

Infrastructure and Project Financing Asia Pacific Scenario

by

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ASIAN DEVELOPMENT BANK

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Asian policy outlines

The lack of adequate infrastructure capacity in Asia Pacific has hindered development and led to a consensus that private investment including foreign investment and reforms are required.

Ajay Sagar writes.

While the will to amend these tribulations has frequently surfaced, few solutions have been realized to find an effective cure to help promote investment in infrastructure projects. This new business model proposes innovative and efficient mechanisms to consider a blend of private finance initiatives (PFI) and public private partnerships (PPP) and engage in development of local currency financing solutions through capital markets and currency swaps to meet the infrastructure development needs of the emerging economies of Asia-Pacific.

Essentially, this will be the crucial recipe for project finance initiatives and in doing so, will set emerging economies on a path of sustainable development. In light of hard lessons learnt after the Asian financial turbulence, stakeholders are now, more than ever, actively following future directions of the financial markets in support of project financing for sustainable infrastructure development. To meet these demands, governments and multilateral agencies are positioning themselves strategically to play a leadership role by constantly addressing the challenges that still exist.

Challenges in project financing

Infrastructure development has huge potential in developing countries of the Asia-Pacific region. Emerging economies in this area need billions of dollars in private funding to spark infrastructure investment. However, the

classic problem of supply and demand puts forth an obstacle – while the demand for infrastructure investment is enormous, these economies have failed to attract a supply of private investment in infrastructure projects.

This lack of ventures in building adequate infrastructure can be attributed to weak tariff regulation, reluctance in honouring concession commitments, inconsistent enforcement of laws, corruption, poor governance practices, lack of availability of long-term local currency financing at fixed interest rates, weak accounting and disclosure norms, and weak securities legislation.

As the problem persists, investors are now reluctant to take currency mismatch, interest rate and refinancing risks. Traditionally, commercial banks have been the suppliers of long-term financing in Asia and in doing so they have heavily relied on short-term deposits to meet their funding requirements. Such a practice, especially in a weak banking environment, exposes the banking sector to systemic risks.

A testament to these issues is the large number of infrastructure projects in Asia that were financed in hard currency and later struggled with the adverse impact of Asian financial turbulence and required restructuring. We are all aware that the real cost of the Asian financial crisis was in the form of reduced lending volumes, and

investment in infrastructure, rises in unemployment, increases in government debt and a sharp reduction in GDP growth rates. In support of private sector-led infrastructure growth, a healthy banking sector and developed local capital markets play an important role.

Now, private investors and project lenders are hesitant to make continued commitments for fear of government intervention and breaches of contractual obligations. Another related risk that investors and lenders bear is the enforceability of obligations of host governments, especially with reference to concession arrangements, and they would like to see this mitigated.

Unfortunately, uncertainty remains about how courts in developing countries will treat sovereign and sub-sovereign contractual obligations. This is an issue in new markets, until market standards and legal precedents are clear. At the same time, countries across the region now recognize that private capital is urgently required in the infrastructure sector to meet targeted growth rate projections. There is an urgent need for developing and implementing a new model to replace the traditional methodologies for project financing as market players now desire bankable solutions for infrastructure project financing.

Public-private local currency financing model

First, there has been an emerging need to review, on a sector-by-sector basis, the strengths and weaknesses of the processes that were used in the past to implement infrastructure projects. Beyond this analysis, it is imperative to then develop bankable versions of these models, ideally backed by the fundamental willingness and ability of customers to pay rather than rely on

government guarantees or public sector assurances. In this process of change for the better, viable tariff structures that are affordable by users for the entire life of a project need to be planned to meet the requirements of all stakeholders.

Second, there are many lessons to be learnt from the Asian financial turbulence caused in 1997 - borrowers must avoid currency and maturity mismatches. Infrastructure projects require long-term financing in the currency of the revenue of the project, and such financing often requires fixed rates of interest. In the case of any adverse movement in the exchange and interest rate of the local currency, an open currency and interest rate exposure will be detrimental to the interests of a project's beneficiaries, users, lenders and sponsors. Experience suggests that the pass-through of sustained devaluation in the tariff structures becomes a credit risk for lenders and investors and we are all aware that incomes of consumers do not go up automatically when either devaluation or an interest rate hike takes place

Third, governments need to ensure that projects are awarded based on competitively bid least-cost proposals rather than awarding project concessions on unsolicited proposals with embedded commercial risk. Such undesirable propositions tend to be politically generated without regard to rigorous financial analysis to determine their sustainability in the absence of major increases in user charges or government guarantees.

Finally, commercial banks have been the sole provider of credit for all types of borrowing requirements. There has been an over-reliance on the banking sector for longterm funding as no

alternative mechanisms have been made available. Banks have limited capacity to provide long-term funding as they rely on short-term deposits for their funding sources, thereby creating a duration mismatch. Alternative lending mechanisms including long-term local currency funding mechanisms need to be created in place of the traditional reliance on bank credit using short-term deposits. One such mechanism is accessing capital markets. Commercial and Investment banks working together with rating agencies can play a useful intermediation role in this activity by providing structuring and underwriting assistance.

With the benefit of hindsight and the lessons learnt, we now need to move towards building up a new model to develop bankable projects with capital markets acting as new sources of finance. Infrastructure project financings require a mix of public-private arrangements and such projects need to be backed by strong public-private partnerships, the critical role of improved regulation and governance, the adoption of viable and affordable tariffs valid for entire life of the project, and the fundamental willingness and ability of consumers to pay, instead of government guarantees. Essentially projects must be viable through full cost recovery.

Simultaneously, regulators in developing countries need to pay attention to issues relating to corporate governance practices, the adoption of sound accounting and disclosure practices, transparency standards, corporate social responsibility, environment management, and development of capital market infrastructure to generate investor confidence. In implementing this new model, local capital markets can play

an important role in providing infrastructure project finance.

State of markets and future directions

The financial markets are witnessing a convergence of the banking, insurance and securities industries. Based on the lessons learnt, the institution best placed to originate a project financing in the form of a loan may not necessarily be best placed to bear the risk. In several emerging economies, more reliance is now being placed on providing access to capital markets to fund large and capital intensive infrastructure projects requiring financial assistance for long durations. Banks may thus no longer be lenders of first resort but remain lenders of second resort by providing liquidity support to boost investor confidence.

It is often mentioned that Asian banks have too much of short-term liquidity. However, this liquidity may not necessarily be backed by adequate capital. Also, investment of such short-term liquidity in long-term assets could expose the investing banks to market risks should interest rates start moving upwards.

Banking regulators are now creating an awareness of the market risks among banks by undertaking stress tests of the banking system. Recently, one of the developing member countries of ADB undertook such a stress test of its banking system and discovered that a 1% increase in secondary market interest rates in the government bond yield curve could wipe out 0.6% of the capital in the banking system.

Maturity transformation of deposits is important and has to be achieved in a gradual manner through the creation of a sound capital market infrastructure. It is now widely acknowledged that developing long-term, fixed-interest

local currency lending options would promote sustainability and affordability in infrastructure projects. High tariffs resulting from currency mismatches or increases in short-term floating interest rates are a major risk in user-pays or pass-through structures, where projects are exposed to unhedged risks. Introduction of local currency financing solutions in infrastructure projects strengthens their viability. Local capital markets are crucial for efficient resource mobilization and investment. Local bond markets can supplement the requirements of infrastructure projects by providing additional risk-taking capacity, which commercial banks are unable to provide. Market players working together are now moving towards an underwriting and sell model for project financing.

Central banks, policy makers and securities regulators are now pushing for deep and liquid capital markets. And here the definition of capital markets is much wider, so as to include swap markets, bond markets and equity capital markets.

Countries are now desirous of developing all three main components of capital markets. It is imperative to develop swap markets, which are crucial for the development of fixed income markets. Thus in terms of sequencing, swap market development has to be undertaken in parallel with bond market development. Countries are now aware of the major issues and challenges, such as a lack of market depth for local currency and underdeveloped legal, political and institutional infrastructures for local capital markets.

Getting financing strategy right is one of the things that define a well conceived infrastructure project. Getting it wrong invariably leads to exposing the project to undue risks that may have far-

reaching implications and may make projects unsustainable in the long term. Lending to infrastructure projects entails two types of risks, namely political risks and commercial risks. And in promoting project financing solutions each party involved in the project, be it the government or the concessionaire or the financier, is required to take the risk that it is capable of taking. For this purpose, a proper understanding of the role of the parties involved, including the potential role governments and multilateral agencies can play to promote private investment in infrastructure, is very necessary.

Role of government

Priorities are now evolving to attract private sector investment in infrastructure. There are comparative advantages of public and private sectors. The role of government in promoting infrastructure investment has changed in character but not diminished. While governments are keen to attract private sector participation in infrastructure development, they still need to play a key role in planning, policy, and regulation. The reason that infrastructure industries have remained so long in the public sector is that they have components that are natural monopolies. The role of the government is to develop independent regulatory mechanisms, as such mechanisms are preferred by investors and lenders.

Also, we need to encourage governments to maintain and strengthen their role in strategic planning of infrastructure sectors and in the process identify where private sector participation should be encouraged and the level of complementary support that should be provided. Governments should also be encouraged to consider PFI and PPP approaches as these structures will

introduce competition and innovation in procurement, speeding up of the rate of implementation by improved access to private sector resources.

Private sector participation without a well-developed regulatory and legal framework increases the level of risk to investors - and the cost of infrastructure projects ultimately paid for by consumers. Governments need to anticipate future bottlenecks and make timely strategic decisions to prevent capacity shortages in the infrastructure sector. At the same time, governments can speed up the privatisation process. Public ownership is neither necessary nor the best way to ensure full and equitable access. The basic objectives of autonomy, accountability, transparency and predictability have been difficult to achieve. Yet enforceability and sanctity of both sovereign and sub-sovereign obligations, including municipal obligations, is important to generate investor confidence.

Role of ADB

ADB is in a position, and is willing, to play a significant role by collaborating with market players. As a multilateral development institution, ADB's mission is to promote economic growth through the development of infrastructure and capital markets in its developing member countries, thereby reducing poverty. More information on ADB's financial assistance programme in the infrastructure sector without sovereign guarantees is available on its website www.adb.org.

ADB has in place equity, loan and credit enhancement instruments including guarantees to provide intervention to address key concerns of sponsors, investors, and the banking community. ADB thus plays the role of an honest broker and is more demonstrational and catalytic in nature.

ADB's dual capabilities of having public and private sector operations under one roof offer important synergies. This combination enables ADB to deliver 'comprehensive development solutions' to a wide range of challenges.

Supporting infrastructure development

Under the traditional model of infrastructure creation, finance used to be regarded as an ancillary function. But in the wake of attracting private investment and structuring sustainable infrastructure projects that are financially viable, finance needs to be at the heart of an infrastructure project's overall strategy.

In the context of promoting local currency financing alternatives, ADB is taking a leadership role in developing local capital markets in the region to provide long-term funding for capital-intensive infrastructure projects.

In a path-breaking initiative, ADB has recently introduced a new mechanism for injecting long-term local currency financing in the targeted sectors that are necessary for economic growth. Under this initiative, ADB will swap its hard currency for local currency with its developing member country for tenors stretching up to 15 to 20 years.

The local currency will in turn be lent to infrastructure project developers, sponsors, and financial intermediaries without sovereign guarantee based on an acceptable credit rating from an international credit rating agency.

The role of the host government under the swap intervention is that of a facilitator. A cross-currency swap is materially different to offshore borrowing. The former simply changes the currency composition of the cash available with the host government during the life of the swap. A cross-currency swap undertaken by a developing country is not a public debt.

CROSS CURRENCY SWAP VS OFFSHORE BORROWING

Item	Cross-currency swap	Offshore sovereign borrowing
Accounting treatment	Creates a contractual obligation to meet swap counterparty commitment	Creates a debt obligation
Form of documentation	ISDA documentation is executed between swap counterparties	Loan agreement
Front-end costs	Generally not associated	Generally associated in the form of arrangement fee, underwriting fee and commitment fee.
Availability of additional cash	No. A swap simply changes the currency composition of the cash held by the host government.	Yes.
Macroeconomic stability	Promotes macroeconomic stability	Funds so borrowed maybe used for financing fiscal deficit.
Counter party risk	Creates a counterparty risk. And in case of swaps with ADB, the host government takes counterparty risk of an AAA rated multilateral institution.	Not created. Cross Instead a borrower and a lender relationship is created.
Balance sheet size	Does not increase	Increases with the amount borrowed.
Number of legs	Comprises two independent legs, a hard currency leg and a local currency leg	Comprises of one leg denominated in hard currency.

The transaction remains neutral in a manner such that the increase in foreign currency funds available with the government is offset by a corresponding decrease in local currency funds and upon maturity of the swap at a future date the decrease in foreign currency funds is offset once again by an increase in local currency funds by same initial amount.

Accounting guidelines also materially differentiate the financial and reporting treatment of a cross-currency swap and an offshore borrowing. The size of the balance sheet goes up in the case of offshore borrowing whereas by undertaking a cross-currency swap the size of the balance sheet

remains unchanged. Governments are now keenly facilitating discussions among market participants on this important initiative. Such an action on part of governments is necessary and timely.

Conclusion

In conclusion, the issues mentioned above as 'challenges' can be, and are being, addressed through the recognition that there is a need to shift to a new best practice model for infrastructure development by creating public-private partnerships. There has to exist a close co-operation and

partnership among host governments, project sponsors and financiers based on a better and more mature understanding of the needs of each party.

Last, new and innovative instruments from private and public sector players working together can help reduce the infrastructure financing gap. ADB has been at the forefront of this groundbreaking and effective initiative to increase the resources available for project financing in the infrastructure

sector. The bank's core mission is to support infrastructure and financial sector projects in its developing member countries by providing long-term financial assistance and sound advice on regulation, governance and competitive solicitation. Essentially, this financing model restructures the project finance blueprint to make it more efficient and accountable – an imperative necessity to witness success in sustainable infrastructure development in emerging economies.

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