

INFRASTRUCTURE FINANCE—COLOMBIA AND FDN

Lessons on Infrastructure Lending from Colombia

The World Bank Group is shifting from lending to mobilizing third-party money by leveraging its financial and advisory resources, with the goal of moving from billions to trillions of dollars in development financing. The promising start to Colombia's 4G road project is evidence of the role that partnerships between governments and development banks can play in unlocking urgently needed infrastructure financing. The lessons learned from the 4G project will help similar partnerships replicate its success in other developing countries with adequate levels of domestic capital market development and similar challenges in infrastructure financing.

Underinvestment in infrastructure limits economic growth in emerging markets, and Colombia is no exception. The South American nation's economic potential and competitiveness are constrained by the poor quality of its national infrastructure. By some estimates it is more expensive to transport a container from an inland city in Colombia to a port than to send that same container from the port on to Asia. The World Economic Forum rates Colombia's overall infrastructure 84th out of 140 countries, and it is estimated that \$40 billion in infrastructure investment is needed across the country over the next ten years.

Colombia's narrative is typical of emerging markets, which collectively suffer from an annual infrastructure financing gap of as much as \$1.5 trillion. Bridging this deficit is at the heart of the Sustainable Development Goals established in 2015. Yet public investment alone is expected to be insufficient, raising the need for a public-private alignment to mobilize additional sources of finance.

FINANCING FOR INFRASTRUCTURE

Traditional sources of infrastructure financing—banks, governments, international financial institutions—cannot meet the financing needs enumerated above. Since the global financial crisis of 2008, structural weaknesses in the banking sector have led to deleveraging and

restrained credit growth. And new banking regulations have adversely affected the ability of banks to provide long-term financing. Governments and government funded financial institutions suffer from strained public finances and fiscal conditions and the distortions that government subsidized funding creates. The emerging long-term financing gap is particularly acute in the emerging-market infrastructure sector.

Meanwhile, over \$5 trillion of emerging-market pension and insurance assets need investment (about \$61 trillion when investors in developed countries are included). Globally, less than one percent of pension assets are invested in infrastructure. That is often for good reason, as infrastructure investments carry a higher risk and institutional investors usually lack the internal capacity to analyze and mitigate construction risk. Further, those investors are required to invest in rated instruments and to meet certain return benchmarks. Regulatory uncertainty, the lack of government support and political commitment, and meager project pipelines dilute their attractiveness. And a shortage of data and benchmarks on infrastructure project returns, as well as a general lack of transparency in the infrastructure sector, further chill investor interest.

But pension funds in particular, as a result of their long-dated liabilities in local currency, may be a good fit with the maturities and inflation indexation inherent in infrastructure assets that also typically require funding in local currency. Infrastructure tends to have a low correlation with traditional asset classes, and unlisted infrastructure (despite being illiquid) can be a beneficial source of diversification. Infrastructure investments produce long-term, predictable, and stable cash flows matching the need of pension funds for certain and low-volatility returns. The participation of pension funds in infrastructure investment also ushers in more transparency in the concession process and more thought toward risk mitigation and innovative investment structures.

On the menu of structures, infrastructure debt funds are an interesting, intermediated product to channel institutional capital. Such funds are a useful means of pooling local currency capital for the financing of projects that allow institutional investors to delegate construction and other commercial risks to professional managers while diversifying their investment in a portfolio of projects. Further, their existence, their visibility, and the scrutiny of their investment activities provides a valuable demonstration effect which can mobilize future investors into the infrastructure asset class.

THE CASE OF COLOMBIA

As a result of its mountainous geography and recent history, Colombia's infrastructure needs are concentrated in transportation. Transport investment is needed to connect areas of concentrated population and production with the country's key ports, a factor critical to Colombia's sustainable growth. To address this need, Colombia's government partnered with IFC and the Development Bank of Latin America (CAF) to create La Financiera de Desarrollo Nacional (FDN), a financial institution that catalyzes investment in Colombian infrastructure and addresses market failures that undercut optimal infrastructure financing.

FDN emerged out of the Financiera Energetica Nacional (FEN), an inactive state owned enterprise established to finance energy sector development. As such, FDN was essentially a start-up financial institution with an entirely new structure, operations, and corporate governance. In 2014 IFC and CAF acquired equity stakes, reducing the government's stake to around 65%, and FDN became a private sector entity no longer governed by the regulations and procedures applicable to state firms. FDN's board was expanded and the government's representation reduced—with even fewer seats in the future—as FEN-era corporate structures were rebuilt to give the government a passive voice.

FDN's mandate is to be the principal catalyst in developing the infrastructure finance market in Colombia. It will offer products and services that are critical to financing infrastructure—including long-tenor loans, subordinated debt, and credit enhancements—that currently absent from the local market. Its operations are intended to supplement, rather than compete with, existing structures through such products and services. And FDN's active presence and participation in transactions facilitates greater participation by local banks, domestic institutional investors, as well as foreign banks and international institutional investors.

FDN plays an important advisory role to market actors in addition to establishing market and industry standards. It offers expertise in project structuring, financing, and advisory services to domestic financial institutions as well as state and local governments. This not only strengthens the domestic market but promotes international best-practice. At the sub-national level in particular there is a strong need for advisory services around project structuring, design and execution of public-private partnerships, concession agreements, and project management. In fact, FDN has partnered with IFC to create a jointly-funded public-private partnership advisory facility that will focus on building public sector capacity.

As a nascent organization, FDN's metrics have yet to fully crystalize. It holds assets of \$228 million but its current financials represent the vestiges of FEN, since much of its ongoing work is only beginning to approach financial close. All products and services will be priced competitively according to the market, with project finance and fee-based advisory expected to meet current shortcomings in the Colombian market. Overall, FDN's activities are expected to not only transform the infrastructure finance sector but further develop and deepen Colombia's capital markets.

COLOMBIA'S ROAD INFRASTRUCTURE

In Colombia, infrastructure finance needs are met mainly by commercial banks and corporaciones financieras, which are nonbank finance companies. Both the increase in sector-concentration risk in the banking system and emerging regulatory constraints will restrict banks' ability to finance these programs. Therefore, the success of the transport infrastructure programs hinges on mobilizing institutional investors, mainly local pension funds, which not only have the capacity to invest in local currency but also benefit from the long tenors and inflation indexation inherent in toll-road assets.

FDN is aligned with Colombian government efforts to upgrade the country's road network. Known as the Fourth Generation, or 4G, road program, the government's toll road development program relies on a public-private partnership structure to improve and build over 7,000 kilometers of roads with an estimated capital expenditure investment of \$24.4 billion. As of February 2016, eight projects under the 4G road program had reached or were near preliminary financial close with an estimated FDN financing of approximately \$331 million. More important, FDN is expected to mobilize more than ten times as many resources for a total of \$3.7 billion.

Colombian pension funds, FDN, and IFC recently invested in the Colombia Infrastructure Collective Debt Vehicle (Infra CDV), the first infrastructure debt vehicle in Colombia, which will provide senior debt financing to greenfield and brownfield infrastructure toll-road projects in Colombia. The investment represents a milestone in the aggregation of efforts by the World Bank Group to deliver comprehensive solutions for infrastructure financing, leveraging investment, advisory, and treasury resources.

The impact of Infra CDV and FDN is best exemplified in the Pacifico 3 road project. Achieving financial close in February 2016, Pacifico 3 is an ambitious component of the 4G program: a 146 kilometer initiative with 26 bridges and six tunnels. FDN has committed \$66 million in credit enhancements through its liquidity facility, while mobilizing \$663 million. Critically, some 59 percent of mobilized funds will come from international capital markets and 28 percent from local financing.

These results highlight FDN's critical role in attracting international investors while also mobilizing more domestic resources. The first part of these funds will be issued as long-term debt financing of 19 years—shifting market tenors from medium to long-term, which will be the first debt financing in an international market tied to the 4G road program. It will also be the first 4G issuance with an investment grade rating, with a local rating of AA+ and international rating of BBB-. While the 4G road program is still in its early stages, FDN's presence is already beginning to reap dividends through the mobilization of diverse financing.

Over a longer time horizon FDN is expected to expand its scope to all segments of the infrastructure sector. These efforts will play a key role in promoting inclusive growth and enhancing competitiveness in Colombia. While domestic capital market development is complex and interrelated, the efforts of FDN to crowd-in local investment will help

deepen Colombia's markets and begin to provide financial products that were previously scarce.

LESSONS LEARNED

1: Governance is key.

It is important to bear in mind the challenges to FDN's launch when considering replication. First and most important, such institutions must maintain operational autonomy and the ability to operate commercially even as government retains a large shareholder presence. In FDN's case this was achieved through an expansion of the board and a reduction of government representation on it, while initiating a competitive hiring process for upper management.

2: Public sector support is critical for successful implementation of public-private partnerships and capital markets solutions.

The government of Colombia has introduced a number of institutional and regulatory changes to promote the development of the infrastructure sector with private sector participation, improving the public-private partnership framework and providing government guarantees and project support.

Further, the government has implemented regulatory changes to allow pension funds to invest in this asset class through infrastructure-debt funds, making these the only vehicles through which pension funds can invest in infrastructure debt. While infrastructure funds have existed for a long time, usually in the form of equity-sector funds or specialist private equity funds (such as energy), infrastructure-debt funds were specifically allowed as an asset class for pension funds.

And the 4G Program benefits from availability payments from the government, top-up payments in the event of lower-than-projected toll revenue, and termination payments for early termination of concession contracts, all of which reduce investor risk. The concession framework was designed by IFC's infrastructure advisory group and provides a clear allocation of risks to both the public and the private sectors, with performance incentives for the private sector.

3: Successful mobilization requires close collaboration with institutional investors in structuring a new asset class.

IFC played an important role in bringing core institutional markets to the table and negotiating a deal that imparts sound risk management with structuring expertise, project finance, and sustainability standards in an innovative way. IFC worked with the pension funds, visiting their offices and explaining IFC's recommendations on structure and commercial terms. In particular, IFC spent time explaining the

environmental and social provisions and how they served as a risk mitigation mechanism, especially in infrastructure investing. IFC is the only investor of global scale with substantial infrastructure expertise, and pension funds derived comfort from this. Via this project, IFC successfully contributed to creating an active financing market for public-private partnerships to deliver key infrastructure. IFC's valued role resulted in a mobilization fee for its efforts.

4: Collaboration is critical when pushing the envelope.

Colombia was one of the first countries selected for a capital markets deep dive in 2013 by the World Bank Group, combining all relevant Bank Group entities focused on capital-markets development. WBG's unique strengths and abilities in working and collaborating across sectors and disciplines can bring the best global development experts together to solve particular development challenges. ■

Meera Narayanaswamy, Senior Investment Officer, Financial Institutions (MNarayanaswamy@ifc.org); Jordan Townswick Pace, Research Assistant, Office of the Chief Economist – Thought Leadership, (jpace1@ifc.org).