## How the mobilization of private capital can bridge the financing gap for infrastructure.

***Introduction.***

The needs for infrastructure in developing countries are enormous. There is a huge gap between these needs and the financing that is available from government’s own resources and funds from Development Finance Institutions DFIs)[[1]](#footnote-1). According to the World Bank the lack of infrastructure comes at enormous economic and social cost.  Over 1.3 billion people – almost 20 percent of the world’s population – still have no access to electricity.  About 768 million people worldwide lack access to clean water; and 2.5 billion do not have adequate sanitation; 2.8 billion people still cook their food with solid fuels (such as wood); and one billion people live more than two kilometers from an all-weather road. This strong unmet demand for infrastructure investment in developing countries is estimated at above US$1 trillion a year.

Involvement of non-development financiers[[2]](#footnote-2) such as commercial banks, official Export Credit Agencies (ECAs)[[3]](#footnote-3) and capital market investors is therefore crucial. Through closer and improved cooperation more financing could become available to finance infrastructure, which in its turn would contribute significantly to economic and social development of developing countries (i.e. the UN sustainability goals). This explains why the mobilization of non-developmental sources of capital is of great importance to developing countries and their strategic business partners, such as DFIs, commercial banks and infrastructure construction companies. This article provides some suggestions on what needs to be done to successfully mobilize non-developmental sources of capital.

***DFI guarantees***

Although it is generally recognized that guarantees are the best instrument to directly mobilize private capital and many multilateral DFIs have a guarantee program (e.g. partial risk and partial credit guarantees), guarantees are hardly used. Currently less then 1,5% of the total business of all leading Multilateral Development Banks (MDBs) concerns MLT guarantees. For most bilateral development financiers this is much lower. The main business of DFIs is currently to provide Medium & Long Term (MLT) loans to governments and projects in developing countries. The problem is that with these loans no or hardly any additional capital is directly mobilized. There are many reasons why guarantees are underutilized. For sovereign projects[[4]](#footnote-4) – this is for most MDBs approximately 90% of their business – the pricing of sovereign loans and sovereign guarantees is the same, which implies that a MDB loan is always cheaper than a commercial bank loan/ capital market bond + a MDB guarantee. The interest margins for (sovereign) MDB financing or the premium for (sovereign) MDB guarantees are not risk based, but for all DFI member countries set at the same (low semi-concessional) level. It does not take into account that the operational costs of a guarantee are in general substantially lower than for a loan. In the commercial market Private Insurers (PRIs) offer premiums, which are roughly 70% of the interest rate margin of a commercial bank loan. The current discriminatory pricing practices of MDBs for sovereign loans / guarantees are therefore a huge disincentive to make use of guarantees.

Another important factor is that both within the MDB community and their borrowing sovereign clients guarantees are often perceived as complex, which has likely to do with the fact that they are not familiar with the benefits of guarantees and how they work. Capacity building on guarantees is therefore crucial.

An important regulatory barrier – in particular for bilateral DFIs – is the fact that guarantees are not adequately recognized within the ODA[[5]](#footnote-5) framework of the OECD DAC. ODA measures development finance flows and guarantees are contingent liabilities, which only lead to a financial flow in case of a claims payment. This clearly shows that the current ODA definition is out dated. A revision of the definition – by including guarantees as viable ODA instruments – is therefore urgently needed.

***The strategic country dialogues between developing countries and DFIs***

It is common practice within the DFI community to develop together with governments of developing countries a country strategy on how to finance the development objectives of a country. In these so-called country strategy dialogues the discussion is focused on the development priorities of governments and how much development finance can be obtained from the DFI and other potential donors. Whether the development objectives can be financed through other (market based) sources of capital (e.g. commercial banks, capital market, official Export Credit Agencies (ECAs) and how scarce DFI capital can mobilize these other sources of capital (e.g. through guarantees) are unfortunately not part of this dialogue. This gap in the dialogue leads to the situation that alternative sources of finance and DFI guarantees are overlooked and that scarce development finance is sometimes “crowding out” market based finance. This is obviously not in the interest of aid efficiency and aid effectiveness.

In the world of officially supported export credits a so-called commercial viability test has been developed to avoid that tied concessional loans crowds out commercial finance[[6]](#footnote-6). It would be in the interest of the development finance community (DFIs and OECD DAC) and developing countries to develop a similar commercial viability test for untied aid. In this way it can be avoided that semi-concessional funds are unintentionally crowding out private capital. Other sources of capital and how they can be tapped should therefore be part of the dialogue with aid recipient countries. Given the limited knowledge about alternative (commercial) sources of finance and how guarantees can be used to mobilize these sources capacity building is also important.

***Enhance cooperation between DFIs, ECAs and PRIs.***

Official ECAs and Private Insurers (PRIs) are an important source of capital for MLT financing of infrastructure in developing countries. The total MLT exposure of all ECAs + PRIs was in 2014 approximately U$ 936 billion[[7]](#footnote-7), which is more than 2 times the U$ 422 billion exposure of all leading MDBs[[8]](#footnote-8). The mandates of ECAs and PRIs are obviously different than those of MDBs, but they have an important developmental impact in facilitating imports and investments in developing countries. The development finance community does not adequately recognize this[[9]](#footnote-9) and opportunities for cooperation are not explored to the fullest potential.

Like commercial banks MDBs could insure part of their loan exposure with ECAs and PRIs or seek reinsurance for their guarantee exposure. A good example is MIGA, which reinsures approximately 40% of its gross exposure with ECAs and PRIs. If leading MDBs would follow this practice approximately U$ 169 billion of additional finance (40% of U$ 422 billion) could become available for development. Important is as well that through enhanced cooperation MDBs could not only mobilize additional funds for their borrowing member countries, but likely also at terms and conditions that are more favourable than what ECAs and PRIs normally offer (e.g. longer tenors and lower premiums). The preferred creditor status of MDBs warrants for a more favourable coverage than for a commercial bank loan. Enhanced cooperation has therefore two important benefits namely: more capital for infrastructure and at better terms and conditions.

***Mobilization of private capital is more than only PPP.***

There is tendency within the DFI community to narrow the discussions on the mobilization of private capital to the development of public private partnerships (PPPs), i.e. projects that have the potential to generate sufficient income that can be used to repay commercial debt financing and pay dividend to equity investors. The focus of the discussion is therefore on how to involve the private sector as investor / sponsor in infrastructure projects. This is in fact a discussion about privatization, which is only part of the mobilization agenda.

The too narrow approach ignores two things, namely (1) that many infrastructure projects can not be financed on a project finance basis, because the projects do not generate sufficient cash flow and (2) that private capital can not only be mobilized for private sector sponsored PPP projects, but also for typical public sector projects, whereby the government (sovereign) or a sub sovereign entity acts as borrower or guarantor. This is for example relevant for many transport and water projects. Most roads, railways, regional airports, harbours and water sanitation projects are and will remain typical public sector projects in many developing countries. This should not come as a surprise, because this is also the case for most so-called developed countries.

The opportunities for the mobilization of private capital for public sector projects is substantial. Many governments in developing countries have good or reasonable access to the private market and can obtain support from ECAs and PRIs for MLT financing for public sector projects. It is noteworthy that many top exposure countries of the DFI community (e.g. China, India, Indonesia, Mexico, Brazil, Turkey, Viet Nam) are also important beneficiaries of ECA / PRI supported commercial bank financing. The impressive overlap of exposures of DFIs and ECAs on many countries show at the same time there are huge opportunities for enhanced cooperation. These opportunities should be explored and utilized.

***Blending for IMF /WB debt sustainability countries.***

Blending can be defined as the utilization of grant money (e.g. from DFIs or private philanthropic funds) to mobilize private capital. It can take many different forms, such as subsidies to lower interest rates or improve returns on investment risks. Within the EU various blending instruments exist. The fact is that EU blending subsidies are currently only available for a limited number of DFIs. The EU blending facilities catalyzes currently only or mainly DFI capital and not private capital.

Furthermore an important amount of the EU blending subsidies is currently used to subsidize DFI loans to ensure that these loans meet the minimum concessionality level under the IMF/WB debt sustainability framework. For many of these projects commercial bank financing with ECA support could be used as well. In many projects for which EU grant money was used to blend with DFI loans ECA were on cover, which means that they could have been involved in these projects. Mixed credits (combining national aid funds with ECA insurance) exist in many individual EU countries, but not at an EU level. To improve the mobilization performance of the EU it is of utmost importance that EU blending funds can be used in the form of mixed credits, whereby cooperation is sought between EU DFIs and EU ECAs.

***What gets measured gets done***

Mobilization of private capital is broadly recognized as an important objective by many DFIs. The problem is that each DFI has its own system to measure its mobilization impact. For many DFIs it is a common practice to attribute the entire financing of a project to their financial intervention, which leads to unrealistically high mobilization figures and “double counting” in case two or more DFIs are involved in the same project. These and other imperfections are recognized by the OECD DAC, which explains why currently discussions take place to develop a common system for the measurement of mobilization. Thus far the OECD DAC has conducted a few surveys with a joint measurement methodology for a limited number of DFI financial instruments (among which for “development guarantees” and A/B loans), but the suggested methodologies are unfortunately not realistic.

For credit guarantees for example the entire principal loan amount can be reported as mobilized capital irrespective the type of cover (partial risk or partial credit guarantees) that is provided. From a technical point of view it would be better to include in the mobilization figure only the uncovered part of the loan (e.g. 10%). By reporting the full loan amount the system ignores that the DFI itself has to allocate risk capital to provide the guarantee and the fact that the DFI already reports this guarantee exposure as its contribution to development. In a sense the current OECD DAC approach for guarantees could lead to a new form of double counting. Moreover this methodology is a disincentive for a DFI to seek reinsurance for its guarantee exposure, for the full loan amount is already captured in the OECD measurement system and reinsurance is not (yet?) recognized as an acceptable way to mobilize other sources of capital. This is also the case for the insurance of DFI loan exposure.

It is important that for guarantees and risk transfer techniques as shown by MIGA’s reinsurance of 40% of its gross exposure, adequate measurement methodologies are developed. The measurement methodologies developed thus far in the OECD DAC do not lead to realistic mobilization figures, which is very unfortunate. Much more concerning is that it does not contribute to the development and implementation of successful DFI mobilization strategies. For what gets measured, gets done.

In conclusion it can be said that mobilization of private capital is of great importance for all stakeholders in infrastructure. If the above-mentioned suggestions would be implemented in the development finance community and solid bridges could be build between development financiers and commercial financiers (incl. ECAs) a lot could be gained. Policymakers and shareholders of DFIs should carefully look at (the impact of) their organisational and staff incentives of their development operations. With the right incentives, policies and regulatory frameworks more finance for both public and private sector infrastructure projects – and in many cases on the basis of improved terms and conditions – could become available. This in turn will lead to development in developing countries, better living conditions for the people living in these countries, a greater developmental impact of DFI’s and more business for infrastructure construction companies. So a win-win for all. Where there is a will, there is a way, so it must be possible to move successfully forward. The UN sustainability goals, which include the importance of infrastructure development, show the direction, so it is now primarily a matter of bringing people and organisations together and build the necessary bridges between them.

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1. There are multilateral and bilateral DFI’s the most well known multilateral DFI’s are IBRD/IDA, IFC MIGA, ADB, IaDB, AfDB, EBRD and EIB. Examples of bilateral DFIs are public sector development banks / agencies such as KfW (Germany) and AfD (France) and private sector development banks such as DEG (Germany), Proparco (France) and FMO (the Netherlands). [↑](#footnote-ref-1)
2. This includes private capital and capital from public non-developmental sources such as official ECAs. [↑](#footnote-ref-2)
3. Many governments in the world have set up an official ECA with the objective to support exports and foreign investments of their national business community. [↑](#footnote-ref-3)
4. Sovereign projects are projects in which the central government acts as borrower or guarantor. [↑](#footnote-ref-4)
5. Official Development Assistance (ODA) is the most important form of development aid provided by the international donor community. The current definition recognizes grants, concessional loans and financial contributions to MDBs as ODA. Guarantees are only recognized in case of a claims payment. [↑](#footnote-ref-5)
6. See the OECD Arrangement on officially supported export credits. [↑](#footnote-ref-6)
7. This figure concerns the MLT exposure of all members of the so-called Berne Union, which is the leading global association of credit and political risk insurers. The figure covers both MLT officially supported export credits and MLT investment insurance. [↑](#footnote-ref-7)
8. The total exposure of IBRD/IDA, IFC, ADB, AfDB, IaDB ,EBRD and EIB (only outside EU) was in 2014 approximately U$ 422 billion. [↑](#footnote-ref-8)
9. For example in the OECD DAC donor countries discuss the developmental impact of their activities. In those discussions only the business of government organizations that have a formal developmental mandate are taken into account. As a consequence official organizations that do not have a developmental mandate but have a important developmental impact, such ECAs are not part of the OECD DAC discussions.

 [↑](#footnote-ref-9)