GEOECONOMICS AND INDO-PACIFIC ENTERPRISE INITIATIVE

International Financial Institutions Key to Meet the Infrastructure Financing Gap

Wilson Center

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At the June 2022 G7 summit, leaders from the world's richest countries **announced**[1] the launch of the Partnership for Global Infrastructure and Investment (PGII) to mobilize up $600 billion in public and private investments by 2027. The goal was to meet the infrastructure needs of low- and middle-income countries, and the Biden administration declared it would offer one-third of the mobilized amount through grants, federal financing, and private sector investments.

The White House **memorandum** set forth the administration's approach to executing PGII, highlighting infrastructure-related priorities that "will be especially critical for robust development in the coming decades: climate and energy security, digital connectivity, health and health security, and gender equality and equity."

In their joint communiqué, G7 leaders recognized the role multilateral development banks (MDBs) play in leveraging private capital in particular. The new G7 resource mobilization effort envisions joint action with the MDBs and other financing institutions to consolidate a pipeline of bankable projects, improve project preparation capabilities, and align support for policy and regulatory frameworks for sustainable infrastructure investments.

As international financial institutions, the MDBs provide loans and grants as well as technical assistance and policy advice- to low-income and middle-income countries to promote economic and social development. These institutions allow donor nations including G7 countries to share the cost of development interventions. MDBs are able to provide aid on a larger scale than many development cooperation agencies operated by individual countries such as USAID and Germany's GIZ.

The MDBs also set high standards for projects when it comes to environmental, social, and governance issues. They can act as a force multiplier too by crowding in financing from other public and private finance institutions when preparing loans for major infrastructure projects. MDBs also seriously consider a country's debt burden before approving loans (something not done by China in its overseas lending). In short, they promote high quality and sustainable infrastructure development in ways that complement and reinforce the PGII's objectives.

1 https://pm.gc.ca/en/news/statements/2022/06/28/g7-leaders-communique

The Biden administration has directed the U.S. Secretary of the Treasury to consult with other federal officials to develop a plan for engaging the MDBs to promote investment and increase private-capital mobilization for low- and middle-income countries, and coordinate with like-minded partners in the plan's execution. In addition, White House has pushed for the chief executive of the U.S. Development Finance Corporation "to develop a plan to enhance engagement with national and international development finance institutions," including MDBs, to mobilize private capital. These plans must propose actions to facilitate commercial financing to developing countries.

All G7 countries are shareholders in the major MDBs, namely the African Development Bank (AfDB); Asian Development Bank (ADB); European Bank for Reconstruction and Development (EBRD); Inter-American Development Bank (IDB); and the World Bank. Collectively, the G7 members, together with other traditional donor countries such as Australia and several Western European countries hold a large share in the MDBs. They entrust these institutions with large sums of capital for use in tackling economic, social, and environmental challenges in the developing world. G7 countries played a key role in raising $93 billion for the most recent cycle of the International Development Association[2] to assist the world's poorest countries to boost their economies and support their populations in the midst of multiple crises.

Given their substantial shareholdings in the MDBs, G7 countries can exert considerable influence on the decisions on MDB boards of governors and directors, particularly when they work in concert on shared interests. The MDBs are very well placed to advance progress on the key infrastructure-related priorities identified by the Biden administration in the context of the PGII and its focus on key issues including energy security, climate risks, digital connectivity, health and health security, and gender equality).

Climate change is a good example of multilateral consensus and cooperation. Eight leading MDBs committed $66 billion for climate finance in 2020. This figure was complemented by $85 billion in co-financing from public and

2 The International Development Association, more commonly known as "IDA", is the part of the World Bank Group that provides development assistance to poor countries. It provides zero to low-interest loans and grants to these countries for projects and programs to increase economic growth, reduce inequalities, and raise living standards.

private sources. The MDBs have substantially boosted their funding of climate adaptation and mitigation projects in recent years, and have identified climate action as a priority in their plans for the coming years." The ADB has teamed up with the Green Climate Fund to support the ASEAN Catalytic Green Finance Facility, which aims to mobilize more than $4 billion in public and private financing for green infrastructure projects across Southeast Asia. The bank has also partnered with other international donors to provide financing for the restoration, conservation and management of coral reefs in Fiji, Indonesia, the Philippines and the Solomon Islands.

Knowledge, and Strategies to Meet This Critical Challenge

On energy security, the MDBs have long been major funders of energy projects and have increasingly promoted renewable energy in their portfolios. For example, the ADB recently approved a $600 million loan to Indonesia's state-owned power company to improve the reliability and resiliency of electricity services on the island of Java, and to promote the use of clean energy. The EBRD has put together a $74 million financing package to construct the largest renewable project in Central Asia, a greenfield wind power plant in the Navoi region of Uzbekistan.

The ADB, Japan International Cooperation Agency, and the International Finance Corporation, the private sector arm of the World Bank Group, are among those contributing funds to the Uzbek project. The EBRD has also brought in Natixis, a leading French corporate and investment bank, providing a recent example of how the MDBs generate project co-financing from the private sector.

The MDBs are also investing to promote digital connectivity, as highlighted in a joint **report** published earlier this year by five MDBs. The report observes that "MDBs have assisted developing economies to adopt new digital technologies and harmonized procedures and practices to expand trade; strengthened regional public health; increase South-South learning and technology sharing; and contributed to making tourism safe, more inclusive and greener." The IFC alone made a record $1.3 billion in investments in telecommunications, media and technology during the last fiscal year. This amount represented a five-fold increase in digital infrastructure commitments by the institution over the past five years.

MDBs have traditionally provided much more financing for hard, physical infrastructure projects than projects in the social sectors. But these institutions have typically responded with robust lending and grant packages in the wake of health emergencies, as has been the case during the COVID-19 pandemic. For example, financing for health accounted for around 3 percent of the ADB's total **commitments** in 2019. In 2021, the share of health commitments soared to about one-quarter of the bank's business. Although the Manila-based institution is unlikely to dedicate such a large share of its overall financing to health over the remainder of the decade, it intends to give much more support than before the pandemic to helping Asian and Pacific developing countries achieve universal health coverage, and prevent and contain communicable and non-communicable diseases.

Many developing countries see the MDBs as an important source of health-related financing and technical assistance. In June 2022, the World Bank approved the establishment of a financial intermediary fund to support pandemic prevention, preparedness, and response, with a focus on low- and middle-income countries. The fund, which will complement existing resources of the World Bank, has received more than $1 billion in financial commitments from charitable foundations and governments, including Germany, the United States, and the United Kingdom.

All of the leading MDBs have policies to integrate gender action across their operations and track their gender-related impacts. Proposed loans are examined for their potential impact on girls and women, and performance is closely tracked. In May 2022, the MDBs held a Global Gender **Summit** on how to advance gender equality after the pandemic, with a focus on the care economy, climate change, and digitalization.

The World Bank houses the Women Entrepreneurs Finance Initiative (WE-FI), a financial intermediary facility that brings together several MDBs and 14 governments, including most G7 countries. Launched five years ago, WE-FI has allocated $354 million to address financial and non-financial constraints faced by women-owned and women-led enterprises in developing countries. Activities are planned in 60 countries, mostly low-income and fragile states. It is expected that 200,000 enterprises will be reached through the facility. WE-FI has mobilized an additional $3.5 billion (achieving a remarkable leverage ratio of 1:10) to improve enabling environments and access to finance, markets, training, mentoring and networks for women entrepreneurs.

How to enhance the effectiveness of MDBs in infrastructure development

The MDBs already play a major role in financing and building essential capacity in the priority areas targeted by the PGII. They have been able to do so with the strong political and financial support of G7 countries. Yet more support will be needed for the MDBs to effectively leverage their valuable comparative advantages to help achieve the PGII's massive infrastructure financing target. In particular, there are four key areas in which MDBs can substantially boost their contributions over the coming years, namely: project preparation, attracting institutional investors, making more effective use of their current capital, and their base capital

Improve Project Preparation

One of the reasons for bottlenecks in infrastructure investment in developing countries is the lack of well-prepared projects where risk allocation meets the requirements of those providing the financing. Attention therefore needs to be paid to critical aspects of project preparation, such as financial metrics, compliance with performance standards, cash flow generation, technical engineering, risk allocation, and the quality and the capacity of the operations, maintenance and management teams.

There are numerous MDB initiatives that aim to improve project readiness on a national or regional level. One example is the NEPAD Infrastructure Project Preparation Facility Special Fund, for which AfDB was assigned the role of trustee. The fund, launched with support from several donors, including four G7 countries, provides grant resources for the preparation of regional infrastructure projects in Africa.

In the Asia and Pacific region, ADB provided a $100 million loan to the Philippines to help identify, analyze, and plan for infrastructure gaps in roads, urban transport, urban water, sanitation, and flood sectors. The facility enabled Filipino government departments responsible for public works and transport to engage international expertise for the preparation and implementation of complex and priority infrastructure projects.

By bolstering MDB efforts to provide capacity building and technical assistance for project preparation, G7 would help to expand the range of credible infrastructure opportunities for investment. Ramped up support to reforms leading to more predictable regulatory environments and strengthened rule of law would also create conditions more conducive to business investment.

Attract Institutional Investors

The development policy world has been talking for many years about the need to tap institutional investors, such as pension funds and insurance funds, to substantially scale up financing available for infrastructure in low- and middle-income countries. Pension funds alone manage **$54 trillion** globally. Institutional investors are eager to expand their exposure to the developing world if the conditions are right. The Ontario...

MDBs have improved their leverage of institutional investment in the last decade. The IFC offers an innovative example for unlocking private capital for direct lending to borrowers in developing countries through its Managed Co-Lending Portfolio Program.

The program allows institutional investors to provide capital alongside IFC on commercial terms in globally loan portfolios that mimic the IFC's portfolio. Investors establish loan eligibility criteria and portfolio concentration limits with the IFC, and then pledge capital. When the IFC identifies eligible transactions, financing from investors is allocated together with the IFC's own loans. Through this program, the IFC has raised more than $10 billion in collaboration with a dozen partners to steer capital to assets that it has originated.

Notwithstanding the success of this initiative, MDBs have yet to mobilize very large pools of institutional investor capital. A variety of obstacles have yet to be overcome. Constraints specific to less liquid investments, regulations, actual and perceived risks in the political, regulatory, economic spheres are some of the key concerns. Investor mandates and the capacity to understand of developing country markets are also roadblocks to unleashing private capital. There is also the aforementioned issue of a lack of high-quality projects ready to receive investment.

With growing attention to environmental, social and governance considerations and limited room for growth in mature markets, institutional investors are open to increasing their exposure to large infrastructure projects in more challenging country contexts, so long as the conditions are right. One thing that MDBs could do is adopt more pooled investment approaches to diversify risk. New financial products could be introduced to cater to the varying risk appetites of different institutional investors.

The Organization for Economic Cooperation and Development has **recommended** several actions to mobilize institutional investors for sustainable development. Among them: make investment regulations more flexible in countries hosting sizable pension funds and insurance companies, encourage greater institutional asset allocation towards developing countries, increase availability and incentives for blended finance to reduce deal risk, and enhance transparency of asset distribution by institutional investors.

Given their decades of experience in preparing and financing infrastructure projects in developing countries, the MDBs are natural partners for institutional investors seeking to diversify their investments toward what they consider more frontier and emerging markets (as shown by the IFC example). G7 countries should take a more active role in promoting and facilitating cooperation between the MDBs and institutional investors.

Improve Use of Existing MDB Capital

The way that MDBs are structured and operate, and the high credit ratings of their sovereign shareholders, enable these institutions to borrow from world capital markets at comparatively low rates. MDBs use the relatively cheap funds generated through bond issues to on-lend to borrowing governments at lower rates than those governments could access on their own. Leading credit rating agencies continue to award the MDBs very high ratings because they maintain low risk profiles. (MDBs also rely on member contributions, earnings from lending operations, and repayment of loans).

MDBs are intent on keeping these high ratings (typically AAA), and thus operate in a very conservative fashion. They keep relatively high levels of capital, which sacrifices room for further lending to support critical development interventions. On average, MDBs' available statutory **headroom** is generally four times larger than their headroom based on their prudential limits.

Independent **analysis** of the benefits and costs of expanding and optimizing MDB balance sheets suggests that the institutions could increase their lending by hundreds of billions of dollars if they were to increase their lending exposure. To date, however, shareholders have been reluctant to allow MDBs to entertain slightly greater risks in their sovereign lending, and credit agencies continue to struggle with how to properly assess the true creditworthiness of public financial institutions that have certain advantages that are not enjoyed by private entities. Such MDB advantages include the ability to draw upon substantial callable capital from their shareholders, and the MDBs' preferred creditor status with sovereign borrowers.

There is growing pressure on MDB shareholders to revise their capital adequacy frameworks and engage credit agencies on changes that could be made to lending policies without sacrificing very high credit ratings. The G7 countries could play a constructive role by advancing this agenda. In the meantime, the MDBs continue to possess large and unexploited lending potential.

Inject More Capital into the Banks

Getting more out of the capital that they MDBs already have could greatly increase international funding for infrastructure finance. But changes to lending and credit review practices would be difficult to negotiate given the well-entrenched positions held by the management and shareholders of these institutions. Another means of increasing the resources that MDBs make available to developing countries is a general capital increase. Yet this path would also require delicate and complicated negotiations that require considerable political manoeuvering. That said, it has been accomplished many times over the years.

A general capital increase is an increase in contributions from all MDB shareholders. It leverages equity capital from shareholders to enable more lending. Shareholders only have to pay a fraction of their agreed contribution, with the largest part coming in the form of guarantees (callable capital). The MDBs are allowed to count callable capital as part of their resources and lend against it, even though, in practice, they never draw on it.

Although the shareholders of a few MDBs, such as the AfDB and the World Bank, have approved a general capital increase since 2018, the continuing high demand for their financing in an extended period of recurring and related crises translates into an eventual need for more resources at these and other MDBs. The AsDB and EBRD have not seen a general capital increase in over a decade.

Earlier this year, the boards of governors at IDB and its private sector arm, IDB Invest, mandated a proposal for a capital increase for IDB Invest. This would be accompanied by changes in the way that IDB Invest operates. The envisioned new model for IDB Invest involves the origination of projects with greater impact, more de-risking of private sector investment, and the use of new financial and technical tools to mobilize capital. This planned move should provide inspiration for capital increases at other MDBs, including at ADB and EBRD, which operate in an environment of growing expectations.

Climate change presents a serious threat to sustainable development, and the effort to tackle it will be won or lost in Asia given the continent's enormous population and booming economies. It is thus critical that ADB's shareholders provide the institution with more resources to leverage in supporting low- and midlle-income countries in the adoption of climate adaptation and mitigation measures. The EBRD is likely be called upon to ramp up its investment in the Ukraine to help that war-ravaged state rebuild and modernize after its ongoing war with Russia. Discussions should begin now on capital increases for these two banks, and G7 countries should take the lead with stated intentions to provide additional contributions.

In addition to supplying MDBs with more resources, G7 members should also support greater staffing of these institutions. During the COVID-19 pandemic, MDB personnel have been stretched to the limit while working to meet the urgent needs of beneficiary countries struggling with the major human and economic costs imposed by COVID-19 and its consequences. The MDBs need more experts in a variety of subject and functional areas to delivery vital support to social and physical infrastructure in the developing world.

The G7 countries have announced a very ambitious, time-bound plan to boost infrastructure financing in developing countries. To mobilize anywhere near the PGII target of $600 billion within the next five years, these global economic leaders will have to depend heavily on the MDBs, which have unparalleled expertise and geographic presence to finance, plan, and implement major infrastructure projects. To ensure the credibility of their major commitment, they must act boldly and quickly.

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