



# Private infrastructure finance for developing countries

## Five challenges, five solutions





## Executive summary

Infrastructure is a crucial driver of economic growth in developing countries. The G20 estimates, however, that there is a **\$1-1.5 trillion annual gap** in developing-country infrastructure financing and that private finance will be needed to close it.

Over the past decade, private investment in infrastructure in developing countries has increased. However, it has been funnelled to **commercially attractive sectors and countries, rather than those with the greatest development needs**. Low-income countries have received less than 2% of infrastructure investment in the last 10 years.

Development institutions have tried to bridge the gap with **innovative policy**, including project preparation facilities, co-financing funds (or ‘blended finance’) and de-risking for private investors. Many of these initiatives have been successful.

However, the reality is that **private finance has not been mobilised on anything like the scale needed**, largely for the following reasons:

- the lack of ‘bankable’ projects,
- the difficulty in managing political and macroeconomic risk, and
- instruments being mismatched to institutional-investor needs.

The solutions will require a more radical and imaginative approach, as well as deeper dialogue with and partnership between public and private stakeholders.

This paper aims to contribute to this dialogue. We put forward five potential solutions for discussion:

- 1. Re-orientate international financial institution (IFI) mandates** to what they do best: financing and enabling projects in the pre-operational phase and securing good governance and business environments.
- 2. Increase the pipeline of ‘bankable’ projects** by scaling up successful project preparation facilities and stepping up support for developing countries to implement best practices in planning and execution and to raise money on the international financial markets.
- 3. Establish a ‘mega-fund’** to turn projects originated by IFIs into investments suited to institutional investors. This will require a global approach, led by the International Finance Corporation (IFC) or by private banks. The IFIs would transfer projects to the fund as they become operational.
- 4. Create ‘fit-for-purpose’ hedging** by scaling up IFI seed-funded market makers in hedging instruments. Products also need to be cheaper, more varied and longer dated to increase investor uptake. This may require public subsidy.
- 5. Develop domestic pension and insurance markets** to invest in infrastructure in local currencies, especially in middle-income countries. Strong regulation and de-risking by the public sector is also needed to ensure that assets remain of an appropriate quality.

# 01

## Private infrastructure financing is failing to have a development impact

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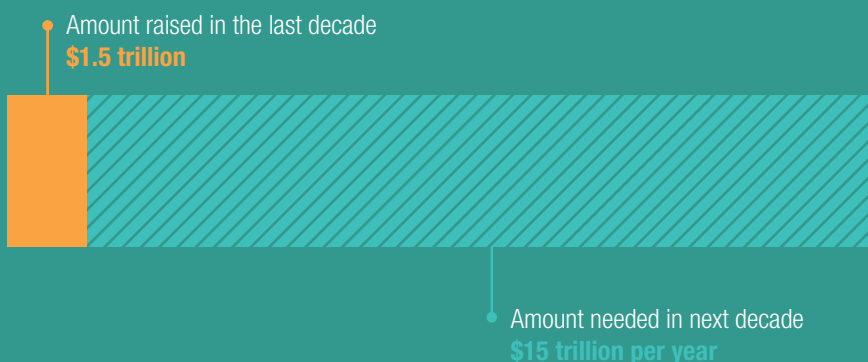
Developing countries need another \$1.5 trillion a year for infrastructure development, according to G20 estimates. **Only \$1.5 trillion of private funding has been raised over the past decade – a mere tenth of what is needed.**

**Private financing has been volatile.** It has been declining since 2014, having risen earlier in the decade, and was at half its peak levels in 2017. The main reason for this has been monetary tightening in the advanced economies, and while policy may have loosened somewhat over the past year or so, the effects on private finance are unlikely to reverse in the near term.

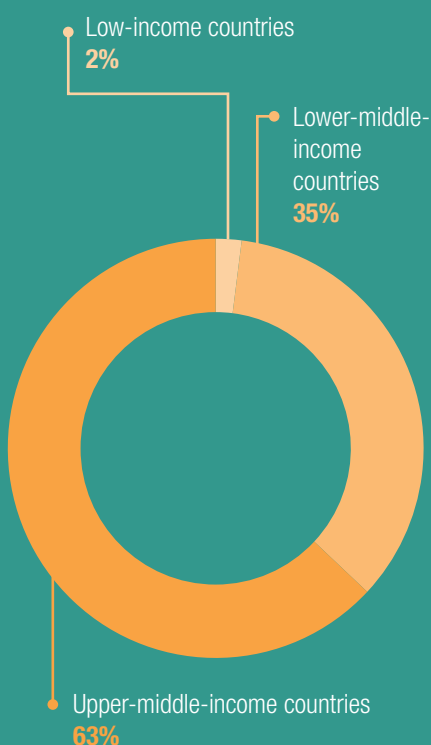
What's more, that private finance has gone almost exclusively to sectors and countries with strong investment fundamentals – commercially attractive ('bankable') projects and good business environments. Consequently, **98% of all financing has flowed to the richer nations**, such as Brazil, China, Indonesia, India and Turkey, predominantly to the energy and telecoms sectors.

**Low-income countries and urban infrastructure have received negligible financing**, despite being among the areas most crucial to poverty alleviation.

## Only one-tenth of the funding required over the next decade has been raised in the last decade



## 98% of finance raised has gone to richer developing countries



“Infrastructure in developing countries are untapped investment opportunities, with only a small percentage of projects attracting private sector investment.”

Laurence Carter, Senior Director, Infrastructure, PPPs and Guarantees Group, World Bank

“There is a fragmented connection between the chronic infrastructure deficits across the developed and developing world and the ready availability of financial capital in the world economy.”

World Economic Forum (2016)

# 02

## Innovative IFI policies have not, to date, delivered the scale of private finance needed

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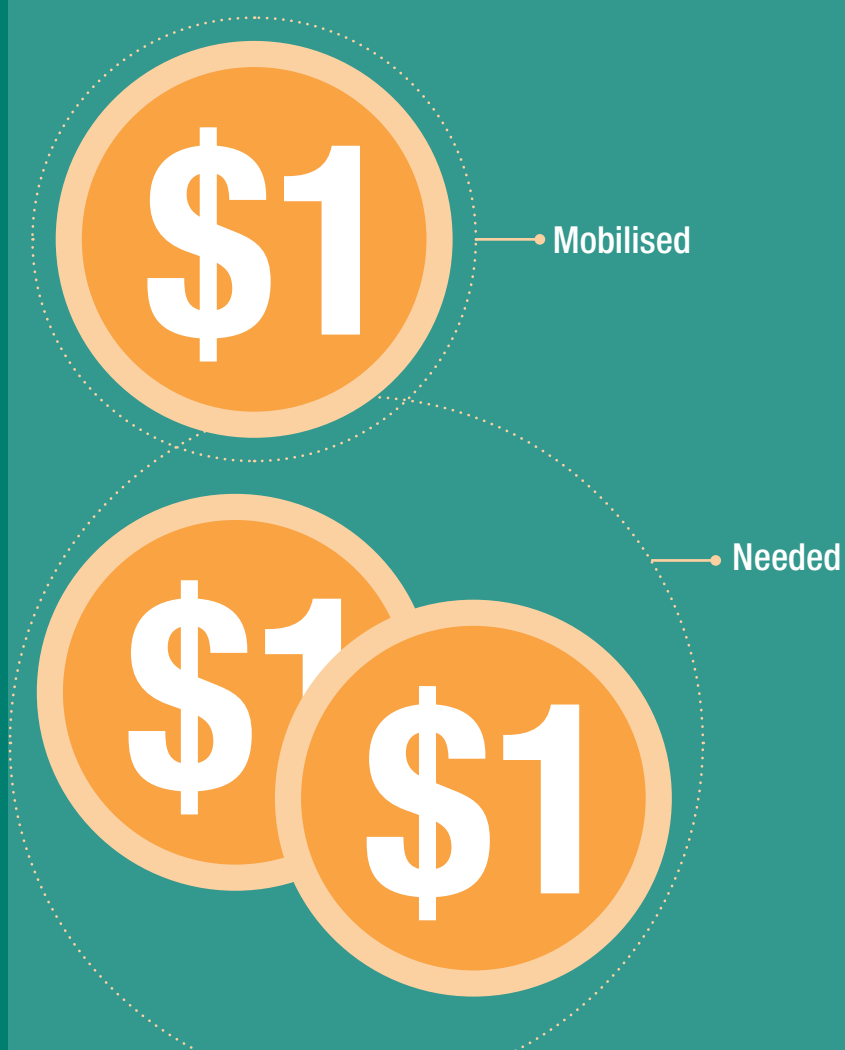
The IFIs have responded to these challenges with a whole host of measures: leading and financing early-stage projects and delivering blended finance, including the provision of equity and subordinated debt and the establishment of nearly 170 specialist funds for co-investment and demonstration projects.

However, **IFI mobilisation ratios** – measured as total direct and indirect private financing mobilised to own operations – **are far below what is needed**.

In the decade to 2017, **less than 7% of IFI-supported deals were in low-income countries**. This was due in part to inherent limitations, such as fundamental investor appetite and absorption capacity. Consequently, development finance institutions (DFIs) remain important investors in low-income countries and fragile and conflict-affected states (FCAS) from a relative perspective.

However, the lack of finance in low-income countries was also down to the IFIs' risk aversion, which stems from the constraints of their mandates to maintain their AAA credit ratings and achieve net profitability.

## Mobilisation ratios of IFI finance are below that needed



**There has been no significant momentum from institutional investors in blended finance.”**

Interview material

# 03

## The lack of 'bankable' projects is a key barrier to ramping-up private finance

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For private investors, developing countries lack 'bankable' infrastructure projects in which to invest. The barriers to investment include the high level of risk and long lead times of early-stage projects and the excessive complexity of bespoke deals.

IFIs have increased finance for **early-stage projects** and given help to national governments to develop projects independently.

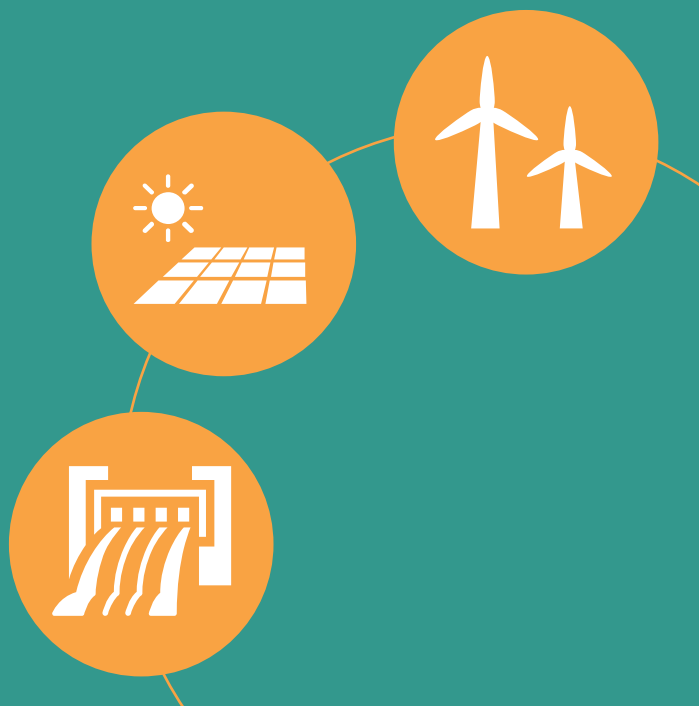
They have also established **project preparation facilities**, the best of which are partnering with major construction firms, institutional investors and commercial banks.

However, the **pipeline of projects remains too small and slow**, and this is proving one of the key bottlenecks in trying to galvanise private finance for infrastructure in developing countries.



## Success story: Financing 'green' power projects

One successful attempt to increase the pipeline of 'bankable' projects has been 'green' power – through a combination of large projects supported by DFIs and 'micro-infrastructure' (small-scale hydroelectric or wind generation plants and solar panels) – which has low barriers to entry and more limited financing needs.



“ **The average developing-country infrastructure project preparation time is seven years.**”

Source: G20

“ **The key constraint is not a lack of funds... but rather a limited number of bankable projects that are ready to be financed ... it has been especially challenging to attract investment at the project development stage.**”

Alan Ebobisse, CEO, Africa50

# 04

## Inability to hedge political and macroeconomic risk is a major deterrent for investors

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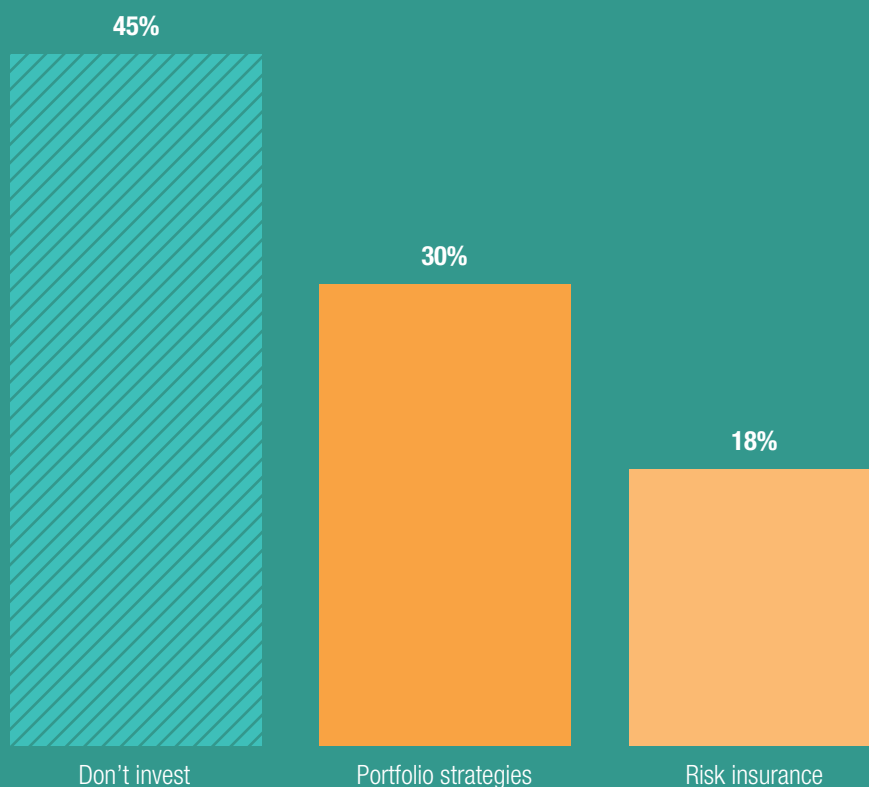
Political and macroeconomic risk is one of the biggest deterrents for investors in developing-country infrastructure. Many investors just do not invest because of it.

**IFIs help investors** manage such risks through their strong relationships with governments, which are instrumental in establishing good governance and resolving difficulties and disputes.

The IFIs also offer **political-risk insurance**, but private investors have been slow to take this up. They claim it is expensive and inflexible, and that making claims is difficult. A mere 4.5% of IFI portfolios are risk-mitigation instruments.

A more successful innovation has been the **seed-funding of market makers** in hedging instruments. An example of a successful model in this regard is TCX, which offers hedging products in emerging-market currencies.

## Investors respond to political and macroeconomic risk by not investing



Source: World Economic Forum (2016), African Venture Capital Association (2017)

“**The annual mobilisation contribution of these instruments has been extremely limited, making at best a marginal contribution to crowding in private sector finance.**”

World Economic Forum (2016)

“**All participants perceive that the market for risk mitigation is operating below par.**”

World Economic Forum (2016)

# 05

## Investment structures do not meet the needs of institutional investors

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Institutional investors have the potential to be key investors in developing-country infrastructure, but there is a **mismatch between the investments available and the needs of institutional investors**, including credit ratings and liquidity.

IFIs have sought to tackle this by structuring deals to offer **lower-risk instruments** through financial engineering. This has improved investor uptake.

More could be achieved if **regulations were challenged** to see if more investment could be made while maintaining standards for pension and insurance customers and whether investments could be bought and sold more easily on financial markets.

## Success story: Colombia's dedicated infrastructure bank

Colombia created a dedicated infrastructure bank and lifted restrictions on pension investments in infrastructure. More than \$300 million of pension fund investments have been made to date in national transport.



“Two main reasons emerge for the apparent decoupling of infrastructure financing and financial capital: the key disconnect between the risk appetite of investors versus the risk level of infrastructure projects; and scant project-development resources in emerging economies and developing countries.”

World Economic Forum (2016)

“Investors don't need to reinvent the wheel every time... we need to buy into an asset class.”

Interview material

# 01

## Re-orientate IFIs' mandates to focus on their unique value-added role

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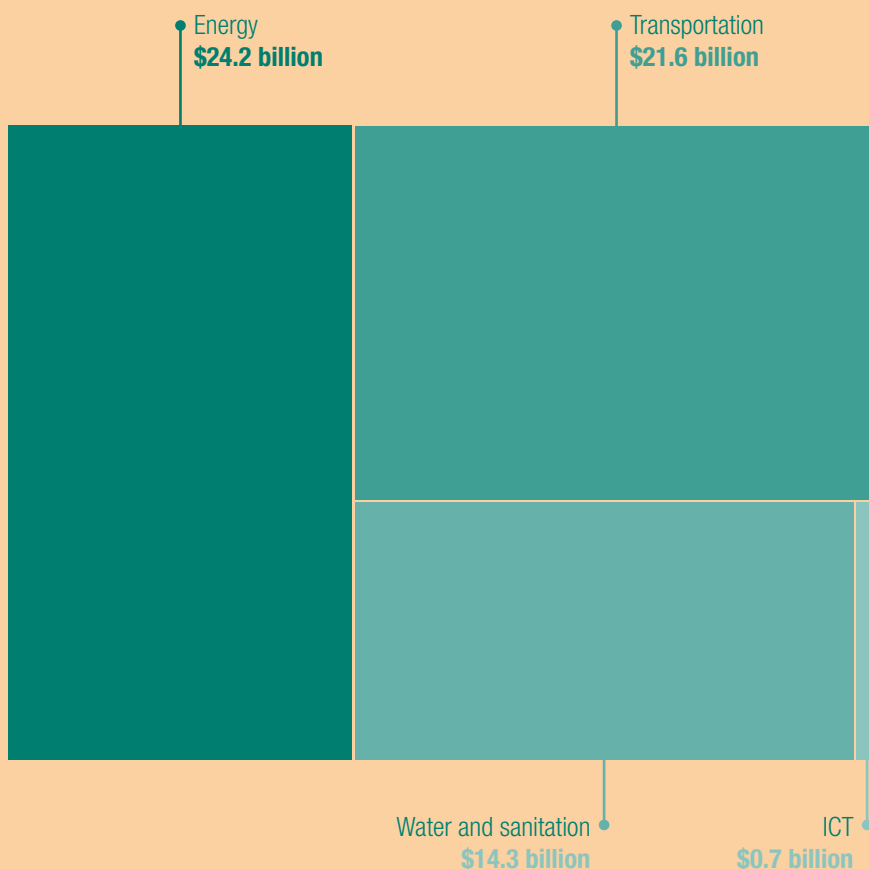
IFIs have a **unique and highly valuable role** to play in financing early-stage projects, namely, helping countries to 'get the basics right' when it comes to their investment environment and the 'soft' management of political risk for investors.

They could add more value if they used their estimated just over \$60 billion of infrastructure assets to kick-start a 'mega-fund' (discussed in the next section) and recycled their own capital.

IFIs could 'originate-to-distribute' by developing projects and then securitising or syndicating to private investors. This could be kick-started using their current portfolios.

Such measures would allow the IFIs to increase financing where it is most needed – **in the poorest countries**, as well as in the **DFI incubator funds** for demonstration and 'impact-accelerator' projects, which could prime low-income countries for future private investment.

## MDBs hold approximately \$60bn of infrastructure assets that could be used to kick-start a ‘mega-fund’



Sources: Author calculations based on data from World Bank, African Development Bank and Asian Development Bank annual reports.

“The role of IFIs - access, credibility, influence.”

Interview material

“MDBs need to de-risk, not simply lend.”

Interview material

# 02

## Generate ‘bankable’ projects via project preparation and in-country support

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Developing projects is tough in poorer countries that lack resources and experience. Attracting financing is especially difficult, because it is specialised and developing countries have limited links to global investors.

**The best project preparation facilities** – those that partner closely with global construction and financial specialists – **need to be expanded**.

There is also a need for **more innovative technical assistance** for governments in developing countries. For example, experienced civil servants from richer countries could be seconded and there could be programmes to advise and support developing countries in raising finance in international centres, such as London.

**Digital project preparation** is an innovation that offers significant time and cost savings. Using this technology on developing-country infrastructure projects could replicate these gains and efficiencies for poorer countries – especially as their governments are engaging with international construction firms, making digital collaboration particularly useful.



## Success story: The Global Infrastructure Facility (GIF)

The GIF is a 'best practice' project preparation facility that partners IFIs with 12 commercial banks and 20 institutional investors including major asset managers, pension funds, insurers and sovereign wealth funds. They act as advisors and investors with a goal of raising \$19 billion in private finance.

## Success story: Digital project preparation

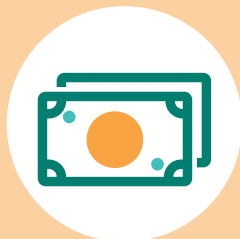
In richer countries, digital project preparation has delivered considerable gains, and could be expanded into developing countries to deliver:



**Increased first time approval rates from 4% to 75%**



**Decreased planning cycle length by 35%**



**Cost savings of 21%**

Source: G20

**“ Creating new instruments or models is not a top priority... we would rather focus on increasing the speed of implementation of models ... we must promote a streamlined process that allows transactions to be closed faster.”**

Alain Ebobisse, CEO, Africa50

# 03

## Create global ‘mega-funds’ for institutional investors

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New investment products suited to institutional investors could be created through the establishment of ‘mega-funds’. These would pool development projects into funds and allow tailored instruments to be created based on specific pools.

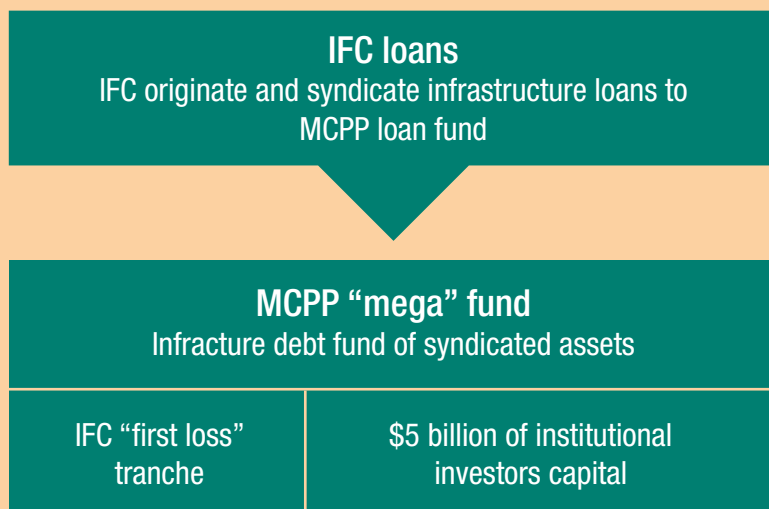
To be successful, a ‘mega-fund’ would need to have assets from as many countries as possible. It would also require financial-structuring expertise.

The **IFC’s Managed Co-Lending Portfolio Program for Infrastructure (MCPPI)** provides a blueprint. It was developed in partnership with institutional investors and has raised \$2 billion in financing to date, with a target of \$5 billion.

**IFIs could kick-start a ‘mega-fund’ by using their \$60 billion of assets** and consolidating their efforts into one or two IFI-led global funds.

Alternatively, **private banks** could create and manage such a fund based on assets offloaded by the IFIs as they reach their operational phase.

## Success story: The Managed Co-Lending Portfolio Program for Infrastructure (MCPP Infra)



MCPP Infra is an example of an innovative 'mega-fund'. It offers scale of originated loans, and sophisticated financial structuring and risk management with significant diversification and de-risking for investors to meet their fiduciary and regulatory requirements.

Source: IFC website

**“ To allow first significant scale up ... [there is a need] to establish a global or regional risk mitigation facility with or without direct participation of international financial institutions.”**

World Economic Forum (2016)

**“ The intellectual capital in the City of London needs to be leveraged.”**

Interview material

# 04

## Create 'fit-for-purpose' hedging instruments

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Investors need 'fit-for-purpose' hedging instruments. One option would be to extend the successful approach of **IFI seed-funded market makers**.

Existing and new entities could be scaled up and their mandates extended to increase the range of currencies, derivatives and maturities they offer.

This could include a new entity to innovate in political risk mitigation and to provide price competition for other providers, such as the Multilateral Investment Guarantee Agency (MIGA).

IFIs could also **partner with private institutions** to leverage their intellectual capital and vast experience in financial engineering in exotic markets.

## Success story: TCX - the currency exchange fund

TCX was seed-funded by 22 IFIs and private investors. It is a vital provider of hedges to investors and has enabled investment into low-income countries and poor households. It has also:



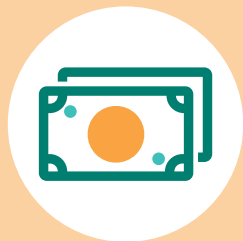
**Become a market-maker in more than 70 emerging-market currencies**



**Hedged \$4 billion in loans in these currencies**



**Built 30% of its portfolio in low-income countries**



**Built 64% of its portfolio in micro-finance**

**“ [IFIs] have created an extensive range of instruments focused on mitigating key risks. However, ... those instruments are not being used broadly by investors, especially institutional investors.”**

World Economic Forum (2016)

# 05

## Develop local pension and insurance investments in infrastructure

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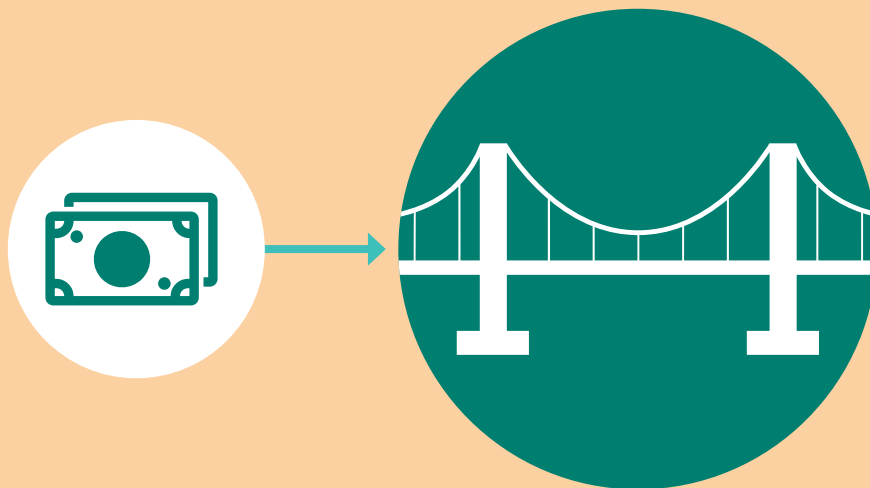
**Local pensions and life-insurers are keen to make investments in infrastructure** because they are in local currencies, low cost and stable.

These should be a particular **focus for middle-income countries** where rising incomes are translating into higher savings in such funds, and a demand for local currency and long-term investments for them.

This can be encouraged by development of the pension and insurance sectors and of financial markets more broadly. **Strong regulation and de-risking by the public sector** are also needed to ensure that assets remain of an appropriate quality.

## Success story: Tanzania and pension-fund investment in infrastructure

In 2017, Tanzania broadened investment classes for its \$5 billion of pension funds to include infrastructure. Investments made so far include a joint investment to build the Kigamboni Bridge, with pension funds taking a 60% stake and the government 40%, with more in the pipeline including in roads, railways and energy. Careful management of assets is needed to deliver both good returns for pension customers and financing for national infrastructure.



**“ Any improvement in the accessibility, complementarity and successful standardization of products across all emerging markets could have a major positive impact on infrastructure investment.”**

World Economic Forum (2016)

**“ Products are needed that are understandable to a broader group of investors.”**

Interview material

## Notes

Quotes have been taken from interviews conducted for this research, published material and conference material. They are attributed where permission has been given or where they are reproduced in publicly available material.

This booklet is adapted from an ODI Working Paper: Tyson, J. (2018) *Partnering with private finance for developing country infrastructure: five challenges, five solutions*. ODI Working Paper. London: Overseas Development Institute.

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## Acronyms and definitions

<b>ABD</b>	Asian Development Bank
<b>AfDB</b>	African Development Bank
<b>AVCA</b>	African Venture Capital Association
<b>DFI</b>	Development finance institution
<b>EU</b>	European Union
<b>IDA</b>	International Development Association
<b>IBRD</b>	International Bank for Reconstruction and Development
<b>IFI</b>	International financial institution (defined in this paper as multilateral development banks, development financial institutions, regional development banks and bilateral donors)
<b>IFC</b>	International Finance Corporation
<b>MCCP</b>	Managed Co-Lending Portfolio Program
<b>MDB</b>	Multilateral development bank
<b>MIGA</b>	Multilateral Investment Guarantee Agency
<b>TCX</b>	Specialised currency exchange fund



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