

ANNEX B. PRICING GUARANTEES

Risk premium (guarantee fee): To finance the risk, which is often calculated using conventional credit risk models, the guarantor usually charges the beneficiary a risk premium or fee. This fee is analogous to an insurance premium. Ideally, across a large portfolio, the premiums collected should cover expected losses and administrative costs, making the scheme financially sustainable or cost-neutral for the donor in the long run. If the default risk assessment of a deal is estimated at 15%, the guarantor would charge a fee roughly equivalent to DKK 1.5 million (present value) for a DKK 10 million guarantee, which could be spread over annual payments. Donors often choose to charge a below-market premium or subsidise part of the premium to make the guarantee viable. The difference between a commercial market premium and the concessionary premium is essentially a grant element. According to DAC rules, any subsidy that lowers the guarantee's price for the beneficiary is a concessional component that counts as ODA, whereas the guarantee obligation itself (being a contingent liability, not a transfer) is not recorded as ODA.

Premium calculation: The premium level is typically based on actuarial or financial risk models. Guarantors consider factors such as the obligors' credit quality, historical default rates, the guarantee's tenor, recovery prospects, and default correlation. They may also include a margin for uncertainty or extreme scenarios. In a purely commercial setting, the premium would also include a profit margin and the cost of capital. In an ODA context, donors can forego profit and accept a lower risk margin, pricing only to cover expected losses and basic administrative costs. If the "break-even" premium remains too high for the project to absorb, the donor may use ODA funds to reduce the premium to a more affordable level.

Structure of payments and reserves: The donor may establish a reserve or designate funds to cover expected losses. Premiums paid by the partner, along with any donor-funded subsidies, are accumulated in a reserve account, an approach taken by Sweden/Sida for some of its guarantees. This reserve is used to pay any claims if defaults occur. By funding expected losses up front through premiums and subsidies, the government ensures it can honour the guarantee without additional budget outlays each time. If the guarantee portfolio performs without losses, the reserve may remain unused (or eventually be reallocated), but the initial subsidy still served its purpose by enabling the activity. Other guarantee structures are designed so that fiscal risk beyond the grant equivalent is borne by the state's contingent liability, but is not reported as aid. For example, one of the guarantee schemes in Denmark is reported in Box 3.

First-loss and subordinated guarantees: Another way guarantees are structured in practice is by layering risk. For example, a donor might take a first-loss position (covering initial losses up to a specified limit), while other partners cover subsequent

losses. This can be seen as the grant-equivalent component. Instruments such as a subordinated guarantee or a junior tranche funded by a donor allow private investors to assume the remaining risk with greater confidence. Only the ODA-funded junior tranches (which have an expected loss) are counted as aid, whereas the total guarantee coverage, including senior tranches, is not counted as ODA.

In sum, guarantees are structured to transfer risk from lenders and investors to the donor, and premiums are used to price that risk. When donors intentionally underprice the risk (or provide a subsidy to cover it), that underpricing constitutes the concessional element reported as ODA. The goal is to strike a balance: charge enough premium to involve the partner's skin in the game and recycle funds, but not so much as to make projects unbankable. Any technical assistance or administrative costs associated with establishing the guarantee scheme are typically funded by ODA grants and reported accordingly. Although the methods for pricing risk premiums are transparent (even if rarely disclosed at the deal level), the pricing of technical assistance and administrative costs appears largely ad hoc.

The Impact Fund Denmark example

Provisions for guarantee losses are calculated in the same way as loan impairment (IFDK, 2020-2024), implying the PD/LGD/EAD-style assessment described above. While specific IFDK documentation on stress simulation models is not public, the organisation states that credit modelling of this type has been part of the due diligence process (IFDK, 2020-2024). For instance, IFDK's Development Guarantees Facility explicitly focuses on underwriting credit risk and incentivising lending in underserved markets, which would require careful modelling of default probabilities and correlations to price and provision these guarantees. In sum, IFDK's risk management practices at the portfolio level (diversification limits, internal rating aggregation, and standardised loss provisioning) appear to be consistent with those of Basel-aligned institutions.

Sources

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