Credit Enhancement for Sustainable Infrastructure

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1.0 Introduction

1.1 Why Focus on Credit Enhancement?

Credit enhancement is particularly valuable for infrastructure planners in developing countries. Policy-makers in these countries face an uphill challenge in preparing projects and raising capital. They face public budgetary constraints on one side coupled with debt ceilings and narrow capital markets on the other. They all aspire to attract private capital, and this might only be realized when good project planning is combined with innovative credit enhancement.

Having advised on sustainable infrastructure in over 22 countries, we continue to be surprised by how little infrastructure planners and policy-makers in lower-income countries know about credit enhancement. They have little information about both the instruments on offer and how these instruments can be used to increase the financial feasibility of infrastructure projects. This is a lost opportunity, for both are needed to close the USD 90 trillion global infrastructure deficit and position infrastructure as a catalyst for realizing the UN Sustainable Development Goals. Developing countries in particular need to make much better use of these instruments.

To address this challenge, over the first half of 2018, the International Institute for Sustainable Development undertook a global survey on the credit enhancement solutions available for infrastructure projects.

Given that policy-makers and infrastructure planners have limited expertise on how to take advantage of credit enhancement opportunities, the International Institute for Sustainable Development and the MAVA Foundation launched an online credit enhancement inventory in September 2018. The inventory can be found at iisd.org/credit-enhancement-instruments. This inventory is by no means exhaustive. Our goal in launching it is to provide users with examples of instruments and suppliers that may be available to them (see tables 1 and 2).

1.2 What is Credit Enhancement?

Credit enhancement instruments can be loosely defined as financial instruments that transfer a certain type of project risk from the project to creditworthy third parties who are better placed to mitigate them.

These third parties include development finance institutions, multilateral development banks, infrastructure banks, commercial banks, insurance companies and export credit agencies, all institutions that have the capabilities to bear project risks.

Table 1. Examples of credit enhancement instruments

Partial credit risk guarantees
Political risk guarantees
Currency risk mitigation instruments
Construction risk mitigation instruments
First-loss provisions
Viability gap funds
Liquidity facilities
Grants
Subordinated debt

Source: *Credit Enhancement Inventory*

Table 2. Examples of credit enhancement providers

Multilateral Development Banks	• Multilateral Investment Guarantee Agency (MIGA), World Bank Group • International Bank for Reconstruction and Development, World Bank Group • International Finance Corporation • European Investment Bank • Asian Development Bank • Asian Infrastructure Investment Bank • African Development Bank • European Bank for Reconstruction and Development • CAF – Development Bank of Latin America • Inter-American Development Bank
Bilateral Development Finance Institutions	• KfW Development Bank • Overseas Private Investment Corporation (OPIC) • USAID's Development Credit Authority • Finnfund, Finnish Fund for Industrial Cooperation Ltd.
International Guarantee Facilities	• GuarantCo • Green Climate Fund • Private Infrastructure Development Group (PIDG) • The Currency Exchange Fund (TCX) • Nationally Appropriate Mitigation Action (NAMA) Facility • Infrastructure Project Preparation Facility, New Partnership for Africa's Development

Regional Guarantee Facilities	• The Arab Investment & Export Credit Guarantee Corporation (Dhaman) • Credit Guarantee & Investment Facility (CGIF)
National Guarantee Facilities	• Danajamin, Malaysian Financial Guarantee Insurer • InfraCredit, Nigerian Infrastructure Credit Enhancement Facility • Department of Economic Affairs, India • Indian Renewable Energy Development Agency • Indonesia Infrastructure Guarantee Fund
Export Credit Agencies	• African Trade Insurance Agency (ATI) • The Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC) • EXIM Bank of the United States • Export Development Canada • Korean Eximbank • Chinese Export Import Bank • China Export Credit Insurance Corporation, Sinosure • Japan Bank for International Cooperation • Credendo, Belgian Export Credit Agency • UK Export Finance • Bpifrance Assurance Export, France • Servizi Assicurativi del Commercio Estero, Italy • Altradius, Netherlands • Euler Hermes, Germany • Swiss Export Risk Insurance (SERV)
Private Insurers	• Compagnie Française d'Assurance pour le Commerce Extérieur (Coface) • Zurich Insurance Group • Allianz Global Corporate & Specialty • American International Group, Inc. (AIG) • XL Catlin, XL Group • Sovereign Risk Insurance Ltd. • Aspen Insurance • Ascot Group • Lloyd's of London

Source: Credit Enhancement Inventory

In recent years, there has been significant innovation in how credit enhancement instruments are used. For example:

- Partial risk guarantees are being used to support the aggregation of smaller infrastructure projects.
- Political risk guarantees and liquidity facilities are being combined to raise the rating of projects.
- Credit guarantees or political risk guarantees are being used with subordinated debt to crowd in foreign institutional investors.

As momentum on sustainable infrastructure gathers speed, we hope to influence innovation in credit enhancement instruments directly aimed at making sustainable infrastructure more bankable.

1.3 Why Is Credit Enhancement Important for Scaling up Sustainable Infrastructure?

Current market conditions do not recognize the value of environmental, social and economic externalities and risks. They also undervalue natural resources such as clean air and water, productive land and biological diversity. Markets also struggle to price carbon, even as the indices and costs of freak weather and changing climates increase. Sustainable infrastructure is therefore more expensive to plan, design and build. It requires longer lead times, larger project preparation budgets and higher capital expenditure.

Credit enhancement is essential for making sustainable infrastructure more financially feasible.

BOX 1. WHAT IS SUSTAINABLE INFRASTRUCTURE?

IISD defines sustainable infrastructure as assets that:

- Lower carbon and environmental footprints
- Steward natural ecosystems
- Move beyond compliance on core labour standards and human rights
- Trigger technological and industrial innovation
- Spur investment in education and research and development
- Increase employment
- Are financially viable
- Crowd in domestic investors and businesses
- Increase foreign direct investment
- Bring value for money for taxpayers and investors

2.0 Why Are Credit Enhancement Instruments Not Used More Widely?

2.1 Overview

As a part of the IISD Global Survey on Credit Enhancement, we conducted interviews with users and providers of credit enhancement instruments, including multilateral development banks, development finance institutions, export credit agencies, private guarantors and other de-risking facilities. Our objective was to find answers to the following questions:

- Why we do not see more infrastructure deals taking advantage of credit enhancement solutions?
- What can be done to increase the use of credit enhancement instruments?
- Do we need more instruments? If yes, which project risks should they address?

IISD has started this project with the hypothesis that the answers to these questions lie in the lack of public sector expertise in planning and preparing infrastructure projects. Financial structuring is the primary responsibility of the financial advisors to the public sector, but governments also need to have a general understanding of the de-risking solutions available to them. How else can they instruct their advisers and negotiate with donors and private financiers on the cost of capital? Moreover, how can they integrate this into their preliminary financial viability assessments and raise it with the relevant parties throughout the procurement and financial structuring processes?

Our research confirms that, while this hypothesis is correct, the reasons behind the limited uptake of credit enhancement are complex. These challenges are discussed in Section 2.2.

2.2 Supply-Side Challenges

The main suppliers of credit enhancement instruments for infrastructure are not only the multilateral development banks and development finance institutions, but also export credit agencies and private guarantors. Multilateral development banks and development finance institutions support large public projects, while the export credit agencies and private guarantors have a more specific mandate to de-risk smaller projects, including private infrastructure. They also focus on mobilizing financing from local capital markets.

GUARANTEES ON MULTILATERAL DEVELOPMENT BANK BALANCE SHEETS

While all multilateral development banks offer some form of credit enhancement, in terms of volume, de-risking instruments significantly lag behind loans. The main reason for this may be that guarantees and loans are treated in a very similar manner on their books.

In other words, the amount of capital multilateral development banks allocate for a guarantee with a principal amount of USD 200 million is very close to what they would allocate for a loan of USD 200 million.

Indeed, this is surprising, as the likelihood of the guarantee to be triggered is minimal.

This conservative approach to risk management can be explained by the fact that multilateral development banks' most valuable asset is their high credit rating—Standard&Poor: AAA; Moody's: Aa; Fitch: AAA. This high credit rating enables them to borrow cheaply from capital markets and on-lend to projects at competitive rates. This is especially important in a development context, where projects rely on the low cost of financing provided by multilateral development banks to become financially viable and crowd in other capital providers. Having a large number of under-collateralized guarantees outstanding with low capital allocations can raise red flags with credit rating agencies and trigger downgrades. In this light, the caution of multilateral development banks can be appreciated, for even the perception of a potential deterioration of their credit rating can have an impact on the cost of financing. This also merits engagement with the credit rating agencies to assess whether multilateral development banks would indeed be at risk of jeopardizing their credit rating if guarantees are not booked as loan obligations on their balance sheet.

MISALIGNMENT OF INCENTIVES

Another important finding was that employee incentive structures at multilateral development banks favour lending over guarantees and other credit enhancement products.

Bankers at multilateral development banks are evaluated at year-end based on the annual business investment they generated. While loans are included in the annual business investment calculations on their scorecard, guarantees are often excluded.

This creates a clear incentive for employees to facilitate lending instead of exploring credit enhancement opportunities. Indeed, providing loans is a bank's core business. Incentives are therefore aligned accordingly, making guarantees less attractive.

This misalignment might be addressed by assessing performance based on the annual mobilized investment instead.

Annual mobilized investment-based evaluation would not only enable the inclusion of credit enhancement products but would also encourage employees to explore opportunities for such transactions.

Guarantees can better leverage multilateral development bank resources and mobilize a larger amount of capital than what would be the case for loans. We could even go further and explore if multilateral development banks should have specific credit enhancement targets in the years to come.

The case for increased de-risking is also augmented as the returns generated on guarantees are often very similar to that of the loans. In other words, profit considerations should not be a barrier to multilateral development banks and development finance institutions considering strategies for increasing credit enhancement transactions alongside lending.

DIFFICULTIES IN ASSET RECYCLING

Banks and other lending institutions are still the largest players globally in financing infrastructure, and their governance has an important impact on their appetite for doing so.

With the implementation of Basel III, the global banking regulatory framework, loans to long-term illiquid assets receive an especially unfavourable treatment.

Banks are required to comply with more stringent capital adequacy, leverage and liquidity requirements. In practice, this means that financial institutions tend not to keep loans to infrastructure projects on their balance sheet, but instead sell them off their books before these loans come to maturity. This process is also called asset recycling, as it frees up the bank's balance sheet to lend to other projects. However, if there is credit enhancement in place, for example in the form of a guarantee, this process becomes administratively much more complicated and, in some cases, practically impossible.

THE SMALL TICKET SIZES OF DEDICATED CREDIT ENHANCEMENT PROVIDERS

Smaller providers of credit enhancement, such as GuarantCo and the Credit Guarantee and Investment Facility, have been highly efficient servicing projects falling outside the focus of multilateral development banks. They have been essential in mobilizing private investment as well as developing local capital markets in their respective regions. They also use a range of strategies to finance in local currencies and reduce local currency risk. This is particularly valuable in lower-income countries where currency risks are predominant. As the capital markets in these countries are underdeveloped, currency hedging might be expensive or even impossible to mitigate through traditional channels. Moreover, if financing can be obtained in the same currency as revenues of the project, the entire project can be greatly de-risked.

The challenge for these dedicated credit enhancement providers is that they are not set up to cover large ticket sizes. In other words, they do not have the balance sheet to guarantee large-scale infrastructure projects. However, this may change in light of the global policy discussion on the merits of a Universal Guarantee Facility.

Export credit agencies also have considerable capacity to provide credit enhancement for infrastructure transactions. While the mandate of export credit agencies is to support export-related investments from their country of origin, partial credit guarantees and insurance for multilateral development bank loans are very valuable for de-risking infrastructure projects.

The complementary role of export credit agencies in financing infrastructure, including their collaboration with multilateral development banks, certainly merits more concerted research.

THE VALUE OF A UNIVERSAL GUARANTEE FACILITY

The global development policy community is discussing the merits of a Universal Guarantee Facility. The facility would offer solutions to transferring off-taker risk, political risk, currency risk and inconvertibility-related risks. Equity would be provided by developed country governments, international finance institutions and philanthropic organizations.

Proponents of the Universal Guarantee Facility suggest that it can leveraged up to 15 times.

In other words, USD 1 million of guarantee is expected to mobilize USD 15 million of additional capital. It is also expected that this facility would enable multilateral development banks to have guarantees and other credit enhancement instruments to off-balance their sheets, thus having no impact on their valuable credit ratings.

The authors certainly welcome the idea of the Universal Guarantee Facility and increased focus on de-risking infrastructure in lower-income countries. However, we remain sceptical, as the lead times and overheads to establish and capitalize such a facility will be extremely high. Would it not be a better strategy to empower existing de-risking agencies, especially given their notable track records to date?

2.3 Demand-Side Challenges

The users of credit enhancement solutions include sponsors and lenders of the infrastructure project. Sponsors are the equity holders, which could be private or public sector entities such as institutional investors, construction companies and governments. Debtholders comprise mainly banks but could also include institutional investors and other capital market participants if the project was funded through bonds. Depending on the instrument used, credit enhancement can de-risk specific parts of the project's capital structure or transfer risks from the project as a whole.

LOW AWARENESS

The general awareness of the range of credit enhancement solutions available is surprisingly low across infrastructure stakeholders.

Public infrastructure planners are often not aware of the variety of instruments offered and if projects under preparation may be eligible.

This is a missed opportunity. While public policy-makers may leave direct work on the financial structuring of the project to transaction advisers, they do need to have an overall appreciation of the value and variety of credit enhancement strategies so that they can instruct their consultants to explore their use earlier in the planning process.

In addition to policy-makers, institutional investors and financial advisors also have little experience with credit enhancement. While some of them have heard about these instruments, only very few of them have actually seen them being used.

COST IMPLICATIONS

Infrastructure policy-makers and project sponsors alike also perceive credit enhancement from development banks and institutions to be expensive. They ask if commercial markets can provide partial credit risk guarantees on better terms than multilateral development banks.

Our research finds that costs vary significantly depending on the region, currency, project size and risk, but they usually fall into the range of 1–3 per cent.

Multilateral development banks have also cited instances when it can be cheaper for the borrowing organization when multilateral development banks resort to buying a loan guarantee from a commercial provider instead of offering additional credit enhancement.

In principle, the cost of credit enhancement should be less than the overall improvement in the cost of financing. Otherwise, the use of these instruments would not be justified from a financial viability perspective.

Another important consideration for project sponsors and lenders is the time it takes to receive compensation from an activated guarantee. If there is a notable delay, this will be reflected in the cost of financing and credit rating of the project, decreasing the positive impact of the guarantee. This could be addressed by having a quick, streamlined process for guarantee activation or by offering liquidity facilities to provide bridge funding for the delay. In fact, this example very well demonstrates how different credit enhancement instruments could be used in a complimentary manner.

2.4 Do We Need More Innovation in Credit Enhancement?

Our research indicates that stakeholders will welcome innovation in:

1. Currency risk
2. Refinancing risk
3. Legal risk for environmental and social compliance

CURRENCY RISK

Infrastructure projects often rely on international sources of financing denominated in a foreign currency, while keeping revenue streams in their local currency. Unless properly hedged, this currency mismatch can pose a material risk for the long-term profitability of the project. While currency risk can be hedged through capital markets for convertible currencies, this might be expensive or impossible to do for non-convertible currencies of lower-income countries. At the same time, currency volatility is the most prominent in these regions, especially during the long lifespan of infrastructure assets. Unsophisticated domestic capital markets together with limited financial activity in the local currency often result in low liquidity or lack of foreign exchange instruments for hedging purposes.

The fundamental step to increasing local currency financing for infrastructure is to provide incentives for domestic savings and investment. This would enable the accumulation of domestic long-term capital while deepening domestic capital markets.

Dedicated credit enhancement agencies such as The Currency Exchange Fund provide swaps and forward contracts to hedge currency risk. At the time of writing, The Currency Exchange Fund reports to be undergoing a capital raise and thus will service large infrastructure projects in the years to come.

REFINANCING RISK

Refinancing risk is particularly important in lower-income countries where local financial institutions may not have the appetite to provide the large, long-term loans that infrastructure projects require. On the other hand, banks that do provide these loans may charge a significant risk premium, materially affecting the financial viability of the project.

The problem with short-term financing is that base interest rates in these countries can change significantly within the usual 5- to 10-year time horizon of these loans. We have seen changes of up to 20 per cent in some countries. In this case, project sponsors have no certainty of the level of interest rate at loan maturity, which makes the bankability assessment of the project more uncertain and inaccurate. Projects financed in currencies with high interest rate volatility need to explore solutions to mitigate the refinancing risk. While the more sophisticated and liquid capital markets offer instruments to hedge interest rate risk, these long-term de-risking instruments do not exist for the local currencies of many emerging and developing countries.

LEGAL RISK FOR ENVIRONMENTAL, SOCIAL AND GOVERNANCE COMPLIANCE

Legal risks associated with environmental, social and governance compliance were also raised as an area where investors want to see more de-risking solutions. Environmental impact assessments, environmental management plans and compliance with the host of other permits related to environmental and social laws can be insufficient to eliminate related legal risks during the construction and operation phases. Moreover, the cost of legal fees as well as the disruption in operation can potentially create a level of uncertainty that can materially affect the cost of financing for the project.

One solution that merits further investigation may be environmental liability insurance. This has had limited application to infrastructure projects, but IISD plans to further explore this topic in the months to come.

3.0 Next Steps

As the development community works to scale up financing for infrastructure from billions to trillions and position infrastructure as the catalyst for realizing the UN Sustainable Development Goals, it is very important that these public assets and services are planned, financed and built to be sustainable.

The International Monetary Fund estimates that an "increase of 1 percentage point of GDP in infrastructure investment spending raises the level of output by about 0.4 percent in the same year and by 1.5 percent four years after. In addition, the boost to GDP a country gets from increasing public infrastructure investment offsets the rise in debt, so that the public debt-to-GDP ratio does not rise."[1] But if infrastructure is to live up to these expectations, assets have to be sustainable. They need to steward the environment, provide for social cohesion, crowd in domestic investors and businesses, and lay the foundations for innovation and growth.

Deploying sustainable infrastructure is far from easy, as capital markets fail to correctly price natural resources and incorporate the cost of environmental and social risks and externalities that range from pollution and freak weather to losses caused by strikes and social unrest. Sustainable infrastructure hence becomes more expensive to plan, finance and build. True, the operating and maintenance costs of sustainable infrastructure can be lower, but this is not always sufficient to make a convincing business case. These savings accrue long after the financial closure of a project, by which time the owners and managers of the asset are likely to have changed. The project may also have been refinanced, as sponsors and lenders with high-risk appetites who financed the construction phase may have opted to move on. Operations savings downstream therefore become less relevant in light of the uphill challenge of planning sustainable projects and bringing them to the stage of financial closure.

Credit enhancement then becomes even more important for deploying sustainable infrastructure. Indeed, we can argue that sustainable infrastructure cannot be deployed unless the use of credit enhancement instruments scales up simultaneously.

We therefore welcome the international development policy debate on the need for de-risking infrastructure and the value of a Universal Guarantee Facility. The most cost-effective way forward may however be to further capitalize dedicated de-risking agencies that have noteworthy track records to date. These actors also have a deep knowledge of developing country markets and employ innovative strategies to take on the likes of currency risks and merchant risks that run high in developing countries.

De-risking sustainable infrastructure could also benefit from better collaboration among the de-risking suppliers, be they private insurance providers, de-risking agencies, export credit agencies or multilateral development banks. We are now seeing greater collaboration between the multilateral development banks on lending to projects, as well as early efforts to couple liquidity facilities with political, credit and construction risk guarantees and liquidity facilities with subordinated lending. The question remains: how this can be done? Would the overhaul of governance frameworks to reward annual mobilized investment be a start?

The International Institute for Sustainable Development has also long pondered the feasibility of directly targeting credit enhancement for the frontrunners of sustainable

[1] Abiad, A., Furceri, D., & Topalova, P. (2014, September 30). IMF Survey: The time is right for an infrastructure push. Retrieved from https://www.imf.org/en/News/Articles/2015/09/28/04/53/sores093014a

infrastructure. For example, can viability gap grants be available to only sustainable projects? Can the eligibility for credit guarantees and liquidity facilities include high standards on environmental and social performance, including resilience to changing climates? Can sustainable projects have access to cheaper subordinated debt from development and other development finance institutions? We would welcome the opportunity to work further on related ideas.

As proponents of sustainable development, we also point out that the widespread de-risking of sustainable infrastructure will only be practical if domestic investors participate in financing. Developing countries have sizable pools of capital that lie idle given that their nascent capital markets offer few opportunities for stable returns over the longer term. Infrastructure can provide such an investment opportunity. Moreover, preparing the groundwork for domestic investor participation in infrastructure will provide a very good incentive to improve the governance of local capital markets. It can also drive reforms on transparency and accountability in how infrastructure is planned, financed and procured. Domestic investors can be powerful actors in their home markets with deep knowledge and a high tolerance of merchant and political risks. Domestic capital also brings the added advantage that capital is sourced in the same currency as the project revenues. Risks on currency convertability hence do not arise. This is not to say that domestic investors will not require credit enhancement—for they will. But these instruments will be far less expensive than those employed to crowd in foreign investors.

The first step, however, is to increase policy-makers' appreciation of the value of credit enhancement and the scope of de-risking instruments available to them. Governments are the custodians of public assets and services. Unless they demand de-risking services and ask the right questions of their advisors, the suppliers of credit enhancement cannot respond.

To this end, the International Institute for Sustainable Development has developed an inventory of credit enhancement instruments that can be found at iisd.org/credit-enhancement-instruments.

This inventory is by no means exhaustive, but it does provide insight into the variety of providers and instruments on offer. As we expand its scope, it will also support further debate and innovation in the credit enhancement space in the years to come.

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