THE NEW BUILD BACK BETTER (B3W) INITIATIVE

June 2021

CEPA'S VIEWPOINT

Introduction

> *"B3W will collectively catalyse hundreds of billions of dollars of infrastructure investment for low- and middle-income countries in the coming years."* (Fact Sheet: President Biden and G7 Leaders Launch B3W Partnership. 12 June 2021).

The B3W initiative represents a desire on the part of the G7 countries to support a post-Covid economic recovery in developing countries through increasing resources for infrastructure investment. It is also seeking to counter the attractions of China's Belt & Road Initiative (BRI). Whilst in part, the West is striving to differentiate itself through better governance, it also recognises that existing approaches may need to be "enhanced" to address the infrastructure gap (and presumably to compete with BRI). This note explores what might be considered as part of these enhanced approaches.

The Communiqué

Specifically, the Carbis Bay G7 Summit Communiqué emphasises:

- Working with the existing cohort of development financing institutions (DFIs), Multilateral Development Banks (MDBs) and International Financial Institutions (IFIs) to enhance their catalytic impact and increase the mobilisation of capital needed for infrastructure investment to ensure that the pace of project development and disbursement meet the needs of partner countries.
- Transparency and other principles of good governance promoted by international institutions are at the centre of the B3W approach.[1]
- Support for climate initiatives with the objective of creating jobs, cutting emissions and seeking to limit the rise in global temperatures to 1.5 degrees.[2]

So, in many ways, this represents a degree of business as usual, but at a greater scale. What stood out as being slightly enigmatic and upon which this note is focused, was the following:

Mobilise private capital through development finance. *"We believe current funding and financing approaches are not adequate to address the infrastructure financing gap and are committed to enhancing the development finance tools at our disposal, including by mobilising private sector capital and expertise, through a strengthened and more integrated approach across the public and private sector, to reduce risk, strengthen local capacities, and support and catalyse a significant increase in responsible and market-based private capital in sectors with anticipated returns, and to strengthen local capacities, in a sustainable manner, in line with the Addis Ababa Action Agenda on Financing for Development."*[3]

So what could that mean? What might the options be for a change from the status quo?

Status Quo

To begin with, how might the existing status quo be characterised, in terms of forms of finance?

There are arguably three main elements, whether on a multilateral or bilateral basis:

- **Public/sovereign finance**: The Development Bank model, including the International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA), involves the provision of finance to governments in which the lending entity usually has its exposure guaranteed by the host country. IDA is funded every five years by contributing donors and is provided to qualifying countries on highly concessional terms (i.e. the risk is not fully priced). IBRD has subscribed capital; a relatively small proportion is paid in by member governments, with the rest being callable (essentially a contingent liability to taxpayers in member

[1] This will include building on multilateral agreed standards on quality infrastructure such as the G20 Principles for Quality Infrastructure Investment and focusing on the importance of transparent, open, economically efficient, fair and competitive standards for lending and procurement.

[2] The G7 committed to "net zero no later than 2050, halving member collective emissions from 2010 to 2030, increasing and improving climate finance to 2025; and to conserve or protect at least 30 percent of land and oceans by 2030."

[3] Carbis Bay G7 Summit Communiqué: Our Shared Agenda for Global Action to Build Back Better. June 2021.

countries). This large amount of callable capital allows these institutions to raise capital highly efficiently through bond issues. This is then on-lent to governments at risk-reflective margins.

- **Non-sovereign risk finance**. Most risk-based capital provided, in whatever form, is channelled through DFIs. These can also raise capital efficiently; most of their finance is paid in, but it can also be leveraged through bond issues. This pricing is also highly efficient due to their strong AAA credit ratings, which are typically maintained through a combination of strong capitalisation, relatively conservative loan portfolios and arguably implicit shareholder guarantees. Fully risk reflective credit margins or target returns (in the case of equity investment) are applied.

- **Development agency grants** can also be provided on a funded or contingent basis, both approaches being highly concessional. Whether on a specific transaction basis or in a finance vehicle structure, such grants can also be "blended" with more commercial finance either to improve financing terms and / or to absorb risk, mobilising more public and private capital as a result.

Possible "enhanced" approaches to the status quo

The forms of enhancement are not stipulated in the Communiqué, so what might this mean?

It could simply be interpreted as an **upscaling of present approaches**. Member governments could increase the subscribed capital of the relevant institutions and their treasury departments could issue more bonds, thus **increasing the quantum of finance available on either a sovereign or risk basis**.

The issues with this approach include:

- The limited amount of the resources available: the scale of the challenge cannot be met by monies raised by G7 governments alone, these funds *need* to mobilise additional private capital.

- The way in which DFIs lend to projects is based around an increasingly dated long term bank credit model which precludes a major opportunity to access increasing sources of institutional capital – both international and local - which is increasingly looking to invest in the debt and equity of infrastructure assets.

- Whilst credit appraisal by the mainstream MDB sovereign lenders is more thorough, countries are still assuming greater and greater external liabilities, putting them at risk from macroeconomic and other shocks. Save for local content requirements, better transparency, governance etc. sovereign lending shares much in common with finance from Chinese institutions (as per BRI).

- Ideally, developing country governments would be assuming *less* financing risk by transferring this to private capital (including the risk capital of DFIs who lend and invest on a non-sovereign basis). This is really one of the main objectives of private finance - to shift risk away from governments and taxpayers except for contexts in which it is optimal for them to assume an element of it. The other is to reduce financing constraints.

So the question becomes one of how to catalyse more private finance, and what role DFIs, potentially supplemented by grant monies (to risk share), play in doing so.

We believe there are three overlapping themes that should guide the development of new enhanced approaches:

- **Prioritising the role of institutional capital in financing operational projects**, by focusing DFI risk capital resources on project development and construction finance, prior to exiting to institutional investors.

- **Encouraging greater involvement by local sponsors and investors**, including local institutional investors.

- **Optimising the point at which private capital is introduced to projects**, in order to expedite project development and implementation.

Promoting the role of institutional capital

This would represent a major shift away from the current DFI model in which debt is provided at financial close and is held to term. This may have been appropriate in a world where the credit, rather than capital markets, were looked to for long term finance. But it generally precludes institutional capital, which is not suited to coming in to a transaction at financial close, but *is* well suited to such long term exposures once projects are post COD. If DFIs continue to lock in their investment from financial close and hold to term there will remain no natural entry point for international or local institutional investors.

The African Development Bank (AfDB) has recognised this, having successfully structured a synthetic securitisation of 10% of its private sector loan assets. It is not sufficient for DFIs to seek to do this through investment in intermediated funds; it needs to become more their core model (although raising more local currency bonds to finance their operations would be welcome).

> This would enable development finance to usefully be **revolving** in nature, and **focus on where it is most catalytic** (and at least risk of crowding out private capital) **in the pre-operational phases of projects**.

Localising project sponsorship and investment

Another important strand of a new approach is the greater localisation of projects. In part, as above, this involves creating opportunities for local institutional investors (such as pension funds) to invest in the debt of operational assets. There is a natural match between the financing needs of projects with local currency revenue streams and the needs of pension funds seeking to identify longer term assets which can be used to meet their long term local currency obligations.

In addition, local equity participation has several benefits. First, local ownership may be politically attractive. Second, when the capital is denominated in local currency, the tariff can then be *priced* in local currency (rather than priced in foreign exchange, even though it is paid in local currency). This largely removes foreign exchange risk (though any foreign equity will likely be seeking a foreign exchange denominated return, which may need to be provided for in the tariff). Finally, this reduces pressure on foreign exchange reserves.

Local currency financing is, however, challenging. DFI risk capital could ideally be provided and priced for as shorter term risk capital, which sponsors will seek to refinance at the earliest opportunity.

> There is no shortage of finance for operational projects. **The financing gap is for the development and construction finance of greenfield projects** – risks which only a relatively small number of specialist institutional investors can take. This is where public monies can have the greatest impact; **once projects are operational, development finance should exit, allowing institutional capital to take over**.

Optimising the timing of bringing in private capital

Whilst there might be a plentiful supply of global private finance, there continues to be a shortage of investable projects, typically because there is a lack of resources for preparing projects in many contexts. The alternative of sole sourced non-competed projects can also be problematic. Competing out robust investment opportunities to a full field of interested bidders is likely to create better value for money than ill- defined opportunities, where interest is likely to more limited, with higher risk premiums sought as a result.

There is therefore a need for much greater funding for project preparation which meets the investability and bankability requirements of the private sector. This should also be provided on a revolving basis, in which at least a proportion of the funds expended are reimbursed by the successful bidder.

There is a wider question, however, of *when* it is optimal to bring in private finance. In contexts with a well-developed infrastructure 'eco-system', project rights can be bid out at a relatively early stage in their development. In others, **it may be more optimal to bring in private capital much later in the project cycle**, (including once a project is operational). This may involve developing projects on government balance sheets, utilising project finance disciplines, with an exit once the project is operational to institutional capital.

For instance, development / equity capital could be provided through a mix of government (sovereign development loans), DFI and minority developer equity. A developer could be procured competitively, with a meaningful but minority equity stake or purchase option to ensure alignment. Likewise construction finance could be provided by government and DFIs. To incentivise government exit from projects, the sovereign loans could include a ratcheting in pricing once the project is operational.

DFIs would have to take a shorter term equity, rather than longer term debt return, which would need to be commensurate with the risk taken to enable DFI financial sustainability. This would mean a significant change to the current rules, which typically prevent DFIs investing in majority owned public sector projects (even if this is transitory).

What are the advantages of these approaches viz BRI?

The three themes outlined above involve revolving publicly sourced funding and finance. The first two are really about adapting the traditional project finance approach so that projects can attract competitively priced local and international institutional capital – arguably playing to what western financial systems do well (that is, the intermediation of such capital) and recognising the increasing potential for local institutional investors.

The third is about recognising the challenges of bringing projects to market. Introducing private finance at a later stage in the project cycle would have a high reliance on development and / or sovereign finance. It would also involve a more joined up approach with fewer cross dependencies, not least in terms of the number of different participants whose specific requirements must be met, which can bedevil project financings in challenging contexts.

Two of the main advantage of BRI are its turnkey nature and competitively priced Chinese EXIM bank capital. What is less attractive are the Chinese content requirements and the onerous sovereign guarantee requirements, which Chinese developers and lenders tend to rely on rather than robust due diligence. Despite this, there has been high take up relative to more traditional DFI supported project financing approaches. The challenge for the West is to evolve its existing models – which have many benefits – in ways which address perceived limitations (not least the time taken to implement projects).

Finding ways to bring in institutional capital, whether foreign or local, is one way of achieving this. Such capital can be highly efficient from both an asset-liability matching perspective and pricing – potentially reducing the gap with Chinese EXIM finance. This can be combined with the existing advantages of the western approach, not least in terms of standards and the ability to source the most appropriate technology.

A further advantage is the potential to localise projects – including in terms of financing through domestically sourced equity and debt – which would also be a differentiator from the BRI model, which is driven by an objective of maximising Chinese finance as well as content.

How CEPA can support you

CEPA is a global economic and financial policy advisory firm that boasts some of the most sought-after infrastructure financing experts who are available. Our infrastructure practice group is led by Mark Cockburn, CEPA's Managing Director and projects are delivered by teams under the oversight of Cheryl Baum, a highly experienced programme manager and our principal infrastructure consultant.

We support governments, infrastructure institutions, developers and investors by providing specialist policy, funding, financing and transaction advice that is commercially-astute and robust. We advise clients across a range of sectors.

Contact us to find out more. We look forward to having an initial discussion to learn about your objectives and to suggest ways in which CEPA may be able to support you.

Contact

Mark Cockburn

Managing Director

E: mark.cockburn@cepa.co.uk

Cheryl Baum

Principal Consultant

E: cheryl.baum@cepa.co.uk

CEPA
economics matters

UK

Queens House

55-56 Lincoln's Inn Fields

London WC2A 3LJ

T. **+44 (0)20 7269 0210**

E. **info@cepa.co.uk**

www.cepa.co.uk

Australia

Level 20, Tower 2 Darling Park 201

Sussex Street

Sydney NSW 2000

T. **+61 2 9006 1308**

E. **info@cepa.net.au**

www.cepa.net.au

cepa-ltd @cepaltd