Sovereign Debt Management Forum 2014

Background Note for Breakout Session 7

The role of debt managers in infrastructure financing

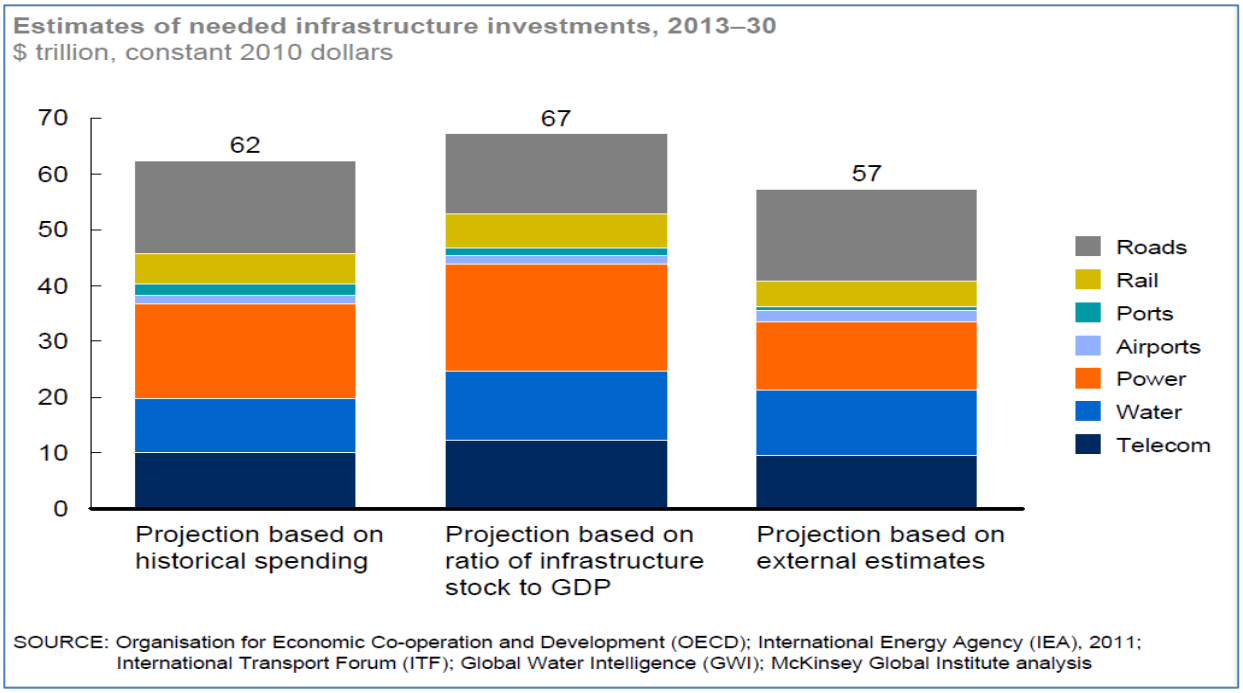
Developing countries and emerging markets have experienced strong growth over the last decade. To sustain high growth levels, through more diversified and competitive economies, substantial investments in new or improved infrastructure are required. Funding will need to be tapped from a variety of sources, including the public sector, private investors, and partnerships between them. This session will discuss the role debt managers can play in raising funds for infrastructure investments and what innovative financial structures countries are exploring and using to tap private capital for such investments. Particular focus will be given to challenges and lessons learned from the ongoing efforts in both advanced economies and emerging markets to increase the role of capital markets in channeling long-term savings and what debt managers can do to support the new instruments being developed. The three panelists in this session will represent the point of view of a Treasury, an infrastructure development bank and an investment bank.

I. Introduction: infrastructure as driver for growth

Sustained growth in both advanced economies (AEs) and emerging markets (EMEs) relies heavily on their capacity to invest in new or improved infrastructure. Over the coming 15 years, investment needs in infrastructure globally are estimated between US$57 trillion and US$67 trillion (Exhibit 1), of which around 37% account for EMEs. Most of these investments are required for energy generation, roads and telecommunications, all of which would be essential to support growth, competitiveness and job creation.

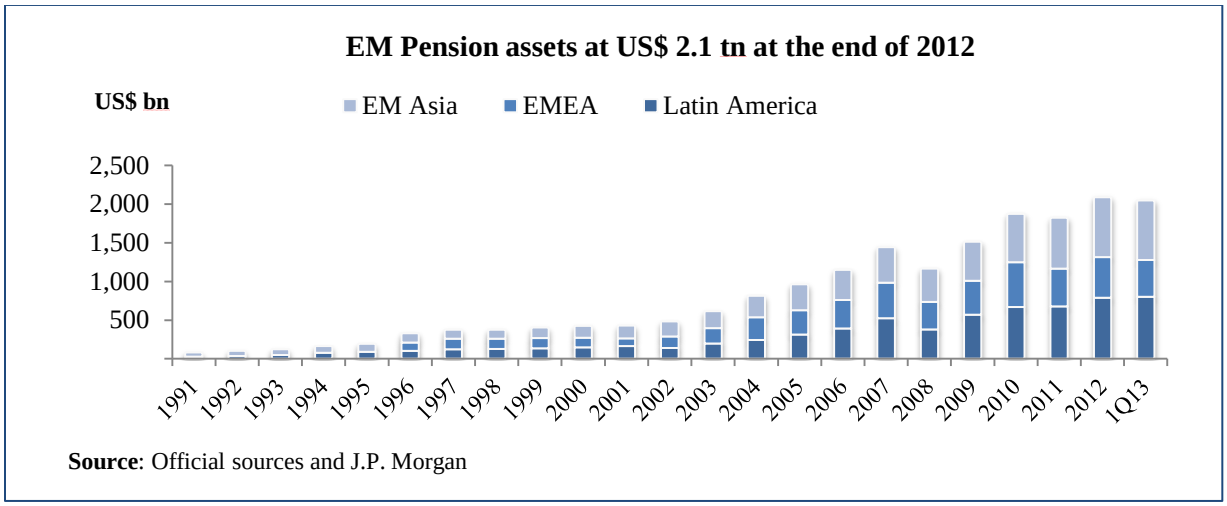
Traditional sources of long-term financing, including for infrastructure, have shrunk since the global financial crisis. Government's fiscal capacity has been substantially reduced and bank lending is being restricted by tighter regulation causing a retrenchment into smaller, shorter maturity, and lower risk projects.

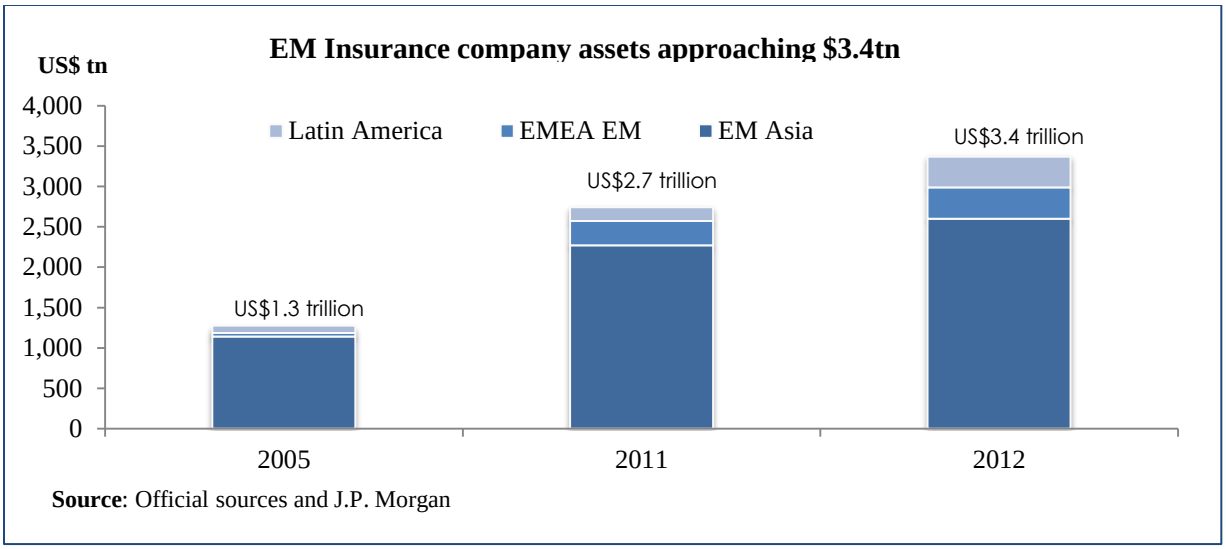
Exhibit 1



Shortage of capital does not seem to be the problem. Institutional investors in OECD countries have around US$80 trillion in assets under management. Domestic investors from EMEs hold around US$5.5 trillion (Exhibit 2). If sovereign wealth funds are included EME's available long term assets amount to USD $10 trillion. However, currently less than 1% of global assets are invested in infrastructure.

Exhibit 2





Capital markets, in spite of promising innovations, such as project bonds, have not yet been able to channel institutional investors' long-term funds in a reliable and sustainable way. The challenge is how to create the conditions regarding projects, markets and investment vehicles to mobilize investment for long-term, including infrastructure projects.

II. Infrastructure financing: a multidimensional problem

The challenges for infrastructure financing

From a policy maker perspective the challenge to develop sustainable financing for infrastructure is complex and multipronged. The main issues that need to be tackled are the following:

- **Lack of a pipeline of investable assets**: this is particularly notable in EMEs, and is often caused by a poor investment environment, including regulatory instability, problems with PPP frameworks, sovereign risk, poor technical skills to structure projects and weak governance.
- **Lack of well-designed Government support:** projects relevant from a socio-economic perspective may not be financially viable unless the Government supports them. This may take different forms, such as support in project feasibility studies, subsidies to crowd-in private investment, equity or debt co-investments, and guarantees for different project risks.
- **Lack of financial instruments**: financial instruments often do not exist to provide institutional investors with the risk-return profile they need. The key to the successful involvement of institutional investors is isolating and packaging risks so that they can be distributed according to different risk-return profiles.
- **Lack of borrowers and investor capability**: structuring infrastructure investments for the capital markets is very different to traditional structures funded by banks. Capital

markets structures require new vehicles and new expertise, which many borrowers and institutional investors lack.

- **Need for "public sector" first mover support and/or incentives for financial innovations:** private financial intermediaries (investment and commercial banks) are generally not willing to take risks in financial innovations and prefer to stay in traditional instruments and assets.

The potential of fixed income markets to finance infrastructure

Fixed income markets, if well-structured, could play an instrumental role in channeling long-term funds from institutional investors into infrastructure projects under PPP structures, by packaging risks according to the profile of each type of investor. This is a challenge in both AEs and EMEs where different types of instruments are being tested with no conclusive results been reached yet.

Instruments that are being tested with promising results include listed and unlisted products such as: different types of equity and debt infrastructure funds, and infrastructure project bonds. The latter was a relevant financing option before the crisis with monoline insurance companies providing a full guarantee to infrastructure project bonds. This eliminated the project risk and exposed investors only to monolines' credit risk which was rated AAA until the exposure of some of them to subprime mortgages brought down their credit ratings and changed the risk profile of infrastructure project bonds.

A number of initiatives in the European Union, the US and several EMEs are currently supporting the development of innovative structures in infrastructure project bonds (see evolution of project bonds in exhibit 3). In the case of EMEs the development of deeper and longer- term local bond markets is critical for the success of the new project bonds and traditional bonds, as well as to channel local and international savings.

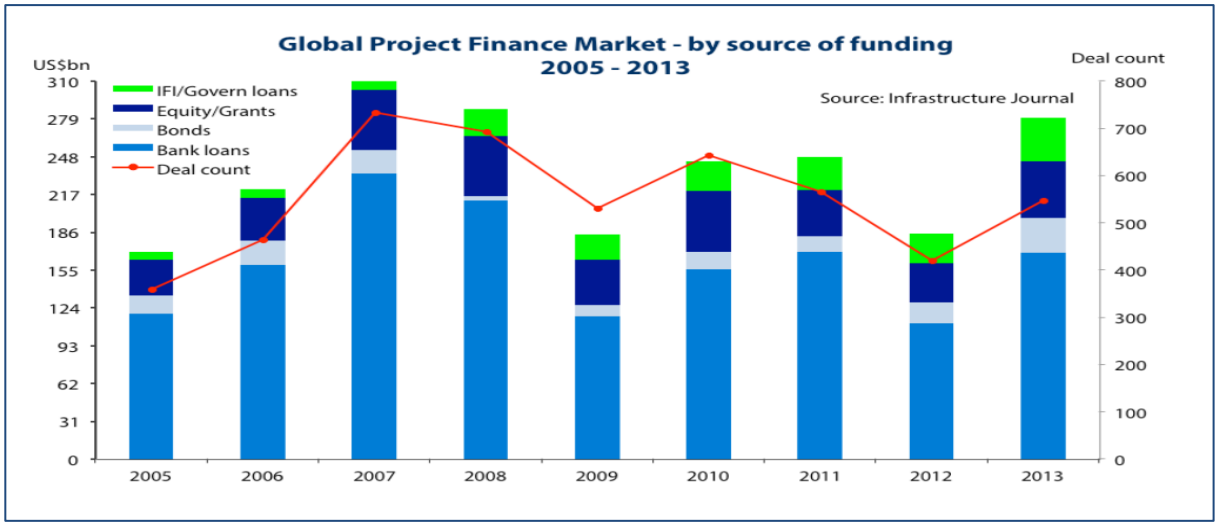
Developing local fixed income markets that facilitate infrastructure financing requires a well-articulated agenda along the following topics:

- **Building a long-term yield curve**: coordinated policies covering the government issuance strategy, and developing competitive primary and secondary government bond markets is critical. Debt managers have a role to play in this picture.
- **Developing regulatory frameworks for non-government bond issuers**: developing special issuance regimes aimed at institutional investors with less stringent regulations than public offers benefits a variety of issuers such as sub-national governments, SOEs, private corporations, and special purpose vehicles (SPVs) issuing securitized products.
- **Developing regulatory frameworks for new types of structured products:** regulatory frameworks which range from redistributing the credit risk of the project sponsor, to

matching project revenues and liabilities, to enabling the distribution of risk between different investor profiles via bundled structures with senior and junior debt or other types of risk mitigating schemes.

- **Developing a local investor base**: this may require changes to investment regulations, but if done prudently can provide the right framework for market stability and attract foreign institutional investors.

Exhibit 3:



The role of debt management offices in infrastructure financing

Debt management offices (DMOs) have a critical role to play in the new environment on several fronts that can be structured in three main areas:

- **Developing a liquid government bond market:** This can serve two purposes. The first one is providing long-term financing at the lowest possible cost so the government can increase its financing capacity for infrastructure while reducing its refinancing risk. The second one is providing a reliable long-term price reference to price private funding into infrastructure.
- **Public sector support to "crowd-in" the private sector:** Depending on the context it may imply the provision of partial guarantees to share risk; support for innovative pilot transactions with demonstration effect; well-designed incentives (e.g. grants, loans under favorable terms, equity investments, tax exemptions).

Developing contingent liability (CL) capabilities: A CL framework and capacity is required for the government to be able to support responsibly a pipeline of projects that are economically relevant but not financially viable. This would include developing credit risk assessment methodologies, procedures to define the DMO's commitments, eventually special

funds or accounts (e.g. Project Feasibility Facilities) and special governance structures for the allocation, management and monitoring of the contingent liabilities.
DMOs could also be involved in the working groups with stakeholders from the private and public sectors established to discuss views and suggestions on ways of supporting infrastructure finance. Their insight on how to structure financing packages for infrastructure investments and how to improve the functioning of the bond markets for infrastructure finance could provide useful guidance

III. Conclusion: finding the right risk sharing arrangements and the role of the public sector

It can be expected that for infrastructure financing to be sustainable it would need to increase its reliance on the private sector, including capital markets options that are still being tested. However, private financing will only take place if there is a strong involvement from the public sector in creating the enabling environment (e.g. liquid fixed income markets, regulations) and in supporting efficient risk sharing arrangements.

Risk sharing arrangements for infrastructure financing come in different layers. Debt managers and other government agencies can play a leading role in developing the right structures. Two levels of interventions would become critical:

- The sharing of risk between the public and the private sector under PPP arrangements. These structures would need to ensure the "bankability" of projects while containing project risks under fiscally prudent limits.
- The sharing of risk between the different types of investors under market based financial structures, including project bonds. This may require in the initial stages the support of development banks or multilateral institutions to provide full or partial guarantees to projects, depending on the nature of the asset.

From the point of view of DMOs or infrastructure finance entities, it becomes critical to develop the necessary expertise for structuring these financing packages without losing sight of the costs and risk implications for central government budget. Additionally, there is the need to develop appropriate governance frameworks and fiscal risk management structures to manage the contingent liabilities created by these packages.

In countries where the financing of infrastructure investments is delegated to a specialized entity, it is frequent that debt management offices keep the responsibility of monitoring the overall risk exposure of the government's budget to the financing of these projects. However, there are cases where special units are created to monitor overall risks, including contingent liabilities for infrastructure financing.

IV. Issues for Discussion

- What are the roles of the debt manager related to infrastructure finance?
- Given the rising demand for using bond markets to finance infrastructure, what can Debt Managers do to help make this happen?
- At what point should the debt managers be involved in the financing of infrastructure projects? This can be at the project selection, during the procurement and structuring of the project implementation, or at the late stage of signing the agreements.
- How can debt managers take the infrastructure finance packages into account when designing the medium term debt management strategy?
- What innovative instruments/products/structures are coming up and are needed to help mobilize more foreign and domestic institutional money and encourage use of bond markets to finance infrastructure?
- What are the most useful arrangements that make a project bankable for the private sector?
- How relevant is the development of a liquid government yield curve to price infrastructure deals? Is this link being made in EMEs?
- What is your firm doing to improve bond financing for infrastructure?

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