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POLICY BRIEF

INSTRUMENTS AND MECHANISMS TO MOBILIZE PRIVATE INVESTMENTS IN LOCAL INFRASTRUCTURE

Task Force 3

INFRASTRUCTURE INVESTMENT AND FINANCING

Authors

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موجز السياسة

أدوات وآليات لحشد استثمارات خاصة في البنية الأساسية المحلية

فريق العمل الثالث

الاستثمار في البنية الأساسية وتمويلها

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ABSTRACT

The world is facing a USD 15 trillion financing gap. This gap is particularly relevant for local infrastructure that has not received adequate attention from domestic and international actors. Half the population lives in urban areas where most of the gross domestic product and greenhouse gas emissions are produced. As countries have implemented expansionary fiscal policies to respond to the COVID-19 pandemic emergency, governments will face debt and deficit limitations, requiring a greater mobilization of private capitals. To scale up private investments in local infrastructures, a set of tools, good practices, and mechanisms are required. The aim would be to leverage private capital by reducing risk, guaranteeing investments, and supplementing public funds.

يواجه العالم فجوة تمويلية بمقدار ١٥ ترليون دولار أمريكي. وترتبط هذه الفجوة على وجه التحديد بالبنية الأساسية المحلية التي لم تحظى بعناية كافية من الجهات الفاعلة على المستويين المحلي والدولي. فنصف السكان يعيشون في مناطق الحضر حيث يتم إنتاج معظم الناتج المحلي الإجمالي وانبعاثات الغاز الدفيئة. وفي حين أن البلدان قد طبقت سياسات مالية توسعية للتجاوب مع جائحة كوفيد-١٩ الطارئة، فإن الحكومات ستواجه حدود ديون وعجز، مما يتطلب حشد هائل لرؤوس الأموال الخاصة. ويستلزم الأمر مجموعة من الأدوات والممارسات الجيدة والآليات من أجل الارتقاء بالاستثمارات الخاصة في البنى الأساسية المحلية. ويتمثل الهدف في الاستفادة من رأس المال الخاص من خلال تخفيض المخاطر، وضمان الاستثمارات، واستكمال التمويل العام.

CHALLENGE

Infrastructure is a driver of economic prosperity, sustainable development, and inclusive growth. Infrastructure investments foster growth and are an explicit goal of the Sustainable Development Goals (SDGs) agenda[1] along with being a key underlying factor for the achievement of other SDGs. The G20 has recently focused on the concept of "quality infrastructure investment" (G20 Japan 2019) with the aim of combining not only the pursuit of economic growth, but also social, environmental, and developmental impact.

However, the world faces a huge financing gap between projected investments and the amount needed to provide adequate global infrastructure. According to Infrastructure Outlook, by 2040, the world would face a USD 15 trillion financing gap between projected investments infrastructure and the amount needed to assure adequate infrastructure.[2] Infrastructure can provide significant economic multipliers that benefit the long-term growth of countries and improve people's quality of life.

Investments in infrastructure are mostly funded by governments that face debt and deficit limitations. The COVID-19 pandemic has further worsened these deficits this year. Only a small share is funded through project finance, primarily in the form of non-recourse loans and bonds that are repaid from cash flow from the project rather than from the balance sheet of the investors. This gap is particularly relevant for local infrastructure that has not received adequate attention and special consideration for the following reasons:

- It is estimated that urban areas, where more than half of the world's population lives, produce almost 70% of global greenhouse gas emissions and 80% of the global gross domestic product.

1. SDG 9: Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation, which is the most direct call for increased investment in sustainable infrastructure.
2. https://outlook.gihub.org.

- The condition of public finances at the subnational level is often worse than that at the national level.

- The ability of cities to develop high-quality projects and efficiently manage their implementation is rather uneven.

- The risks associated with local projects are usually higher and more challenging to assess than those at the national level, while the instruments to mitigate these risks are not always available.

International organizations, governments, and private actors should give greater attention to local infrastructure. Several multilateral development banks (MDBs) and national financial institutions have recently launched programs and investment facilities regarding urban infrastructure. Nevertheless, these actors could improve their coordination to promote good practices and to maximize the effectiveness of local infrastructure investment strategies. International cooperation can foster collective action on common goals, peer learning, and mobilization of technical and financial support to mitigate this investment gap. Furthermore, if private and blended finance increase their importance for local infrastructure, their deployment should be accompanied with a proper engagement of local stakeholders.

PROPOSAL

International organizations, MDBs, and governments have designed and developed a variety of tools aimed at improving project pipelines and attracting investment throughout the lifecycle of infrastructure projects. Since the UN published its Addis Ababa Action Agenda in 2015 (UNDESA 2015), the focus has been on blended finance investments that capitalize on partnerships among diverse actors. These include international organizations, development co-operation agencies, and private enterprises, to mobilize capital. The Private Participation in Infrastructure Database, developed by the World Bank, is an interesting initiative that collects and publishes data and trends on private investments in infrastructure. According to its 2019 report, private investment commitments in infrastructure dropped from its peak of almost USD 180 billion in 2012 to around USD 100 billion between 2017 and 2019 (Marcelo et al. 2019).

To scale up private finance, a set of tools, good practices, and mechanisms are required with the aim of leveraging capital by reducing risk, guaranteeing investments, and supplementing public funds. The World Economic Forum's Global Future Council on Infrastructure has stressed that practitioners have difficulty in properly assessing the wide range of tools available, undermining the effectiveness of existing instruments (George, Kaldany, and Losavio 2019). Furthermore, an enabling environment is a key factor in ensuring adequate returns for private investors. Thus, local infrastructure could also attract institutional investors who traditionally perceive infrastructure investments as too risky. Institutional investors could be well-suited for infrastructure assets as these types of investments are long-term, matching the long-dated exposure of their available funds. Furthermore, the stream of revenue related to local infrastructure investments is less volatile because it is constrained by a contract with national or subnational governments. A recent article published by the World Bank acknowledges that, even though pension funds, sovereign mutual funds, and other institutional investors manage assets for more than USD 100 trillion, their contribution to infrastructure investments is very small due to perceived risks (Lu 2020).

Implementing standardized infrastructure project frameworks

Although each infrastructure project would have project-specific features, standardized tools, where feasible, could help reduce project development timescales and the costs of a project's bidding and procurement phases. The G20 working group could develop and produce a set of standardized force majeure clauses for different types of projects that could be used by governments. This could help mitigate the risks of perceived ambiguity in contracts that could disincentivize investors. Furthermore, better standardized contracts could help expand the secondary market

for the associated debt and equity of the project. Force majeure clauses could be implemented to assure the responsibility of a country's government in case of any issue that could damage the project. These clauses could also mitigate perceived risks for investors (World Bank, n.d.). For example, in developing countries, the risks of political turmoil are of great concern to investors. In this case, the grantors could offer force majeure clauses for reasonably unforeseeable political events to mitigate perceived risks.

Addressing the current information gap on local infrastructure investments

In 2019, the G20 Summit agreed to develop a database on investment flows and returns, covering many types of projects and geographical locations to mitigate transaction costs due to different methodologies, collection, and aggregation of data. To reduce these costs in local infrastructure, governments, international financial institutions, and MDBs could develop the national databases and local infrastructure investments that are required to apply a common framework to calculate indicators. The database could also include environmental, social, and governance indicators. These local infrastructure investment databases would be used to disclose key information on profitability to attract private capital in local infrastructure projects. The development of "smart-infrastructures" is key to augmenting data collection and reliability, mitigating perceived risks, and encouraging investments.

Providing guidelines for the bundling of local infrastructure investments allocated in the same country

If national governments bundle infrastructure assets with different profile risks, they would produce an overall less risky asset, which could potentially attract more private capital. This mechanism could, however, generate a counter-productive decrease in transparency. Potentially, governments could aggregate investments with different profile risks without properly disclosing the specific technical features of the investments contained in the overall asset. To avoid moral hazard behaviors and maximize the benefits of this mechanism, investors would require international standards that ensure transparency on the different assets comprising the overall asset.

Supporting local governments to assess the economic value of projects

The cost-benefit analysis is a useful tool but, if inconsistently applied, it could be misused. However, this analysis could improve decision-making at the local level. The G20 working group could develop and publish clearer guidelines on performing the analysis. Despite empirical difficultly in assessing many impacts, there should be a

consistent way of improving transparency. Vast data are currently available on the condition, maintenance, and operation of infrastructure. Governments should work with private infrastructure players to increasingly use data analytics across the project life cycle. This comprehensive analysis would also help to develop the guidelines for a more efficient cost-benefit analysis, improving the environment enabling private investors. These guidelines should also include standardized environmental and social indicators. Further, in this case, the development of "smart-infrastructures" could help to increase the accuracy of the data available.

Improving the role of MDBs in adding value to private investments into local infrastructure assets

To reduce the perceived risk gap of this type of investment, MDBs could expand the credit enhancement mechanisms (such as guarantee instruments) currently available. Thus, the enabling environment would improve, and private investment would be attracted. MDBs could also implement tailored insurance mechanisms and instruments based on country-specific weaknesses. This would help to specifically address private investors' concerns in a country.

Developing a clear methodology to properly assess the dimension of sustainability in infrastructure investments[3]

Improving the framework on how to include sustainable indicators (considering all dimensions, i.e., social, financial, ecological, economic, and institutional sustainability) will be crucial to achieving project transparency and better governance. This approach should be implemented along the entire life cycle of an infrastructure process, from project selection criteria to the assessment of procurement responsibility.

3. International and regional organizations have developed urban sustainability indicators: the European Foundation (1998), the European Commission on Science, Research and Development (2000), the UN Habitat (2004), the European Commission on Energy Environment and Sustainable Development (2004), the United Nations (2007), and the World Bank (2008). Increasing effort has also been directed toward composite sustainability indices: Sustainability Index (ESI), the Environmental Performance Index (EPI), the Environmental Vulnerability Index (EVI), the Rio to Johannesburg Dashboard of Sustainability and the Wellbeing of Nations and National Footprint Accounts.

Revising the Basel framework to attract private investments from commercial banks

As stressed by a recent study published by the World Bank, "infrastructure projects are asset-intensive and generate predictable and stable cash flows over the long term, with low correlation to other assets" (Jobst 2018). This could also be applicable to local infrastructure projects on a smaller scale. However, in the standardized approaches for credit risks in national regulatory frameworks, infrastructure investment classification appears to not exhibit a risk profile adequate to its characteristic structure and rates of default, disincentivizing commercial banks to invest in long-term assets. As a result, several small and mid-sized commercial banks have been forced to exit the market, penalizing the development of local infrastructure. The return is not adequate.

- In case of a local infrastructure investment backed by MDBs, private capital should be allowed for a more flexible regulatory treatment.

- The Basel III framework should re-evaluate the risk weighted assets assessment procedure. First, it should consider if including specific factors related to the project (such as maturity, characteristics, or collateral) could foster a risk differentiation. Second, it should further analyze if the current risk weight assessment framework properly reflects infrastructure risks, as this type of investment is generally highly collateralized and constrained by tight pre-project agreements.

Conclusion

Blended finance should be deployed in accordance with public and private stakeholders of the recipient country. The efficiency of an infrastructure investment is tailored to the local context as it would need to address local development priorities and needs. The coordination between international actors and recipient countries is often inadequate, potentially having a major adverse impact on local communities. An increase in private investment in infrastructure projects through blended investment should be accompanied by the effective engagement of local communities, governance transparency, and social and environmental safeguard.

Disclaimer

This policy brief was developed and written by the authors and has undergone a peer review process. The views and opinions expressed in this policy brief are those of the authors and do not necessarily reflect the official policy or position of the authors' organizations or the T20 Secretariat.

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