Global Economy and Development at BROOKINGS

Supporting Partner: EMSD EMERGING MARKET SUSTAINABILITY DIALOGUES

G20 Brainstorming Workshop

September 7-8, 2017
Buenos Aires, Argentina

Mobilizing private finance for sustainable infrastructure

Jeremy Oppenheim and Katherine Stodulka on behalf of the Blended Finance Taskforce

Business and Sustainable Development Commission

Prepared for the 2017 G20 Brainstorming Workshop in Buenos Aires, Argentina

---

Argentina and the G20

G20 members represent 85 percent of the gross world product, two-thirds of the global population, and 80 percent of international trade. As the main forum for international economic and financial coordination, the G20 is in a unique position to address global challenges through more effective policy cooperation and the promotion of concrete actions that have an impact on its member countries and on other international stakeholders. As chair of the G20 in 2018, Argentina is right to focus its leadership on driving policies, which facilitate significantly more private investment into sustainable infrastructure, which is central to delivering on the 2030 Global Goals and into which mainstream institutional capital has only directly invested about 1.6 percent of assets.

Blended Finance Taskforce

Recognizing the critical role that private capital needs to play to narrow the SDG funding gap—especially for sustainable infrastructure—the Blended Finance Taskforce was established by the Business and Sustainable Development Commission. Working closely with other initiatives—notably the OECD, multilateral development banks and development finance institutions, and New Climate Economy-led blended finance efforts, and supported by a Steering Committee of approximately 20 experienced practitioners and experts (see full list in Annex 1), the taskforce is focused on bringing the voice of the "private sector" into this agenda. We need to acknowledge the inherent diversity of the private sector. It is made up of a range of different actors within very different segments (one breakdown would distinguish between (i) institutional asset owners including pension funds, insurers, sovereign wealth funds; (ii) asset managers including wealth managers, private equity firms; (iii) commercial and investment banks; and (iv) corporates including project developers). Each of

these segments operates with different mandates, constraints and risk/return preferences, and seeks to participate at different stages of the financing lifecycle. Disaggregating the private sector in a useful way therefore enables us to understand the investment needs of each segment.

This paper sets out some broad topics for exploration where we see strong potential to motivate different investors to allocate billions of dollars a year toward sustainable infrastructure. It will feed into a set of recommendations designed to break down the systemic barriers to mobilizing large-scale private capital for Sustainable Development Goal-related investments at Davos in January 2018.

1. What will it take for different types of private capital to participate at scale?

Investors perceive many barriers which stop them playing in the infrastructure space, particularly in emerging markets. We need to systemically break down these perceptions and identify how tools like blended finance can mitigate risks before we can understand what it would take for mainstream institutional capital to come to the table in a substantial way. We explore several of these considerations below.

a) Improve the enabling investment environment

One of the most important considerations for the private sector when making an investment decision is the enabling investment environment. This means that national policy is a critical lever when looking at how to drive more private investment into sustainable infrastructure. Key concerns for the private sector include political instability, corruption risk, a weak or complex legal framework, financial exchange risk, lack of contractual enforcement, low counterpart quality, construction risk, offtake risk, reputational challenges around environmental, social, and governance criteria, compliance, etc. A government's execution capacity and willingness to make decisions (e.g., applying cost-covering tariffs or committing availability payments over the project life cycle) are also important. Improving the enabling policy and legal framework in host countries will therefore be powerful in catalyzing more private investment for sustainable infrastructure.

Greater effort should be made to include local intermediaries and local pools of institutional capital in projects. Denominating projects in local currency should be encouraged wherever appropriate, with financial exchange hedging support where it is not.

b) Driving deal flow and supporting project development

The lack of a stable project pipeline, linked to sectoral development plans and policy frameworks, is often cited as a barrier to scaling up private investment into sustainable infrastructure. Current project preparation facilities are an important form of concessionary donor finance that can help grow the investment pipeline. Some facilities work well, especially when closely aligned with work to improve the enabling environment. However, the track record is uneven and many of the facilities appear to be more focused on a technical consulting model than on supporting private sector project developers who could be incentivized to expand their development activities.

Perhaps even more important for project developers are pools of capital for early stage startup costs, rather than technical assistance grants for project preparation. Since project developers require longer-term, lower cost debt, one of the best uses of concessionary capital may, in fact, be to (a) install off-take guarantee mechanisms using best practice developed over the past 20 years (e.g., a feed-in tariff mechanism that provides credit enhancement for the off-take), particularly to move the needle on further development of clean energy infrastructure; and (b) to build the management, capacity and financial health of utilities (e.g., water or power companies) in low and middle-income countries. We will not have the ability to fully deliver the SDGs with a sole focus on "project finance." Rather, there needs to be both corporate balance sheet capitalization ("blended finance") plus significant risk-mitigation at the project level ("blended risk"). Replicating and scaling the successes of the past (e.g., blended finance models which have supported the clean energy agenda) will be key to mobilizing more private finance for sustainable infrastructure.

c) Mobilize institutional capital

Large-scale institutional investors prefer investment grade assets with large ticket sizes and long-term horizons with exit/liquidity features. Their focus is on reducing the cost of capital through risk mitigation, provided that returns are in line with long-term requirements. This means that one way to drive greater investment into sustainable infrastructure is to use risk mitigating blended finance instruments that deploy first-loss, subordinated capital to improve the risk/return profile of infrastructure assets, particularly for those projects which are close to being standalone with an acceptable returns profile but where there is still excess uncertainty and risk in the enabling environment.

2. What are the implications for blended finance and risk-sharing/ mitigation structures?

The use of public/philanthropic funds in well-designed blended finance instruments to mitigate specific risks faced by private capital providers has the power to mobilize large-scale financial flows toward sustainable infrastructure. These blended finance instruments need to balance the private sector requirement for well-defined, market-rate risk/return characteristics, but must also have appropriate risk sharing profiles and deliver on the public interest or development need. For example, there will be cases in which the public good element of the investment would justify the provision of a material subsidy (e.g., to encourage the shift to low-carbon assets or to support access to better health services for low-income households). In these cases, while first-best practice would be to provide the support through a direct revenue grant (e.g., to support feed-in-tariffs or more robust off-take agreements) or an advance market commitment (e.g., in the case of International Finance Facility for Immunization for vaccines), there may be cases where the use of a concessional finance instrument, lowering the weighted average cost of capital, will be effective in making the overall project viable and hence crowding in private investment.

Optimizing the design of blended finance instruments to use the least amount of public/philanthropic capital to crowd in the largest flows of private capital is key to mobilizing investment toward sustainable infrastructure. Some initial areas for exploration appear below.

a) Asset pooling with the appropriate credit enhancement can help scale institutional investment for sustainable infrastructure

Aggregating underlying assets into blended finance fund structures/portfolios can increase transaction size, improve liquidity of long-term assets, diversify risks and create tranches of capital that appeal to different institutional investors. Creating more investment vehicles with the "right" risk/return profile that are familiar to a broad public market (i.e., by pooling below-investment grade assets and then applying some credit enhancement to end up with an investment grade vehicle) will be critical to scaling up institutional investment in blended finance transactions for the SDGs. Asset pooling, of course, requires there to be enough assets for bundling, which again speaks to the upstream challenge of deal flow.

b) Product standardization can reduce barriers to blended finance

Standardizing a set of core blended finance instruments (specific risk insurance products, subordinated loans, first loss guarantees, social impact bonds etc.) by aligning their contractual terms and conditions will alleviate some private sector difficulties with blended finance including deal complexity, high transaction costs associated with delay, complexity, and lack of familiarity and in-house expertise to deal with bespoke financial structures. This has been done in a number of other contexts, including in the credit market. Green bonds are also a good example.

Standardization has led to increased transparency, concentration or aggregation of liquidity, and operational efficiency to execute and settle trades. Standardization has also been an important ingredient for products that have successfully migrated to trading efficiently on electronic platforms. As well as standardization, encouraging larger, high profile transactions with liquidity, rating, CUSIPS, etc. rather than bespoke one-off illiquid trades will help achieve scale.

c) Enhanced support for long-term intermediaries can attract more private investment for sustainable infrastructure

Relatively few institutions have the network orchestration capacity to take infrastructure projects in low and low-middle income countries from design and preparation phase, through to construction and into long-term asset management. The relative lack of intermediaries means that blended finance is not being optimally deployed in this space—traditional models where private equity infrastructure funds support undercapitalized project developers is not working well as a model for greenfield infrastructure development in low and low-middle income countries not least because of the fundamental timing mismatch between private equity investment (which maximizes returns on an average three-five year hold), and project development (which takes five-seven years on average, and another two-three years to reach commercial operation). Given that the private equity model typically does not fit infrastructure development well, permanent capital or longer life funds can be good here. However, in relation to blended finance, we need to be focused on specific pain points to get most bang for the buck. The current base case is for multilateral development banks and development finance institutions to buy and hold for seven-10 years. They try to syndicate and/or bring in other investors alongside for the complete ride. This is good for sponsors/borrowers (if they get the funding) but limits investor appetite since investors are being asked to take greenfield risk *and* hold for a long period.

There will often be a good case to disaggregate the value chain to reflect different risk profiles across different phases of the project lifecycle (development, greenfield, brownfield/operating asset). In other words, we should separate blending solutions for the "construction" or riskier initial period from less risky

funding required once the infrastructure project is completed. This would separate those forms of blended finance that would help with the riskiest phase (e.g., partial risk guarantees) from those that might help down the road (e.g., providing some first-loss protection on a pool of existing assets). As well as segmenting the blended finance, this fits with segmentation of the investors since some (e.g., many pension funds) would only consider operating assets anyway.

While disaggregation may be the most "efficient" way of designing solutions in theory, in practice this requires the markets to operate more effectively than they are currently, particularly at handoff points between the different stages. Where markets appear to be failing to provide this effective handoff, then creation of longer-term (20-25) year funds may be the interim solution. In the long term, we need to create easier refinancing mechanisms so that projects funded past greenfield stage can be refinanced for the operating phase. This should give greenfield investors higher returns for riskier and shorter period and provide a pipeline of operating assets for more risk averse investors.

3. How can the G20 give momentum to the creation of sustainable infrastructure as an asset class?

The G20 is in a unique position to encourage policies which facilitate private investment for sustainable infrastructure, to develop or reinforce platforms which strengthen the project pipeline and to support institutions like the multilateral development banks (MDBs) and development finance institutions (DFIs), which are critical to this agenda and. Some possibilities in this space are explored below.

a) Working with ratings agencies and regulators

Blended finance vehicles should speak primarily to recognized asset classes (e.g., infrastructure, real estate, etc.) rather than the SDGs, whilst acknowledging that the two are not mutually exclusive. Despite a rising focus on mobilizing private capital to meet the SDGs, blended vehicles that are created to address specific asset classes will meet with better success than SDG-focused vehicles (perhaps with the exception of vehicles relating to more commercially-oriented sectors such as clean energy or specific healthcare funds). Blended finance vehicles should therefore, at least initially, fall within the accepted asset class definitions so that the largest numbers of investors can access potential solutions without asking them to amend current portfolio allocations. The next step is to work with rating agencies to develop a unified approach to rate blended finance vehicles and to engage with regulators to get favorable regulatory treatment to take these instruments from being an alternative asset to being a true fixed income asset class. This would be hugely beneficial, especially to mobilize capital from pension funds and insurers, which must adhere to strict regulatory frameworks and fiduciary duties when investing.

b) Supporting the role of the MDBs and DFIs

The MDBs and DFIs are critical to delivering the promise of blended finance and have the capacity to leverage more private capital for sustainable infrastructure by further optimizing internal processes. MDBs and DFIs are, and will continue to be, central players in the blended finance ecosystem. MDBs typically have some policy role to play as well as acting as project sponsors and the G20 should consider how to support the MDBs to play an even stronger role. DFIs are bilateral players and typically only act as project sponsors. Both are critical for risk mitigation and market building.

Addressing issues like high transaction costs associated with lengthy underwriting processes, complexity of access and slow decisionmaking, and other small transparency, measurement, and incentive adjustments within the leading MDBs and DFIs would have an immediate and outsized impact on private capital mobilization. For example, currently, only a small number of these institutions incentivize staff based on private capital mobilization and, even where they do, this is often in tension with other incentives to reward "deal size."

Where MDBs and DFIs are only incentivized by deal volume but not capital mobilization, this creates a dynamic where investment staff may have a perverse incentive to crowd out private capital. They could, instead, consider linking incentives to development output not volume (e.g., a 10 megawatt project, at a given kilowatt hour price, financed through blended finance with 10 percent public and 90 percent commercial capital, is better than 10 megawatt financed with 50 percent public and 50 percent commercial capital, or 100 percent public capital) without compromising their financial stability.

The G20 could also encourage streamlining within and between MDBs and DFIs to reduce transaction costs associated with complexity and delay and to systematically share project pipelines, harmonize products and technical standards/criteria (e.g., as they relate to the definition of sustainable infrastructure) and pool assets to create large and standardized, yet diversified, asset offerings so that institutional investors have better access to risk-adjusted returns. This could also include pooling funds and resources to develop a joint technical assistance facility to support project preparation.

c) Strengthening deal pipeline and enabling environment

The G20 could also look to address upstream constraints by supporting integrated strategic platforms at the country level to increase and improve deal flow. It could do so through institutions like the multilateral development banks or existing platforms like its Global Infrastructure Hub to grow the global pipeline of quality, bankable infrastructure projects, drive a clearly articulated sectoral plan for infrastructure, and develop best practices in terms of policy, use of local capital, and project preparation.

Calling for the development and adoption of a common set of permitting, contracting and funding-related laws for the purpose of project financing sustainable infrastructure in several regions (e.g., sub-Saharan Africa, South East Asia, and Pacific Island nations) would also promote increased certainty, and reduced legal costs and complexities, especially for project developers.

d) Revising global financial regulations

Current thinking suggests that misalignment between the global financial regulations that govern G20 banks, and the policies that govern development institutions' guarantees, is limiting the ability of those guarantees to attract private capital to the SDGs. Although there is more than $4 trillion in reserves above minimum requirements in G20 banks, development guarantees are not designed to provide capital relief or to meet the Basel definition of high quality liquid assets. Without a redesign of Basel or guarantee rules, banks will remain on the sidelines, and importantly, keep other institutional investor classes on the sidelines given their reliance on banks to manufacture financial products and monitor risk. Modifications to Basel guidelines on risk weightings for SDG-aligned investments, or re-designed features in development-

focused guarantees to convert them into standardized and truly high quality (unconditional) liquid assets (tradable) under current Basel III guidelines, could improve the incentives for banks to scale up investments.

Donors may also be disincentivised from using blended finance instruments that can crowd in institutional capital for sustainable infrastructure by mitigating risks for private investors because of quirks in the international regulatory environment, especially in relation to guarantees. For example, under OECD guidelines, a guarantee commitment does not qualify as part of a donor country's 0.7 percent foreign aid pledge. As such, providing a $100 million guarantee (that might never be called) gives the donor country less "credit" in the international community than giving a direct $1 million grant. Regardless of the development impact or magnitude of investment mobilized, donors thus remain incentivized to engage in simple transfers rather than deploying a blended finance instrument such as a guarantee. Although guarantees may not be the only instrument in the blended finance toolkit, addressing nuances in the international regulatory environment would provide a quick win by removing disincentives for donors to deploy leveraged investments that can mobilize more capital, and potentially be more effective in achieving the SDGs.

Catalytic leadership

By emphasizing the importance of private finance for sustainable infrastructure through policy development and promoting concrete action (including by encouraging the deployment of concessionary capital for blended finance initiatives), Argentina's G20 leadership has the potential to be incredibly catalytic for the Global Goals agenda.

Annex 1: SteerCo members[1]

[1] Members of the SteerCo act in their personal capacity. "Private sector" shaded grey.

Member	Organization
Vinay Chawla	Abraaj
Carsten Stendevad	ATP/Bridgewater
Abyd Karmali (TBC)	BAML
Brian Herlihy	Black Rhino
Ashley Schulten	BlackRock
Ed Mathias	Carlyle Group
Michael Eckhart	Citi Group
Joseph Brandt	Contour Global
Tony Adams	EastSpring
Stewart James	HSBC
Hendrik du Toit	Investec
Fuat Savas	JP Morgan Chase
Daniel Hanna	Standard Chartered
Neo Gim Huay	Temasek
Lord Mark Malloch-Brown	BSDC (Chair)
Mattia Romani	EBRD
Nanno Kleiterp	EDFI
Gavin Wilson	IFC
Nick Stern	LSE/NCE
Aron Betru	Milken Institute
Charlotte Petri-Gornitzka	OECD – DAC
Elizabeth Littlefield	OPIC
Lorenzo Bernasconi	Rockefeller Foundation
Rick Samans	WEF