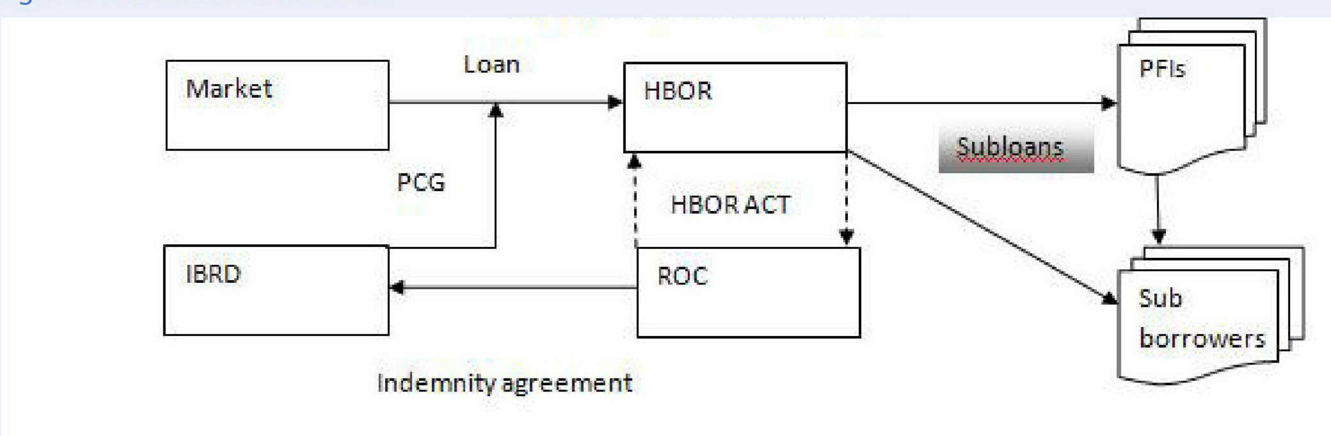
The World Bank responded with a project consisting of a Partial Credit Guarantee for HBOR that would enable financing of up to €250 million from the international banking market for on-lending to private sector companies. The underlying borrowing would be through sequential commercial loans, involving a three-party arrangement between the commercial lenders, HBOR, and IBRD.[1] The objective of the transactions is to raise up to €250 million, achieve a long maturity (seven-plus years), and obtain competitive market pricing (3–4 percent all-in cost). The World Bank PCG may be called only after a payment default by HBOR and failure of the Republic of Croatia to make payment under its statutory guarantee. Salient features of the borrowing and guarantee structure include a high level of guarantee coverage (IBRD guarantees up to €200 million of the total amount of loans arranged, distributed across principal payments or a combination of principal and interest), and a grace period of at least three years, for an operation with the longest maturity achievable and the most competitive pricing available in the market.

HBOR would then on-lend the raised amount to subprojects in Croatia, based on the eligibility criteria developed and agreed with the World Bank. HBOR will intermediate the funds through participating financial institutions, which in turn will on-lend to eligible private exporters and quasi-exporters (FX-earners). In addition, HBOR will on-lend directly, in partnership with participating financial institutions, up to 40 percent of the guaranteed borrowed funds. The overall scheme for the flow of funds is illustrated in Figure 1.

The PCG differs from previous engagements between the World Bank and HBOR in several aspects and provides numerous benefits, especially in its ability to leverage private sector funding. Previously, for example, the World Bank provided direct loans to HBOR to provide long-term finance to Croatian companies. However, these loans involved lower notional amounts and used the country's exposure limit, which was significantly constrained at the time of the operation. Also, given the funding structure of HBOR, it was advisable to design a product that would help the bank diversify its funding sources and modernize its dialogue with lenders and investors. The PCG allows HBOR to 1) access long-term funding from international investors and banks at favorable interest rates and with a long-term maturity, 2) facilitate the long-term development of HBOR as an institution, 3) leverage private sector funding for HBOR, and 4) use the IBRD guarantee to show investors the World Bank's confidence in the creditworthiness of Croatia as a sovereign and HBOR as a subsovereign. The PCG aims to create the conditions for investors to lend to HBOR, helping it move toward market-based funding.

1 IBRD is the World Bank Group's International Bank for Reconstruction and Development.

Figure 1: Overview of PCG for HBOR



The PCG also aims to improve HBOR's debt sustainability. The guarantee would enable HBOR to raise funds from the international markets at terms consistent with its on-lending arrangements, which HBOR can comfortably manage in debt absorption and repayment. HBOR would not achieve these objectives if it borrowed on a stand-alone basis under current market conditions. In addition, the PCG enhancement greatly reduces transactions closing risks in a climate of market volatility. Finally, to minimize negative carry costs associated with drawdowns, the targeted volume and proposed transaction sequencing allow HBOR to support project beneficiaries quickly and efficiently.

### *Lesson 1: Explain instrument rationale and secure full client ownership.*

The Bank team spent considerable time with HBOR, explaining why the PCG was the most suitable instrument for it to mobilize medium-term to long-term financing for eligible companies while reopening access to the international banking market and transitioning from low-cost direct multilateral financing to a fully commercial funding structure. High-level discussions with the client ownership were critical to obtaining its full ownership of the instrument.

### *Lesson 2: Understand client needs for determining objectives for financial terms.*

Terms and conditions of any PCG-supported commercial financing are set in interaction with the market. The final price, tenor, and other terms will depend on the amount of PCG support available and how the guarantee is structured. The Bank team knew that it had a highly price-sensitive client in HBOR and that a high amount of coverage would be required. The available PCG amount was therefore set at approximately 80 percent of the total commercial financing. However, during transaction preparation the client indicated that a higher amount would be preferable, to lower the financing cost further for the final beneficiaries. It would have been useful for the Bank team to explore feasible financing terms at the subborrower level to address HBOR's concerns on final funds absorption.

### *Lesson 3: Allow for flexibility in internal World Bank processing.*

Bank processing requirements were effectively adjusted to meet client preferences for the transaction timeline. World Bank Board approval was secured before HBOR sent out the request to commercial banks for financing proposals, and the operation was divided into stages to accommodate the client's funds placement needs. At no time did the client hold Bank processing requirements responsible for delays in commercial negotiations. The Bank team moved at HBOR's preferred pace for the market-based transaction, which reassured both the client and market participants of the Bank's flexibility on the timing of its own processing steps.

### *Lesson 4: Manage the transaction carefully, and respect the division of responsibilities.*

It was important to clarify from the outset that the client would be leading the market-sounding and negotiation process, with continual support from the Bank team. Although the client stayed in the lead throughout the operation, the Bank team could have provided more support for the drafting of the request for proposals (RFP). Fewer banks than expected ended up bidding for the commercial financing, partly because of the rigid financial specifications of the RFP. For the second stage of the transaction, both the client and the Bank team agreed to spend more time on anticipating market reactions during RFP drafting.

### *Lesson 5: Provide timely capacity building and technical support.*

Most PCG operations of the Bank involved considerable capacity building to support clients in accessing commercial financing. In this case, HBOR was a sophisticated client that had accessed certain areas of international markets before. The main need for capacity building lay in estimating the financial terms to be derived from the blending of HBOR and World Bank risks and how the PCG structure would affect the results. Bank support was also requested in assessing the financial offers during the first transaction and in determining to what extent the PCG was adding value in price reduction and tenor extension. The Bank team received positive feedback from the client as a source of useful analysis when it was needed.

### *Lesson 6: Promote effective teamwork across World Bank departments.*

The Bank team was organized as a truly cross-department effort, with one core staff member each from Financial and Private Sector Development (FPD), Treasury, Poverty Reduction and Economic Management, Sustainable Development, and Legal. FPD provided both the task team leader and management support, and relevant guarantee specialists were mobilized from the other departments. Teamwork throughout the operation was effective, with a clear division of responsibilities. All team members were committed to quickly turning around analysis and assistance when required during the market-based operation. The Bank team also built on the good rapport with the client, carrying out many of the activities, such as market sounding, as one joint team.

## Conclusion

Credit guarantees are highly valuable for lenders, especially in a crisis environment. Since the onset of the financial crisis, as lenders have deleveraged from perceived problem areas or riskier investments, guarantees have proven to be an ideal instrument to keep banks and investors engaged globally with various borrowers. Recent transactions—in the Europe and Central Asia region in particular—have also shown that the instrument can be used not only to leverage funding, obtain longer maturities than otherwise achievable, and reduce costs for issuers with an established borrowing track record in the markets, but also facilitate market entry for new issuers.