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THE FUTURE OF INFRASTRUCTURE FINANCE IN MEASA

Infrastructure brings economic and social value to a country: it can drive economic growth by facilitating business activity; it can provide residents with essential services, from mobility to electricity; and new projects can create new jobs. However, particularly in emerging economies, there is a chronic shortage of necessary investment to build transport, communications, energy and water infrastructure. In the Middle East, Africa and South Asia (MEASA) region, the funding deficit amounts to over US$500bn annually.[1,2,3]

Domestic sources of capital—the mainstay of infrastructure development in emerging markets—fall short, owing to fiscal pressures from the chronic deficits run by many countries in the MEASA region, or because of the risk of overindebtedness arising from excessive borrowing. Similarly, funding from multilateral development banks (such as the World Bank), regional development banks (such as the Africa Development Bank and India's Infrastructure Development Finance Company) and country donor partners (notably China) cannot hope to close the investment gap completely. Fresh sources of funding and new funding mechanisms will be essential if governments are to make progress in addressing their countries' infrastructure needs by building roads, connecting populations to power, and providing clean drinking water and sanitation.

In the MEASA region, when infrastructure is not paid for directly by governments themselves, it is primarily financed by banks, rather than through capital markets or public-private partnerships (PPPs). "But we think that those conditions are changing and that the region will be less reliant on bank financing for infrastructure in the future," says Michael Grifferty, president of the Gulf Bond and Sukuk Association. He cites several reasons for this. Among them is the mismatch of timelines between infrastructure projects and banks: banks prefer shorter-term debt to meet short-term obligations. In addition to this, regulatory changes such as concentration limits and those stemming from Basel III, such as increasing minimum capital-adequacy ratios, may constrain growth in banks' balance sheets. "Enforcement of banking regulation will inadvertently result in pushing some financing towards capital markets," says Mr Grifferty. Such shifts will create an opportunity for greater use of PPPs, capital markets, and alternative sources of finance such as pension funds and insurance companies that value predictable long-term income.

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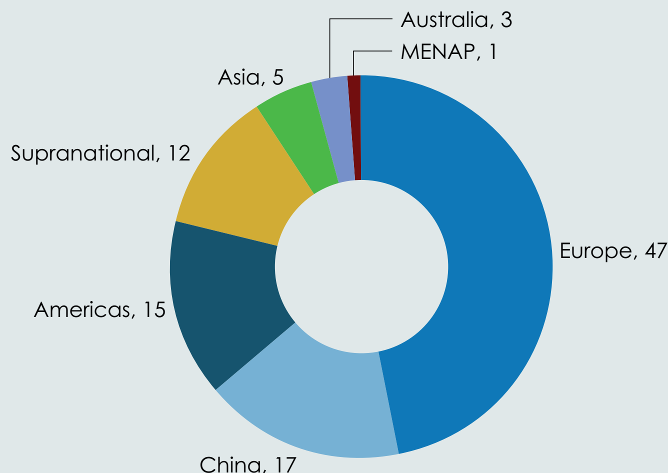
BUILDING BONDS FOR THE LONG HAUL

Bonds are often cited as a financing solution for infrastructure projects. But the MEASA region faces challenges in this regard, as Mr Grifferty explains: "The region lacks a strong and diversified institutional investor base for fixed-income—and particularly for longer-dated—securities, which are suitable for infrastructure. So that's a constraint that needs to be addressed."

Although traditional bonds dominate, many players are exploring the suitability of sukuk—sharia-compliant debt whereby investors each hold an undivided beneficial ownership in an underlying asset. Given that sukuk need to be linked to real economic activity and tangible assets, this form of debt is well suited to infrastructure projects. But the investor base will remain narrower for sukuk than for traditional debt, even in most of the Muslim-majority countries in MEASA. "We find that a five-year horizon is still acceptable for most investors but ten years is a bit too long," says Khaled Al-Aboodi, chief executive officer of the Islamic Corporation for the Development of the Private Sector (part of the Islamic Development Bank Group). "To develop this, you need to make sure that sukuk are listed, to provide an exit to the investor. If it's privately held and there is no market for it, it will be very difficult. Bringing in institutional investors, such as insurance companies, to invest in this long term will be important."

Figure 1

Green bond issuance by region, Jan-Aug 2017
(% of total of US$ 80.9 bn)



Source: Standard Chartered.

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Another instrument emerging in the region is the green bond, says Mr Grifferty. Green bonds are fixed-income securities that can be used to raise finance for environmentally sustainable projects.[4] Although the first green bond in the world was issued in 2007, the number of issuances in MEASA has been very limited, particularly in the Middle East and Africa (although the number has been higher in India).[5] At US$86bn, global issuance of green bonds accounted for only 1.3% of the US$6.6trn total of global debt issuance in 2016.[6,7] But despite the fact that green bonds are a niche product, there is room for growth thanks to the emergence of the environmentally conscious investor. Green-project evaluation tools, such as that recently launched by Standard & Poor's, a credit-rating agency, will bring more structure to this sector.

While many countries in the MEASA region have issued external sovereign debt to pay for infrastructure projects, subnational municipal bonds have been slow to emerge. These are popular in developed markets such as the US: the belief is that local authorities are often better placed to meet local needs. In MEASA, municipal bonds have been issued in only a handful of countries, such as India and South Africa, and are non-existent in the Middle East (although Egypt is considering introducing "munis" as part of its wider economic reform programme). Among the challenges facing the development of a municipal-bond sector are inadequate regulation and oversight at local level, and political risks. The experience of Senegal's capital, Dakar, is a case in point. The city attempted to issue a municipal bond in 2015, following several years of donor-funded reform and improved fiscal management, but was blocked by the central government only days before launch.

BUILDING PRIVATE PARTNERSHIPS

PPPs can be a very effective way to deliver infrastructure projects: the private sector is generally more efficient at mobilising capital and at building, managing and delivering services, and tends to complete projects at a lower cost than most governments, despite the latter's lower borrowing costs. Furthermore, the fiscal impact of PPPs is much lower than that of direct project development by governments, even with the fiscal commitments that PPPs entail.

However, the success of PPPs depends on governments' commitment to building the appropriate frameworks and institutions. A few countries in MEASA, including South Africa, Bangladesh, Senegal, Egypt, Kuwait, and Dubai in the UAE, have dedicated PPP laws.[8] But for PPPs to be more effective, the World Bank believes that a sound legal and policy framework is only the beginning; institutional and human-capital capacity, both to manage projects and to identify project pipelines, as well as

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greater government transparency and accountability, are also essential to reduce risk and support success. Indeed, poor governance of infrastructure is one of the most fundamental bottlenecks to achieving long-term development objectives.

BLENDED FINANCE FOR THE FUTURE

Private-sector investment in emerging-market infrastructure remains well below potential, despite growing interest in investment opportunities and improving governance. Donor governments have been active: China has been one of the most important sources of infrastructure investment in Africa in particular, often as part of its broader commercial engagement with an eye on African resources. But in developing economies, particularly in sub-Saharan Africa, infrastructure is still overwhelmingly financed by the development finance institutions (DFIs) and multilateral development banks such as the World Bank and its private-sector investment arm, the International Finance Corporation (IFC). Even with the popularity of independent power producers (PPPs for the power sector), projects still rely on some funding—plus guarantees—from DFIs.

The IFC is leading efforts to increase private-sector participation, in a bid to realise the 2015 Sustainable Development Goals. This includes blended finance, which involves combining concessional development funds with commercial funding from the IFC and co-investors.[9] It creates an opportunity to attract private capital for development projects for which the risks are deemed too high for commercial players alone. Blended finance goes further than providing guarantees to projects; it can also fund projects that do not have a steady stream of revenue, by de-risking and bringing projects to commercial viability.

In 2016 the IFC launched an innovative platform, MCPP Infrastructure, to mobilise infrastructure investment in emerging markets from global institutional investors. Through this, it aims to generate US$5bn by 2021, having raised US$1.1bn so far from Allianz and Eastspring Investments. Such initiatives are expected not just to boost investment from commercial sponsors and their commercial lenders, but also to unlock the huge potential of the pension and insurance sectors, which seek the regular cashflows that infrastructure projects can deliver.

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NOTES

[1] "Up to $2.5 Trillion Needed for South Asia Infrastructure-World Bank", *World Bank,* 2 April 2014.
[2] EY, *Addressing Africa's infrastructure deficit.*
[3] "Why infrastructure is key to a stable Middle East", *World Economic Forum,* 23 May 2015.
[4] Rosembuj, F. and Bottio, S., Mobilizing Private Climate Finance: Green Bonds and Beyond, International Finance Corporation (IFC), December 2016.
[5] Climate Bonds Initiative, *Labelled green bonds data,* 2017.
[6] Standard Chartered, *Growth of the Green Bond Market,* September 2017.
[7] "Corporates lead surge to record $6.6tn debt issuance", *Financial Times,* 27 December 2017.
[8] World Bank, *Public-Private Partnerships Laws / Concession Laws,* 7 September 2017.
[9] International Finance Corporation, *Blended Finance at IFC,* May 2017.

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