

Capital market instruments to mobilize institutional investors to infrastructure and SME financing in Emerging Market Economies

Report for the G20



Disclaimer

This report has been prepared by staff of the World Bank Group (WBG), the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD). The views expressed therein do not necessarily represent the views of the corresponding organizations.

Table of Contents

| | |
|--|----|
| EXECUTIVE SUMMARY | 6 |
| I. INTRODUCTION AND BACKGROUND | 15 |
| Why the need | 15 |
| Where the potential might be | 17 |
| The instruments to mobilize institutional investors in EMES | 17 |
| The structure of this Report | 18 |
| II. INSTITUTIONAL INVESTORS IN EMES..... | 20 |
| The importance of institutional investors | 20 |
| Portfolio composition of institutional investors | 25 |
| III. INSTRUMENTS TO MOBILIZE INSTITUTIONAL INVESTORS TO INFRASTRUCTURE FINANCING | 28 |
| IV. INSTRUMENTS TO MOBILIZE INSTITUTIONAL INVESTORS TO SME FINANCING | 46 |
| Instruments to provide SMEs access to capital markets | 52 |
| Instruments to refinance SME lenders | 55 |
| V. KEY PRECONDITIONS AND CHALLENGES AFFECTING THE DEVELOPMENT AND USE OF THESE INSTRUMENTS IN EMES | 62 |
| Challenges affecting the enabling environment..... | 62 |
| Challenges affecting the availability and offering of the instruments..... | 65 |
| Challenges affecting institutional investors' demand for these instruments..... | 73 |
| VI. THE ROLE OF GOVERNMENTS AND MULTILATERAL DEVELOPMENT BANKS..... | 78 |
| The need for an integrated strategy..... | 78 |
| Delineation of responsibilities in developing and implementing the strategy | 79 |
| Developing risk-sharing mechanisms | 81 |
| The need for coordination..... | 82 |
| VII. CONCLUSIONS AND RECOMMENDATIONS | 84 |

Executive Summary

This Report seeks to identify key capital markets instruments that can help mobilize institutional investors to infrastructure and small and medium enterprises (SME) financing in emerging market economies (EMEs)¹. EMEs face financing gaps in infrastructure and SMEs that if not addressed can stifle growth and affect shared prosperity. On the infrastructure side, it is estimated that an additional US\$1 trillion to US\$1.5 trillion of annual investment in low and middle income countries will be required through 2020 to meet the infrastructure demand from industry and households. On the SME side, the credit gap for formal SMEs in EMEs was estimated at \$0.9 to 1.1 trillion as of 2013. Another \$0.5 to 0.6 trillion represented the credit gap for the estimated 60 to 70 million formal microenterprises in EMEs.

Traditional funding sources will not be sufficient to meet these financing gaps. Fiscal consolidation and the sheer size of the funding gap constrain the capacity of many EMEs governments to directly address the infrastructure financing gap. At the same time the appetite of banks to provide funding for infrastructure financing is being affected by both transitory factors such as the deleveraging process in Europe, and permanent factors, in particular the new Basel requirements. On the SME side, the crisis has led to an active debate about the importance to broaden the range of financing instruments available for long-term credit for SMEs, beyond banks. In this context, institutional investors² have shown significant growth and have the potential to contribute to bridging the financing gap. However, their current level of investment in these two strategic sectors is limited due to complex set of issues, including the need to develop instruments that cater to their risk-return appetite.

The focus of this Report has been on fixed income instruments that could be help mobilize domestic institutional investors in EMEs. For many EMEs the role that capital markets can have in bridging the financing gap in strategic sectors is determined by their domestic institutional investor base, given its size and importance vis-à-vis other investors. In this context, fixed income instruments are likely to be a better fit for the appetite of a broader range of institutional investors in EMEs as they have the potential to deliver long cash flows with attractive yields but with less volatility than equity investments. However, the role of equity financing must be acknowledged.³ The analysis relied on a qualitative and conceptual approach, drawing from our experience to gauge current use of these instruments, challenges faced by EMEs to develop such instruments and potential lessons from relevant experiences in both EMEs and advanced economies (AEs).

The experiences found show that traditional funding sources remain key to the financing of both infrastructure and SMEs in EMEs; however capital markets and institutional investors, in particular, can complement such financing. Thus, G20 countries and middle income countries, in particular those

¹ In this Report the term EMEs is used to encompass both emerging and developing economies.

² Throughout this Report, unless indicated otherwise, we define institutional investors as the 'traditional' institutional investors: pension funds, insurance companies, and collective investment schemes (CIS).

³ The G20 could consider a separate report on the role of equity to mobilize investors to infrastructure and SME financing.

with a wide institutional investor base, should make a priority the development and implementation of actions plans to effectively mobilize institutional investors to these sectors in the shorter time frame possible. Table 1 provides a summary of fixed income instruments that could be used for infrastructure and SME financing, their current use and assessment of potential.

- **On the infrastructure side**, the challenge for EMEs lies in addressing the disconnect between the theoretical appeal of this asset class and the current low levels of investment by institutional investors, so that their potential can be realized. In this context, bank lending currently appears better suited to provide financing to greenfield projects. Given the importance of greenfield infrastructure for EMEs the key challenge and opportunity resides in finding ways to integrate such source of financing into a strategy that allows banks to offload loans into capital markets instruments that could appeal to institutional investors, once they mature, thus freeing capital that can then be reinvested into greenfield projects. Project bonds and infrastructure debt funds appear to be well suited for this, provided that appropriate risk sharing mechanisms are designed. Sukuk appear to have similar potential, but catering initially to Islamic institutional investors. That said, in many EMEs there is also a need to enhance and/or expand existing infrastructure. All such capital instruments are well suited to directly finance brownfield infrastructure.
- **On the SME side**, the characteristics of SMEs (small, informal, with limited ability to provide information suited to capital markets) make them better suited for bank lending and complementarily for asset based lending by trade partners. Therefore working on enhancing the quality of SMEs so that they can access bank loans should remain the key priority of EMEs. However, the experiences show that institutional investors can play a key role in SME financing mainly by providing financing to SME lenders, thus ensuring that a steady flow of funding from SME lenders remains available to SMEs. In the short to medium term such refinancing will continue to take place via plain vanilla instruments, mainly corporate bonds. As markets develop the challenge and opportunity will also lie in finding additional ways to integrate bank and asset based lending with capital markets, such as securitization or fund structures into which SME loans, receivables or other SME related assets can be offloaded. Risk sharing mechanisms will also be key. However, that is more of a long term endeavor. The role of institutional investors as direct providers of funding to SMEs via SME issuances appears to be much more limited, with focus being on the larger, more formal SMEs.

However, in many EMEs the role of institutional investors in bridging the financing gap in these sectors has not yet fully materialized, as they face important challenges for the development of key capital market instruments. Nevertheless it is important to mention that some of these instruments are already being used in some EMEs, which provides valuable evidence of the role that capital markets can have in infrastructure and SME financing, if challenges are addressed. To a large extent, the existence of challenges is a reflection of the level of development of capital markets in many EMEs, which affect the preconditions necessary for the development of these instruments. In this regard, many EMEs still face

challenges that affect (i) the enabling environment, (ii) the availability and offering of the instruments and (iii) the demand of institutional investors for them, as summarized below.

- *Challenges affecting the enabling environment:* These include challenges (i) related to the state of development of the fixed income markets, in particular the lack of a deep and liquid government yield curve with long-dated maturities, of well-functioning money markets, of credit rating and research analysis services and of robust market infrastructure, including payment systems, central securities depositories and custodians; and more generally (ii) challenges in the macroeconomic environment, the tax framework, and the rule of law in particular in connection with creditors' rights and the quality of regulation and supervision of securities markets.
- *Challenges affecting the availability and offering of the instruments:* They mainly relate to (i) the lack of a robust pipeline of high quality investable assets, whether infrastructure projects or SME related assets; (ii) limitations in the legal and regulatory framework for the instruments themselves, in particular the frameworks for securitization and closed-end funds, (iii) in the offering regime through which they can be placed, including challenges related to the robustness of the information given to investors and intermediaries such as asset managers to assess the risks involved, and (iii) the economics of the transactions, as at least in the short term some of the instruments might not be financially viable.
- *Challenges affecting institutional investors' demand for these instruments:* They mainly relate to (i) rigidities and misalignment of incentives in the investment framework of institutional investors that limit their investment in "alternative" assets and incentivize short term investment, (ii) compounded by the limited risk-analysis capacity of many of these investors in EMEs and (iii) the lack of mechanisms to align their risk-return appetite, in particular, the absence of regulatory guidelines or industry standards that identify simple, transparent and comparable structures that could facilitate investors' understanding of the risks imbedded in the instruments, and the absence of risk sharing mechanisms such as guarantees.

In some EMEs these challenges are compounded by the limited size of the institutional investor base. While domestic institutional investors have grown across EMEs, this growth has not been even. In general, a sizeable institutional investor base does not exist yet in low income countries; thus limiting the role of capital markets. In contrast, that role would be greater for middle income countries, where domestic institutional investors have already reached significant size, both in absolute terms and vis-à-vis the size of the economy. There is no pre-determined cut-off size. Valuable examples of the role of domestic institutional investors have been found in middle income countries such as Costa Rica, and El Salvador, whose capital markets could be characterized as "modest" in terms of size and level of development. In contrast, for a smaller subset of EMEs, such institutional investor base may also comprise foreign institutional investors. In general such a subset of countries corresponds to the larger EMEs that exhibit a strong macroeconomic environment, and higher level of development of their financial markets. Finally, also for a subset of EMEs, the investor base would comprise of sovereign

wealth funds. All this suggests that the analysis of the actual role of capital markets must be conducted on a country by country basis.

This Report provides a set of recommendations that can be used by EMEs governments to develop actions plans aimed at mobilizing domestic institutional investors to infrastructure and SME financing, as part of a broader strategy to address the financing gap in these two sectors. These plans in turn should be well linked with the more general strategies for capital markets development. Table 2 summarizes such recommendations. Overall the actions recommended aimed at strengthening the preconditions necessary for these instruments to develop, by ensuring that an enabling environment is in place and that the supply and demand side challenges identified earlier are addressed. It is important to highlight, however, that any expansion of institutional investment in infrastructure and SMEs should be aligned with their mandates and fiduciary duties. To this end, the recommendations also underscore the importance of robust regulatory and supervisory frameworks being in place, and the need for institutional investors in EMEs to enhance their risk analysis and risk management capacities. Further, active supervision from the financial supervisory authorities is needed to ensure that any emerging and systemic risks are identified early on and addressed.

As challenges are country specific, the list of recommendations is intended to serve as guidance that country authorities must tailor to their specific circumstances, including the type of investors that they want to target. The list of recommendations is most useful for middle income countries where the institutional investor base has already achieved certain minimum size and importance. The key for these countries is to work in parallel on addressing the challenges identified in different areas so that the potential of capital markets can be realized in a shorter timeframe. In this regard, while EMEs governments should continue to give priority to the development of a pipeline of investable projects and to actions to enhance the universe of “bankable” SMEs, they should also made progress on the remaining challenges that affect the supply side as well as on demand side constraints, to speed up the mobilization of institutional investors. In the case of low income countries, the recommendations could serve as a long term working plan. For them, working on the enabling environment should be the priority; while the other sets of recommendations would become more important as the institutional investor base develops.

The development and implementation of the corresponding strategies and action plans will require strong leadership and accountability. The challenges are complex and the implementation of actions to address them would require the participation of a variety of public entities and private sector participants. Thus, it is critical that a clear line of accountability be established by charging a high level government authority with the responsibility for the development and implementation of the strategy. Further, the constitution of high level committees with broad representation of key stakeholders to provide advice, ensure proper consultation and buy-in is recommended. Finally EMEs government should commit to report to the public, on a periodic basis, on progress with the implementation of such strategies and action plans.

Multilateral development banks (MDBs) have an instrumental role to play supporting EMEs governments in the articulation and implementation of such strategies, by offering advice, providing risk-sharing mechanisms, participating in the structuring and underwriting of the instruments and even serving a catalytic role with their participation in strategic transactions. In this regard, it is critical that they be in a position to provide an integrated solution to EME governments, where all types of services (whether advisory or direct market operations) are aligned to achieve this common objective of mobilizing institutional investors to infrastructure and SME financing, and designed to support and complement each other. In this context they should also continue to reassess the instruments through which they have provided support to infrastructure and SME financing, and develop strategies that integrate the use of both banking and capital markets solutions in ways that ensure the optimal use of all types of funding.

There are benefits to the sharing of experiences and the leveraging of efforts of both governments and international organizations including MDBs. For this, it is crucial for new instruments and risk sharing arrangements to be developed and tested across different countries, and the lessons could benefit EMEs as a whole. Different platforms have been recently created that would enable the sharing of such experiences, but also leverage the technical expertise and financial muscle of different participants, such as the Africa 50 Fund, the Global Infrastructure Facility (GIF) and the Global Infrastructure Hub (GIH) on the infrastructure side and the SME Finance Forum on the SME side. They are all relatively new, and thus it is still early to assess the impact that they will have. Such platforms could, along with other international groups and organizations already engaged on these topics, periodically inform the G20 on good practices and valuable experiences that have the potential to be replicated across EMEs. Relevant regional and international organizations, including MDBs could also share relevant experiences in the context of the IFI group (ADB, AfDB, EBRD, IADB, IMF, OECD, WBG) and their diagnostic framework for local currency bond markets (LCBMs) development. When appropriate, further dissemination through seminars and workshops could be considered.

Table 1: Assessment of Potential to Mobilize Institutional Investors in EMEs

| INFRASTRUCTURE FINANCING | | | | | |
|--|---|--|--|--|--------------|
| Instrument | Examples of actual use of the instrument in EMEs | | | | Potential |
| Project bonds | Used frequently in Latin America, mainly in Brazil, Chile, Mexico and Peru. There are also recent examples of individual issuances in Kenya, Russia and South Africa. | | | | |
| Infrastructure debt funds | Examples in India, Peru and South Africa. Colombia is currently considering them. | | | | |
| Sukuk for infrastructure | Examples concentrated in Malaysia and the Gulf Cooperation Council (GCC) countries, performing closer to corporate bonds than project bonds | | | | |
| SME FINANCING | | | | | |
| Instrument | Examples of actual use of the instrument in EMEs | | | | Potential |
| Bond issuances by banks | Several examples across all types of EMEs. In fact banks are among the main issuers of corporate bonds across all EMEs | | | | |
| Bond issuances by other SME lenders | Examples across a number of EMEs, including China, Colombia, Guatemala, India, Kenya, Mexico, Morocco, Peru and Turkey. Most cases involve microfinance institutions. However in a few countries leasing and factoring companies are also recurrent issuers | | | | |
| Bonds issued by SMEs via alternative markets | Examples in China and Peru | | | | |
| Bonds issued by SMEs via private placement | Examples across many EMEs, including Brazil, India, Malaysia, Peru and Turkey; but linked to larger SMEs | | | | |
| SME bond funds | One example in Peru, where a SME debt fund was recently created to invest in companies that issue bonds in the SME alternative market | | | | |
| SME funds based on receivables and factoring | Examples in Chile and Peru mainly related to factoring and reverse factoring | | | | |
| SME covered bonds | A few issuances of covered bonds with SMEs as collateral have taken place in Turkey | | | | |
| SME loan securitization | A few examples in particular in India and Korea, and more recently in China, with the securitization of the portfolio of loans of Alibaba | | | | |
| SME loan funds | No examples known so far | | | | |
| Color Coding | Proven potential across a wide range of EMEs | | | | No potential |

**Table 2: A Blue Print for Mobilization of Institutional Investors for
Infrastructure and SME financing in EMEs⁴**

| Key outcomes | Key areas | Key actions and recommendations |
|--|---------------------------------------|--|
| Ensuring commitment from the government and market participants | General | Appoint a high level governmental authority to lead efforts and constitute a high level committee with public and private sector representation to provide advice, and ensure consultation and buy-in of key stakeholders |
| | | Develop a national policy and a comprehensive strategy for infrastructure and SME financing, which should be appropriately linked with the national strategy for capital markets development. Such strategies should include concrete action plans, including when appropriate, for the mobilization of institutional investors to infrastructure and SME financing. |
| | | Prepare periodic reports on progress with the implementation of the strategy and corresponding action plans and make them public |
| Ensuring that the enabling environment is in place | Well-functioning fixed income markets | Continue developing the government yield curve and money markets |
| | | Continue encouraging the establishment of credit rating agencies and/or further strengthening their regulation and supervision, and of debt analysis services |
| | Investment climate | Continue encouraging the development of robust market infrastructure, including payment systems, central securities depositories and custodians. |
| | | Ensure macroeconomic stability, a neutral tax treatment of vehicles used and more generally a clear and stable tax framework, a robust framework for creditors' rights and robust regulation and supervision of capital markets |
| Ensuring availability of instruments | Supply of underlying assets | Develop (i) a robust pipeline of investable infrastructure projects, by working on identifying key strategic projects, and conducting the necessary feasibility analysis and (ii) robust legal and institutional arrangements for PPP including (iii) standardized PPP contracts and (iv) bidding procedures that put on equal footing banking and capital markets financing |
| | | Work on expanding the universe of bankable SMEs mainly by (i) improving credit information, (ii) allowing the use movable collateral supported by the constitution of the corresponding collateral registries, (iii) enhancing SME skills for accounting, financial and risk planning, and (iv) improving SME corporate governance and quality of investment projects. |
| | Legal and regulatory | Encourage the development of multi-origination platforms or multi-origination instruments for SME related assets |
| | | Complete the securitization and CIS frameworks, in particular (i) ensure the existence of robust vehicles that |

⁴ See also G/20/OECD *High level Principles for Long Term Investment Financing by Institutional Investors* and the G/20/OECD *Checklist on Long Term Investment Framework Strategies and Institutional Investors*. *Local Currency Bond Markets- A Diagnostic Framework* also provides an important reference point.

| | | |
|---|--|---|
| | framework for the instruments | are bankruptcy remote, and (ii) clear but flexible rules in connection with the eligible assets |
| | Offering regime | Develop a regime for offers addressed to qualified investors which (i) simplifies regulatory requirements, (ii) but ensures that such investors have mechanisms to avail themselves with sufficient information about the offering initially and on a periodic basis, the latter in particular by encouraging the development of standardized disclosure requirements, including on fees in the case of fund structures |
| Ensuring demand by institutional investors | Investment framework for institutional investors | Reform investment regimes to allow alternative investments, and consider the creation of separate buckets at least for infrastructure |
| | | Review prudential frameworks and consider giving high quality assets a favorable regulatory treatment |
| | | Reform provisions that incentivize short term behavior, including benchmarks and rules that allow affiliates to move from one fund to another without penalties and within short periods of time |
| | Capacity of institutional investors | Establish strong governance and risk management requirements and encourage capacity building |
| Alignment of risk-return appetite | | Work on simple, transparent and comparable structures for different types of instruments |
| | | Support the development of risk sharing mechanisms, in particular guarantees that could be linked to capital market instruments. |
| | | Develop a framework for the provision of guarantees which should ensure that guarantees are (i) clear and transparent, (ii) financially sustainable, (iii) impactful, (iv) designed to mitigate moral hazard and (v) subject to periodic evaluations. |
| Leveraging global efforts | Ensuring dissemination of good practices and valuables experiences | Global platforms could, alongside other relevant institutions, periodically provide information to the G20 on good practices and valuable experiences that have the potential to be replicated across EMEs |
| | | Relevant regional and international organizations including the MDBs should share experiences in connection with instruments that allow to better leverage banking and capital market solutions in the context of the IFI group for LCBMs development. When appropriate, further dissemination through seminars and workshops could be considered |

I. Introduction and Background

This Report seeks to identify key capital market instruments that can help mobilize institutional investors to infrastructure and small and medium enterprises (SMEs) financing in Emerging Market Economies (EMEs⁵) and provide policy recommendations to facilitate their use.⁶ There is limited quantitative data available in this topic on EMEs. As a result, the approach taken in this report is qualitative and conceptual, drawing from our experience to gauge the current use of these instruments, the challenges that EMEs face to develop them and potential lessons from relevant experiences in both EMEs and advanced economies (AEs).⁷

Why the need

There is a huge gap in the quality and coverage of infrastructure in EMEs that if not addressed could stifle growth and affect shared prosperity. Such gap stems from a complex set of issues, from the limited investment in infrastructure in some EMEs that have left them with significant gaps in greenfield infrastructure to the rapid economic growth that others have experienced, along with migration and urbanization which have put pressure in existing infrastructure. Indeed in many EMEs the existing infrastructure base, including roads, port and utilities is not able to meet the demands of a growing population, with increased economic power. It is estimated that an additional US\$1 trillion to US\$1.5 trillion of annual investment in low and middle income countries will be required through 2020 to meet the infrastructure demand from industry and households. Electricity, water, and transport are expected to account for the bulk of future spending needs.⁸

Traditional sources of funding will not be sufficient to address this gap. Infrastructure in EMEs has mostly been financed directly by the government and other public entities, such as local governments

⁵ In this Report the term emerging market economies (EMEs) is used to encompass both emerging and developing economies.

⁶ This Report focuses on the instruments themselves. A forthcoming Note *on Risk and Return Characteristics of Infrastructure Investment in Low Income Countries* prepared jointly by the WBG and OECD will provide an in-depth view of construction risks.

⁷ Extensive research has been conducted by the OECD on infrastructure and SME financing in AEs. For infrastructure finance, see e.g. Della Croce, R., Yermo, J., (2013), *“Institutional investors and infrastructure financing”*, OECD Working Papers on Finance, Insurance and Private Pensions, No.36. Recent work on SME finance includes e.g. *New Approaches to SME and Entrepreneurship Financing: Broadening the range of instruments* and *SME Debt Financing Beyond Bank Lending: the Role of Securitization, Bonds and Private Placements* transmitted to G20 Finance Ministers and Central Bank Governors in February 2015; and *Financing SMEs and Entrepreneurs 2015. An OECD Scoreboard* transmitted to the G20 Finance Ministers and Central Bank Governors in April 2015. A synthesis note on the opportunities and constraints of market-based financing for SMEs was recently circulated to the G20 (2015). As a result, information on AEs would be included in summarized form and only when deemed relevant to gauge lessons and recommendations for EMEs.

⁸ Global estimates of future infrastructure financing needs through 2030 range from USD 50-70 trillion, of which about 37 percent is in to EMEs. This suggests that, on average, roughly USD 3 to 4 trillion in financing is needed annually. However, today just around USD 2.6 trillion are being spent annually on infrastructure. This estimate incorporates only infrastructure needs in road, rail, ports, airports, water and telecom development and excludes other costs such as schools and hospitals. See McKinsey Global Institute (2013), *Infrastructure Productivity: How to save \$1 trillion a year*.

and state owned enterprises, while private participation has been limited.⁹ However, the need for fiscal consolidation and the size of the funding gap makes it clear that stronger private participation in infrastructure is needed.¹⁰ So far bank loans have been the main source of funding of private participation. Nevertheless, additional funding channels will be needed to finance a stronger private participation as the capacity of banks to provide long terms loans is being affected by transitory factors such as the deleveraging process in Europe, and permanent factors, in particular the new Basel requirements. In this regard, it is expected that higher capital ratios, the Liquidity Coverage Ratio, and the Net Stable Funding Ratio, will affect long term bank lending, which includes infrastructure lending.¹¹

SMEs¹² also face a financing gap that if not met can affect economic growth and shared prosperity. Formal SMEs represent approximately 45 percent of employment and 33 percent of GDP in EMEs.¹³ However their potential to grow is stunted due to a complex set of challenges, both non-financial and financial. Some of the major non-financial obstacles are related to deficiencies in infrastructure (for example, access to electricity), the regulatory environment, taxation, and corruption. However, SMEs worldwide consider access to finance as one of their greatest obstacle to growth, with the credit gap for formal SMEs in EMEs estimated at \$0.9 to 1.1 trillion. Another \$0.5 to 0.6 trillion represents the credit gap for the estimated 60 to 70 million formal microenterprises in EMEs.¹⁴

Thus, there is an increasing need to explore mechanisms to expand current sources of funding. As in AEs, finance to the SME sector in EMEs has been predominantly in the form of bank lending. This is due

⁹ Private participation in the form of PPP in EMEs has been estimated at 20 percent. See Marian Maszoro, Gonzalo Araya, Fernanda Ruiz-Nuñez, and Jordan Schwartz (2015), *“Institutional and Political Determinants of Private Participation in Infrastructure”*, study published by World Bank.

¹⁰ Any public infrastructure is ultimately financed by either rate payers (who fund operating costs, utility of PPP debt service) and/or by tax payers (who fund government subsidies and the government’s debt service).

¹¹ It must be emphasized that it is still too early to make a definitive judgment on the effects of Basel III in long term funding. For one, Basel III is being phased in through early 2019, while ongoing changes to banks’ business models, and potential changes to the expected returns on infrastructure investments may offset some of the first-order effects emanating from the new Basel III-based regulations.

as it will be phased out in over eight years. Thus, the importance of further quantitative analysis as Basel gets implemented.

¹² There is no single definition of SMEs that can be applied globally. In general countries categorize companies based on a combination of factors, such as the number of employees, their turnover and/or the size of their balance sheet. The thresholds to define each category are highly dependent on the size of the economy and thus vary greatly from country to country.

¹³ Global Partnership for Financial Inclusion (GPII) and the International Finance Corporation (IFC) (2013), *“Small and medium enterprise finance: New findings, trends and G-20/Global Partnership for Financial Inclusion Progress”*, and IFC and McKinsey and Company (2010), *“Two trillion and counting: Assessing the credit gap for micro, small, and medium-size enterprises in the developing world”*.

¹⁴ SMEs also need financial services beyond credit, whether these are transaction accounts, insurance, payments services, or other products and services. Indeed, the potential deposits of SMEs in EMEs without bank accounts represent many billions of dollars. Equity finance is also particularly important for small businesses, especially early in their life cycle. IFC and McKinsey (2010), *Op. cit.*

to the high initial due diligence and ongoing monitoring costs of SMEs, relative to the size of credit demanded. Banks can have an ongoing relationship with SMEs and their owners and/or management, involving multiple financial products. This allows them to reduce such costs, or cross-subsidize them by selling other products or services. It is estimated that financing from banks accounts for approximately 50 to 70 percent of the external financing used to fund SMEs' investments in growth.¹⁵ However, the crisis has led to an active debate particularly in Europe but relevant to all financial markets, about broadening the range of financing instruments available for long-term credit for SMEs. Alternatives may enable better responses to the diverse needs of the SME sector, and reduce vulnerability to credit shocks.

Where the potential might be

Institutional investors have experienced considerable growth over the last decades and have sizeable capital that could potentially be invested in these strategic sectors. As of 2013, institutional investors in OECD countries alone had roughly \$80 trillion in assets under management (AUM), while EMEs accounted for another \$4-5 trillion as of 2012.¹⁶ However the reality today is that their investment in both sectors is very limited. It is estimated that less than one percent of their assets is invested in infrastructure (mostly brownfield), and very little in EMEs. The same applies to the SME sector-although quantitative data in this area is much more limited.

The focus of this Report is on domestic institutional investors given their size and importance vis-à-vis other investors in EMEs. It is important to acknowledge, however, that the investor base for a subset of EMEs could also comprise foreign institutional investors and sovereign wealth funds. While the recommendations in this paper would focus on mobilizing domestic institutional investors, most of them would also be relevant to attract these other classes of investors.

The instruments to mobilize institutional investors in EMEs

The limited investment of institutional investors in infrastructure and SMEs stems from a complex set of issues, including the need to design instruments that can cater to their risk-return appetite. This Report will explore key capital markets instruments that could facilitate their mobilization to these strategic sectors. It will focus on fixed income instruments as they are likely to be a better fit for the appetite of a broad range of institutional investors in EMEs, given their potential to deliver long stable cash flows with attractive yields but potentially with less volatility than equity options. The following instruments were targeted for analysis:

- Corporate bond issuances (by SMEs and SME lenders), including debt private placements,

¹⁵ GFFI and IFC, *Op. cit.*

¹⁶ Source: OECD for AEs data and Official sources and JP Morgan for EMEs data.

- Securitization structures (project bonds and sukuk¹⁷ on the infrastructure side and loan securitization on the SME side),
- Covered bonds (mainly for SME financing), and
- Debt funds (for infrastructure and SME related assets)¹⁸

The instruments listed above do not exhaust the universe of fixed income structures that can be used to mobilize institutional investors to infrastructure and SME financing. Significant innovation is taking place in product design that can potentially change the risks that institutional investors are willing to take and expand their investment in these two strategic sectors. However, other products are at a very early stage and thus it is difficult to assess the potential that they could have.

While this Report focuses on fixed income products, the role and importance of equity investment must be acknowledged¹⁹. Equity investment plays an important role in both infrastructure and SME financing. However, this type of investment, particularly private equity, caters mainly to global institutional investors and to the more sophisticated investors in EMEs;²⁰ but might not be well suited for a broader range of institutional investors in EMEs, which have a more limited risk appetite.

The structure of this Report

This Report is structured as follows:

- This Section explains the objective of this report and the scope of the work undertaken.
- Section II provides an overview of the size and importance of institutional investors in EMEs and their current portfolio allocation.
- Sections III and IV analyze key capital markets instruments that might help to mobilize institutional investors in EMEs to infrastructure and SME financing, and their current use in AEs and EMEs
- Section V explains the challenges affecting the development of capital markets instruments in EMEs.
- Section VI provides an overview of the role of governments and multilateral development banks (MDBs).

¹⁷ Technically sukuk is not a debt instrument; however in practice it can be structured in ways that perform closer to debt instruments. Thus, its inclusion in this Report.

¹⁸ Technically the units/shares of debt funds are classified as “equity” instruments. However, in practice they perform in a way similar to fixed income products, given that the underlying assets are credits.

¹⁹ Thus further analysis on the role of equity investment for infrastructure and SME financing would be valuable.

²⁰ For example, in the context of infrastructure financing, the OECD survey on large funds shows that the large funds from EMEs are much less invested in unlisted equity infrastructure compared to the global average. See OECD (2014 and 2013) “*Annual Survey on Large Pension Funds and Public Reserve Funds: Report on Pension Funds Long Term Investments*”.

- Section VII draws conclusions and offer recommendations about actions that EMEs will need to undertake to mobilize institutional investors to infrastructure and SME financing.

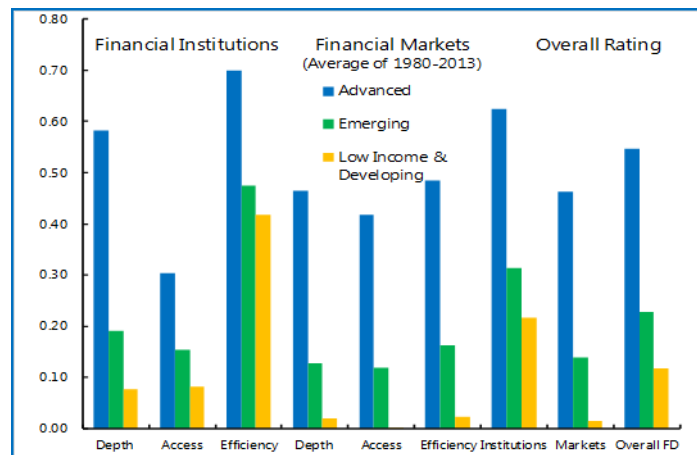
II. Institutional Investors in EMEs

The importance of institutional investors

Capital markets in EMEs have scope to play a stronger role in infrastructure and SME financing. Both banks and capital markets have a fundamental role to play in providing access to finance and supporting growth.²¹ However, evidence shows that EMEs generally lag AEs financial development by a wide margin

(Figure 1). Interestingly, EMEs are closer in development to AEs in terms of institutions than markets; which suggests the need for further capital markets deepening.²²

Figure 1: Financial Development Index: Peer Group Averages



Source: Sajay et al, 2015

The level of development of capital markets varies significantly across EMEs.

There is a high correlation between fundamentals, and in particular income level, and the level of development of capital markets. In general capital markets are at an incipient stage in low income countries, while they are more developed in middle income countries, albeit also with significant differences across countries.

There is also a basic sequencing, whereby government bond markets usually develop first, providing the foundations for other

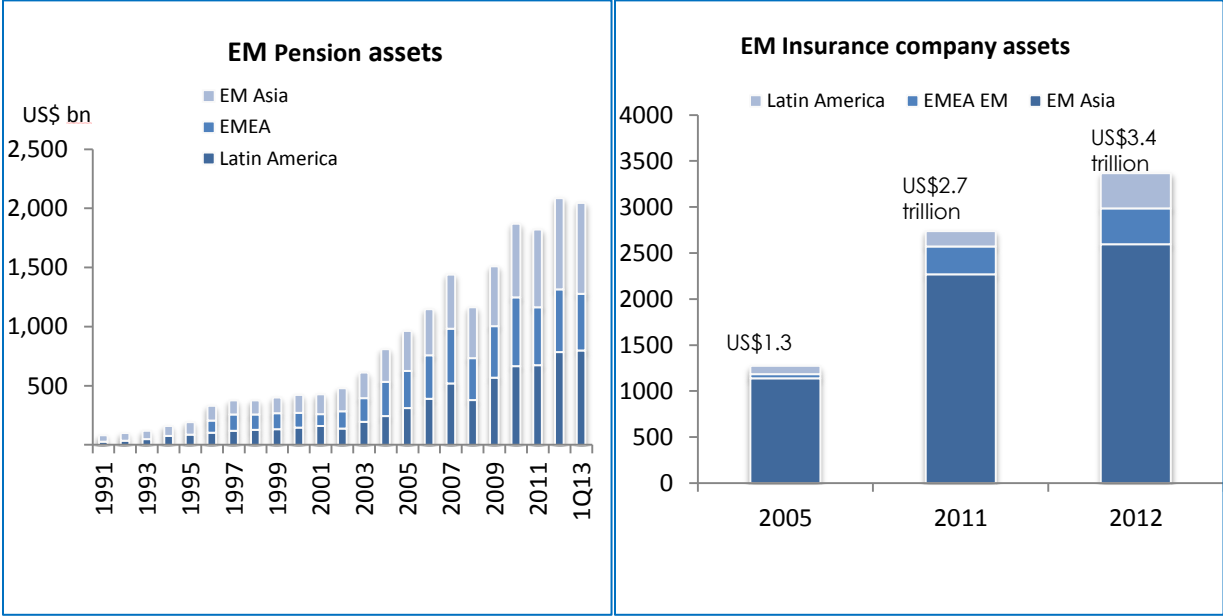
fixed income markets. In line with this sequencing, in most EMEs government bond markets exhibit higher levels of development, than other segments of the fixed income markets. To a large extent this correlation can be seen also in the investor base, as will be explained below.

²¹ While the empirical literature mostly corroborates the causal link from financial development to growth (King and Levine, 1993), more recent studies have shown that this link may turn negative at higher levels of development (Arcand et al (2012) and Sahay et al (2015). However, Sahay et al (2015) find that current EMEs financial systems have scope to grow before their contribution to growth turns negative. Financial development also contributes to economic and financial stability by lessening frictions and information asymmetries, promoting risk sharing and lowering the sensitivity of financial conditions to changes in the net worth of borrowers (Bernanke et al. (1999). See: Sahay et al (2015), "Rethinking Financial Deepening: Stability and Growth in Emerging Markets", IMF Staff Discussion Note 15/08 International Monetary Fund; Arcand, Jean-Louis at (2012), "Too Much Finance?" IMF Working Paper 12/161, International Monetary Fund; Bernanke, Ben at al (1999), "The Financial Accelerator in a Quantitative Business Cycle Framework," NBER Working Paper 6455, National Bureau of Economic Research; and King, Robert and Ross Levine (1993), "Finance and Growth: Schumpeter Might Be Right", the Quarterly Journal of Economics, 108(3), 717–37.

²² Recent work at the IMF establishes a comprehensive view of financial development, encompassing depth, access and efficiency. (Sahay et al, 2015).

In most EMEs the potential of capital markets to help address their infrastructure and SME financing gaps is determined by their domestic institutional investor base, mainly pension funds and insurance companies, due to their size and importance vis-à-vis other investors. Similar to AEs, domestic institutional investors in EMEs have experienced considerable growth, and they currently hold around USD \$4-5 trillion in assets (excluding investment funds).

Figure 2: Institutional Investors in EMEs



Source: Official sources and JP Morgan

The growth of pension funds has been spurred by pension reform in many EMEs. Mandatory pension savings systems have been introduced in many countries, particularly across Latin America (following Chile’s lead) and in Eastern Europe, while in other regions there has been a move from unfunded *pay as you go* schemes to fully funded pensions (such as for the large public sector schemes in some African countries). Demographics and economic development are also supporting the growth of pension assets. Pension fund assets in EMEs can be expected to increase from around USD \$2.5 trillion to USD \$17 trillion by 2050²³.

Assets of insurance companies in EMEs are also growing fast – an estimated almost three fold from USD 1.3 trillion to USD 3.4 trillion between 2005-2012, with BRICS countries and Asia being the main areas of growth.²⁴ Insurance penetration is rising from a low base in these countries and is high correlated with economic growth. Innovative products and delivery mechanisms are also drivers.

²³ Source: World Bank estimate.

²⁴ Source: J.P. Morgan Local Markets Guide (Oct 2013).

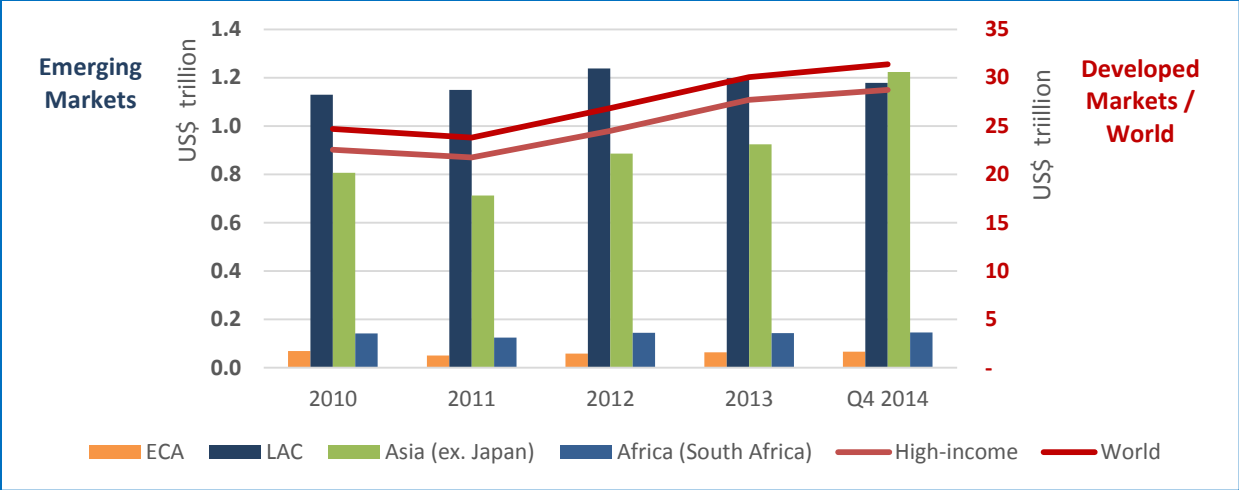
It must be acknowledged, however, that the size and importance of institutional investors varies significantly across countries. The growth of institutional investors has not been even across all regions and countries; rather, they are mainly located in Asia (predominantly China) and Latin America (Figure 2), but still with significant variation across countries even in the same region. In some EMEs the institutional investor base remains limited due to the lack of privately managed pension funds that are financed through mandatory contributions and an insurance industry heavily weighted towards the non-life sector.

Equally important is to note the composition of retirement savings across countries. EMEs with relatively young retirement systems have leaned more towards establishing defined contribution (DC) systems, as opposed to defined benefit (DB) systems. DC systems have a much different regulatory environment and investor circumstance than DB systems, thus the instruments available for long-term investment finance by retirement systems should be tailored to the composition of the local retirement savings base. For instance Chile's retirement system is 100 percent defined contribution based – project bonds could fit into DC plans, but illiquid infrastructure debt funds may face challenges. Korea's domestic retirement savings is split amongst DB and DC plans, making both vehicles feasible.

In most EMEs retail investors have not reached considerable size, which suggests that their potential to play a significant role in bridging financing gaps in strategic sectors is more limited. In general, in most EMEs retail investors do not have a strong presence as “direct” investors in the capital markets; although there are important exceptions such as China and India. In the majority of EMEs retail investment takes place in an indirect manner via collective investment schemes (CIS), in particular mutual funds (MFs). MFs have grown considerably in many EMEs over the last decade, in tandem with economic growth and the rise of a middle class; however with the exception of Brazil their size still remains small compared to MFs in AEs (Figure 3). Further, in most EMEs, their size and importance is much smaller than that of other institutional investors in the country.

However, CIS play an important role for institutional investors. In many EMEs institutional investors prefer to invest in particular asset classes via CIS, as they allow them to obtain scale and diversification, while transferring the selection and monitoring functions to a specialized manager. Thus, in this Report CIS would be looked at as another type of instrument that could help align the risk-return appetite of institutional investors with the needs for infrastructure and SME financing.

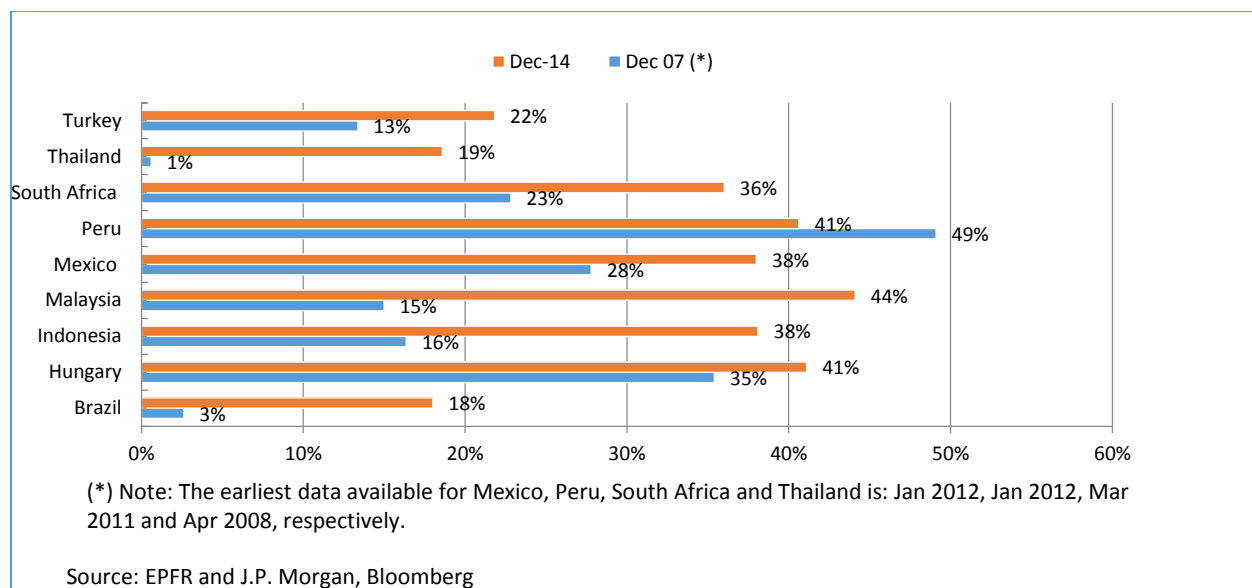
Figure 3: Mutual Fund Assets



Source: ICI, 2014

A subset of EMEs would be attractive to foreign institutional investors, which could suggest that in such countries they could potentially help to bridge the financing gap in infrastructure and/or SMEs. In this regard, there is a high correlation between the level of implementation of an enabling environment (including macroeconomic stability) and foreign investors’ participation in the capital markets. During the last decade the larger EMEs have been able to attract foreign investors to their government bond markets, some of them in local currency and in the domestic markets. Further, the presence of non-resident investors is at peak levels, with non-residents holding more than 40 percent of government debt in larger EMEs (Figure 4). The interest of foreign investors for other type of instruments from EMEs is much more limited. However, in recent years the largest companies from EMEs have also been able to tap foreign investors, and so have SPVs related to large infrastructure projects from a few Latin American countries; but in these cases issuances have usually been in the off-shore markets and in hard currency. This suggests that foreign investors are not likely to substitute the importance of domestic institutional investors, but could complement them.

Figure 4: Foreign Ownership of Local Debt

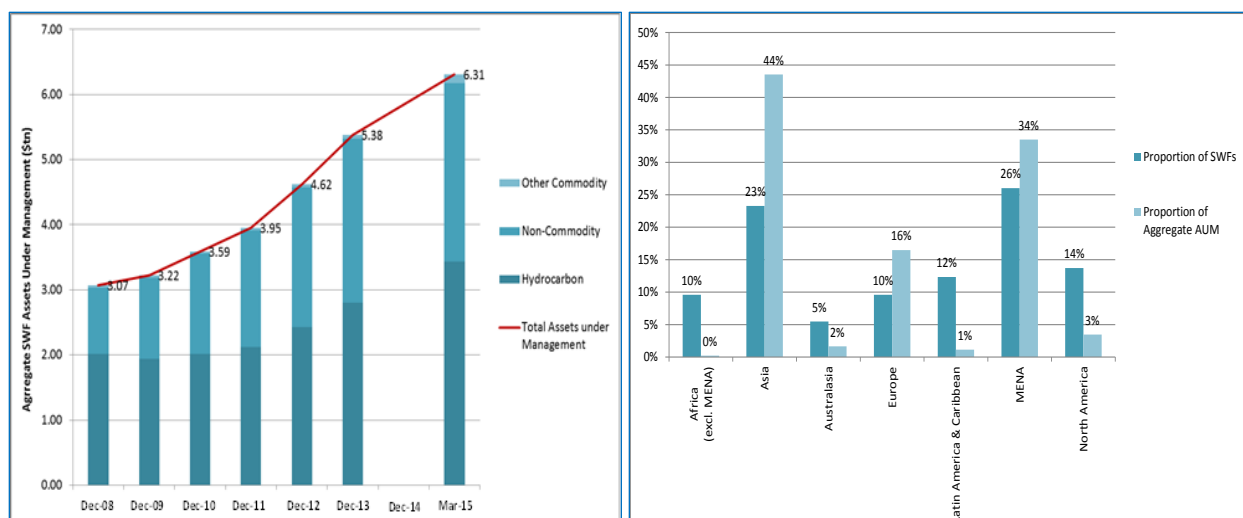


In a smaller set of EMEs, sovereign wealth funds (SWFs)²⁵ can help bridge the financing gap in infrastructure and SMEs. As of 2015, SWFs held roughly US\$ 6.3 trillion in AUM. Funds based in Asia and the Middle East and North Africa (MENA) region represent almost 80 percent of total AUM, and almost half of all SWFs worldwide (Figure 5). Many of such funds have been set up by EMEs.²⁶ These funds stand apart from other investment funds because they tend to have longer term investment horizons without explicit liabilities. This makes them well suited to invest in both infrastructure and SME related assets, as they can potentially manage well the long term nature and illiquidity associated with these types of investments. In fact, 60 percent of SWFs already invest in infrastructure; furthermore increasingly SWFs are being set up with the express purpose of investing in domestic infrastructure. That is the case, for example, of the Nigeria SWF. In addition, 47 percent of them invest in vehicles traditionally suited for SME investment such as private equity funds.

Figure 5: Sovereign Wealth Funds: Growth and Composition by Regions

²⁵ Sovereign Wealth Funds (SWFs) are government investment agencies typically sourced from foreign exchange (e.g. hydrocarbon revenue, which currently represents 55 percent of SWFs AUM) or reserve assets. SWFs are a growing phenomenon in today's global financial architecture. According to Preqin's 2015 analysis, 73 SWFs globally currently control \$6.3trillion in AUM. Despite the negative impact of recent falling oil prices, this represents approximately double the AUM that these funds controlled in 2008 (\$3.07 trillion).

²⁶ Besides from SWFs in AEs, SWFs exist in Algeria, Angola, Azerbaijan, Bahrain Botswana, Brazil, Brunei, Chile, China, Colombia, Ghana, Hong Kong, Indonesia, Iran, Kazakhstan, Kiribati, Kuwait, Libya, Malaysia, Mauritania, Mexico, Oman, Nigeria, Palestine, Panama, Peru, Qatar, Russia, Sao Tome and Principe, Saudi Arabia, Singapore, South Korea, Timor-Leste, Taiwan, Trinidad and Tobago, Venezuela, Vietnam, United Arab Emirates (U.A.E.). The largest SWF is located in Norway, but China, Kuwait, Qatar, Singapore and U.A.E. have SWFs with AUM of over 100 billion.



Source: Preqin 2015

This Report will focus on domestic institutional investors given their presence and importance in a wider range of EMEs. It is important to note, however, that many of the challenges that limit the investment of domestic institutional investors in infrastructure and SMEs are applicable also to foreign institutional investors. Some of the challenges also impact the level of investment of SWFs in these sectors. As a result, many of the recommendations provided in this Report would also help to mobilize foreign institutional investors and SWFs to EMEs infrastructure and SMEs financing.

Portfolio composition of institutional investors

In most EMEs, pension funds remain heavily concentrated in government bonds and bank deposits, although there is significant variation by regions and countries.²⁷ This is especially true of pension reserve funds that back pay-as-you-go schemes. Compared to AEs, pension funds in EMEs have limited exposure to listed equities and corporate bonds, with excess assets often ending up in real estate investments. Investment in other types of assets is still rare. In many jurisdictions these heavily concentrated portfolios in turn have often failed to keep pace with wage growth (Figure 6).

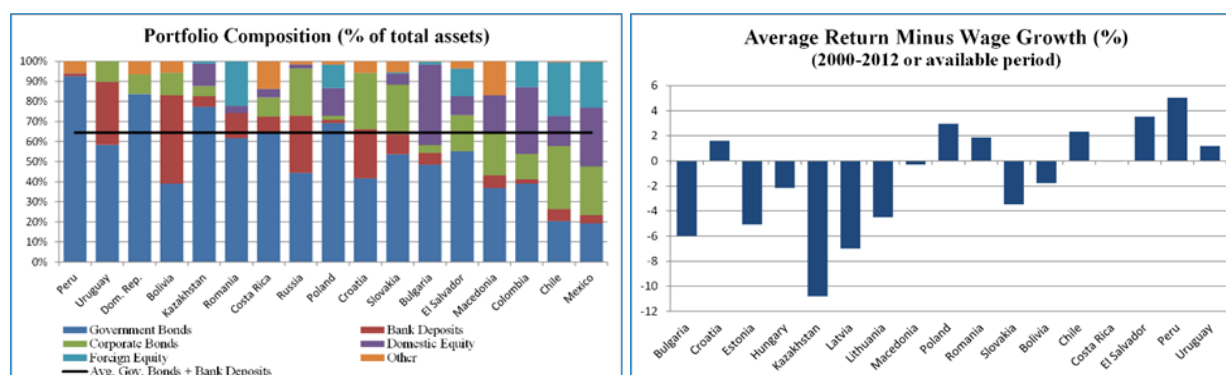
As will be further explained, this has been mainly the result of rigid investment frameworks combined with the lack of domestic products in which to invest. While frameworks differ from country to country, many of them impose low limits or even bans for specific types of assets, including “alternative” investments. They also limit illiquid investments, and in some cases also equity investment.²⁸ Diversification is also hampered by the fact that in many EMEs, investment in foreign

²⁷ See OECD (2014), *Annual Survey of Large Pension Funds and Public Pension Reserve Funds, Report on Pension Funds’ Long-term Investments*’.

²⁸ For a discussion on limits on investments see OECD report to the G20 on the Regulation of Insurance Company and Pension Fund Investment (2015), OECD (2014), *“Survey of Investment Regulation of Pension Funds”*; and IOPS (2011), *“Pension Fund*

instruments has usually been limited for a set of reasons, from concerns about capital flows to a desire to use institutional investors as a catalyst for the development of the domestic market. However, domestic markets remain underdeveloped; hence their investments remain concentrated on government bonds and short-term bank deposits. This is particularly the case in Africa. In other regions, such as Latin America and Eastern Europe, performance benchmarks have operated as a disincentive for diversification into longer term assets.²⁹ Finally, rules that allow affiliates to change from one pension fund to another without penalties within short periods of time have also exacerbated short term behavior, as pension funds see the need to keep more liquid assets in their portfolios to face withdrawals of funds.

Figure 6: Diversification of Pension Fund Assets / Investment Performance vs. Wage Growth in EMEs



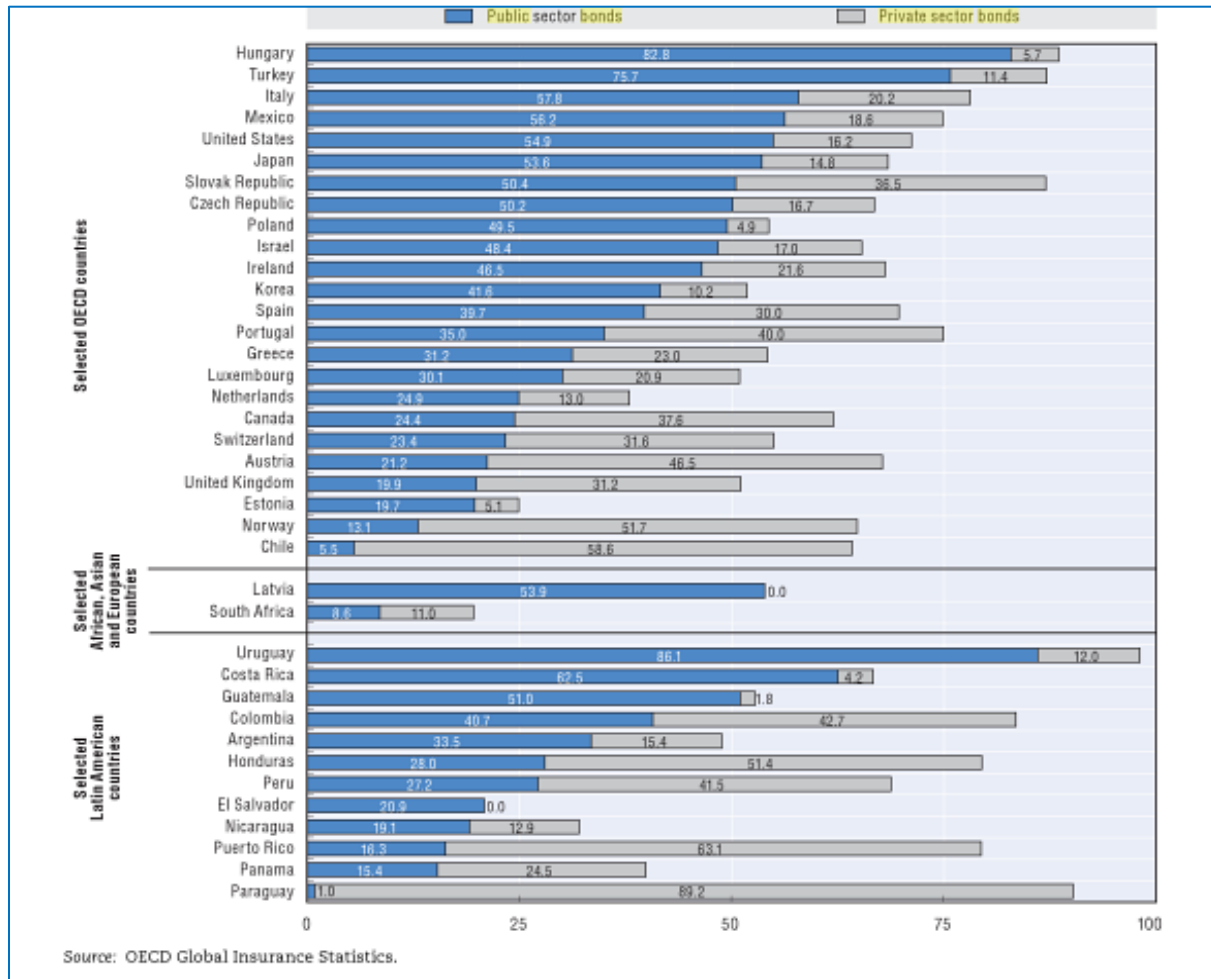
Source: World Bank Pensions Database

Portfolios of insurance companies also remain concentrated in fixed income investments; particularly government bonds (Figure 7). In many EMEs, their investment frameworks are similar to those of pension funds, and risk-based solvency frameworks are not yet in place – although the larger EMEs are working towards the implementation of such type of frameworks.

Use of Alternative Investments and Derivatives: Regulation, Industry Practice and Implementation Issues, IOPS Working papers on Effective Supervision, No 13.

²⁹ For a discussion of the impacts of investment regulations see Stewart, F. (2014), "Proving incentives for long-term investment by pension funds: the use of outcome-based benchmark", World Bank Working Paper 6885.

Figure 7: Insurance Portfolio allocation to Bonds, Public and Private-sector Bonds (2013)



III. Instruments to Mobilize Institutional Investors to Infrastructure Financing

Theoretically there is significant potential of institutional investors to act as a source of infrastructure financing. Infrastructure investments may be attractive to institutional investors such as pension funds and insurers as they can match the long term duration of pension and insurance companies' liabilities and provide duration hedging. Further, these investments are expected to generate attractive yields in excess of those obtained in the fixed income market although with potentially higher volatility. In addition investments in infrastructure assets linked to inflation could hedge pension fund liabilities that are also linked to inflation. Even though pension funds have the rationale to hedge against inflation, the extent that they are compelled to do so is quite different for define benefit versus defined contribution funds.

It is important to mention, however, that the risks involved in infrastructure investment vary considerably.³⁰ Overall there are significant differences in project risk between greenfield and brownfield projects.³¹ In general the former are considered to be riskier given the construction risk involved and the lack of revenues during the construction period. Nevertheless construction risk can vary significantly depending on the category of infrastructure involved, whether social infrastructure or economic infrastructure, and even within these categories, it varies also depending on the specific type of infrastructure been built. Other risks, including financial and regulatory risks may also vary depending on the category and type of infrastructure. As a result, the appetite of institutional investors for

³⁰ Risks can be categorized in pre-completion risks, post-completion risks and risks found in both the pre- and post-completion phases. The most common pre-completion risks are bad activity planning, technology risk and construction risk. Post-completion risks are associated with the performance of the infrastructure built and the sale of the product or service involved. Risks found in both the pre- and post-completion phases involve (i) financial risks (interest rate risk, currency risk, inflation risk), (ii) regulatory risk related to permits and authorizations, as well as to the definition of tariffs and potential subsidies, (iii) political risk, (iv) country risk and (v) legal risk related to contract enforceability and creditors' rights protection. Moody's has estimated that projects that successfully passed the construction phase experience defaults later and emerge earlier from default than projects under construction. This evidence seems to support the higher propensity of purely financial investors, such as institutional investors, to accept operational risks and their reluctance to be involved from the early stages of infrastructure development. See OECD (2014), "*Private Financing and Government Support to Promote Long term Investments in Infrastructure*".

³¹ Greenfield refers to building an infrastructure that does not exist (e.g. a new road), while brownfield refers to expanding the capacity of an existing infrastructure that, in most cases, is already generating revenues (e.g. increasing the number of lanes in a road).

different types of projects varies. In general institutional investors are reluctant to invest in greenfield projects given the construction risks involved.³²

In practice, despite growing interest, institutional investors have invested very little in infrastructure, even in AEs. The OECD has estimated that the largest pension funds³³ have invested less than one percent of their assets in infrastructure, excluding indirect investment via the equity of listed utility companies and infrastructure companies. However, there is significant variation in their appetite. The Canadian and Australian funds lead the way with five to 10 percent allocation in this category (one even at 15 percent). Nevertheless most are languishing in the single digits, if they have any allocation at all.³⁴

Their investment in EMEs infrastructure is much more limited. These leading funds invest around one-third of their total portfolios in foreign markets. However, their infrastructure investment shows an even greater ‘home bias’. Most of the overseas projects they invest in are in other OECD countries – with ‘BRIC’ markets (such as Brazil, Chile, in some cases India) being as far into emerging market infrastructure as they will go.

Box 1: The role of global institutional investors in infrastructure financing

Diversified Global Pension Funds and Insurance Companies

While infrastructure finance in EMEs may likely be limited to local sources, global investors can play a role in financing projects either through project bonds or shares issued in off-shore markets, or through instruments issued in local markets.

Institutional investors AuM in AEs have increased substantially since the financial crisis – pension funds, public pension reserve funds, and insurance companies combined managed USD 55.9 trillion at the end of 2013, up from USD 40.4 trillion at the end of 2008 (OECD Survey). Most large institutions invest part of their portfolio in foreign markets, including in EMEs – some of which invest substantial amounts. Over the past ten years, funds have diversified holdings to include foreign investment in traditional categories like stocks and bonds, but also alternatives such as real estate, private equity, and infrastructure (Figure 8 below).

Attracted to higher yields, global investors have included hard currency emerging market debt, both government and corporate, as part of the global fixed income universe. A recent trend amongst some investors has been the expansion of emerging markets debt portfolios into local market government bonds. Infrastructure project bonds issued in hard currency may appeal to global investors, potentially increasing the source of funding for large infrastructure projects in EMEs. However, such issuances should be properly structured to avoid any potential currency mismatches between the sources of finance and project revenues. There may be scope for foreign participation in local market issuances. However reducing currency risk is difficult as there are seldom effective long term-hedging instruments available in EMEs currencies. Therefore this is a risk that

³² However, as noted above, the appetite of institutional investors for greenfield projects varies depending on the type of infrastructure. For example, institutional investors might be more willing to take construction risk in social infrastructure, such as hospitals and schools, as construction risks in such type of projects might be more predictable.

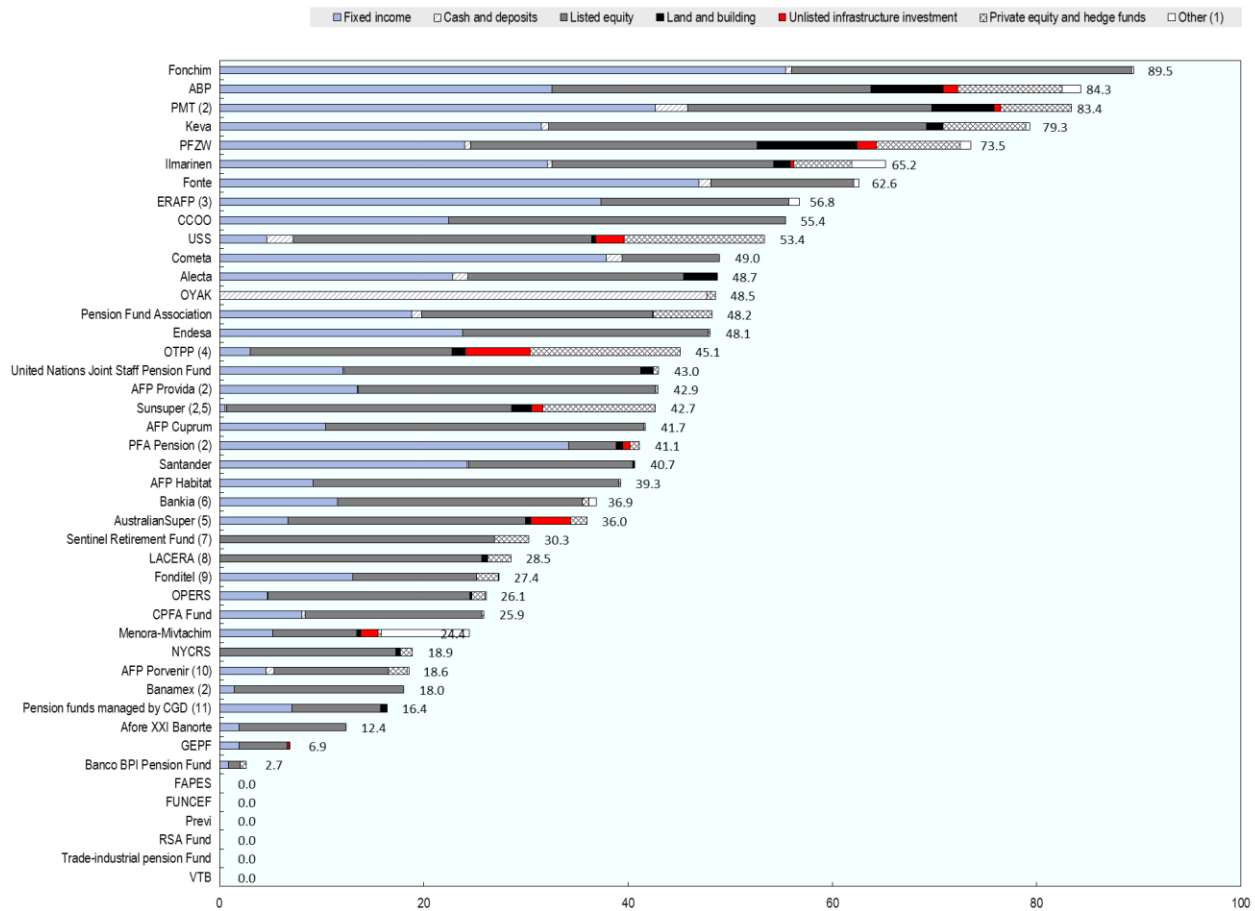
³³ The OECD conducts annual surveys of individual pension funds both within and outside of the OECD that are amongst the largest in their respective country. This information is presented in combination with the OECD Public Pension Reserves Funds (“PPRFs”) survey carried out at the same time. For example, for 2013 data was compiled for 86 institutional investors from more than 35 countries around the world including some non-OECD countries such as Brazil, Peru, Nigeria, and South Africa, accounting for over USD 9.7 trillion of assets under management.

³⁴ See Della Croce, R and Y. Yermo, 2013, *Institutional Investors and infrastructure financing*.

institutional investors would need to take on and be adequately compensated for, or it must be transferred to a third party willing transfer. In many EMEs the only counterparty capable of taking on the currency risks are the national governments and MDBs. So far global institutional investors have been mostly limited to purchasing local sovereign bonds. Infrastructure bonds issued as quasi-sovereign instruments may have appeal.

As global institutional investors continue to build out their infrastructure equity investments, diversification into emerging markets may be part of their strategy.

Figure 8: Foreign Investments of Select Large Pension Funds



Source: OECD

The exposure of institutional investors in EMEs to infrastructure is even lower than that of the leading OECD funds. There are a few exceptions, mainly in EMEs with a larger institutional investor base such as Chile, Mexico and Peru.³⁵

Therefore the challenge lies in addressing the disconnect between the theoretical appeal of this asset class and the current low level of investment by institutional investors, so that the potential of institutional investors can be realized. Assuming some increased ‘North-South’ allocation by OECD investors into EMEs infrastructure, combined with a growth in EME domestic institutional investor assets and the development of infrastructure investing on their part, a figure of US\$ 1 trillion over a

³⁵ See Inderst, George and Stewart, Fiona (2014), “*Institutional Investment in Infrastructure in Emerging Markets and Developing Economies*”. See also BBVA (2011), “*A review of recent infrastructure investment in Latin America and the role of private pension funds*”, Economic Analysis.

prolonged period would not look unreasonable (Table 3). Though not sufficient to solve the infrastructure financing gap alone, this could certainly prove as an important source of new capital to help fill the EME infrastructure financing gap, translating into a contribution of up to 10 percent of investment needs.

Table 3: Current and Potential allocation of institutional Investors to EME infrastructure

| Institutional Investors | AUM USD | Current Investment in Infrastructure | Asset Allocation Scenario- Infrastructure | Current Investment in EMEs | Potential Investment in EMEs infrastructure | Comments |
|---|----------|--|---|--|---|--|
| OECD Institutional Investors | US 80tn | 1% on average implies US\$ 800bn-mostly in OECD Leading investors: 5-10% | Increase to 3% (5%) on average implies USD 2.4tb (USD4tn) | Estimated 10% in EMDE in general- but very small in Infrastructure | 5% EME of 3% in Infrastructure = USD 120bn 10% EME of 5% in infrastructure = USD 400bn | Limited by both supply (e.g., available projects and assets) and demand factors (capacity, investor regulation, liquidity needs) |
| Emerging Market Institutional Investors | USD 5tn | < 1% on average - 0.5% would imply USD 25bn Even more limited than OECD investors | Increase to 3% on average implies USD 150bn | High percentage in EME | 80% EME of 3% = USD120bn 70% EME of 5% = USD175bn | Growth potential - e.g. EMEs Pension funds currently \$2.5 trillion AUM estimated to rise to USD 17tn by 2050 |
| Of which: EME PPRFs/SSFs | USD 1tn | Limited - some examples - up to 10% | Increase to 5% implies USD 50bn | High Percentage in EME | 70% of 5% assets = USD 35bn | High targets- often the largest source of capital in a developing country |
| Sovereign Wealth Funds | USD 4tn | Unclear - 2% implies USD 80bn | Increase to 5% implies USD 200bn | Relatively high in EME | 30% EME of 3% in Infra= USD36bn 50% EME of 5% in infra = 100bn | Many new EME SWF being set up to specifically invest in domestic infrastructure |
| Other global institutional capital (asset/ | USD 20tn | Assumed 1% on average implies | Increase to 3% on average implies USD | Very small in EME | 10% EME of 3% in infrastructure= | |

| | | | |
|------------------------|----------------------|-------|----------|
| wealth managers | USD 200bn | 600bn | USD 60bn |
| Total | USD 300-700bn | | |

Source: Inderst and Stewart 2014

Finding instruments that well suit the risk-return appetite of such investors, in particular those in EMEs, is a key step in such direction. However, it is important to emphasize that the challenges that affect the mobilization of institutional investors are more complex, from the lack of a strong enabling environment to the lack of high quality projects in which to invest and rigid investment frameworks. All these challenges will be explained later in this Report.

Table 4 below summarizes the key features and preconditions of the main categories of instruments that have been used by institutional investors in AEs to invest in infrastructure.³⁶ Investment through listed companies and fixed income instruments constitutes the main exposure of institutional investors to the sector. However, over time investment through unlisted instruments, in particular equity has become more important especially as many investors in AEs recognize infrastructure as a distinct asset class. For the majority of institutional investors investment in equity is done via unlisted equity funds –as this provides them with diversification and scale of investment and allows them to transfer selection and monitoring functions to a specialized manager. The largest investors have preferred direct investment and co-investment as they opted to develop their dedicated infrastructure teams, with the added benefit of eliminating management fees. More recently there has been increased interest of institutional investors for debt funds, especially given the combination of bank retrenchment and the low interest environment faced by institutional investors in AEs. However, investment in debt funds remains very small compared to their investment in equity funds.

In practice the list of instruments that can suit the risk-return appetite of a broader range of institutional investors in EMEs might be more limited. The risk appetite of institutional investors in EMEs has been limited by regulatory and practical constraints that have kept them invested in plain vanilla products, with low risk. This suggests that their potential appetite for equity investments, in particular private equity, would be more limited than that of institutional investors in AEs, given its higher volatility. It could be expected that the larger and more sophisticated institutional investors in EMEs would have appetite for this type of investment –and examples in this regard exist in countries like Chile, Mexico and Peru. However, in this case, investment via direct investment or co-investment would

³⁶ We have excluded from the table investment in infrastructure companies that are listed on an exchange, as this type of investment does not have any feature that differentiates it from any other investment in listed companies. In contrast we have included sukuk, in spite of the fact that their use is not yet widespread. The reason for this is the increasing role that these instruments are playing for Islamic institutional investors, many of which are located in EMEs.

be reserved to an even smaller group of institutional investors in EMEs.³⁷ As institutional investors in EMEs become more sophisticated, their appetite for equity investment would grow. It is important to acknowledge, however, that in practice the risk appetite of institutional investors can differ significantly across categories, as well as from one country to another, and even among the same category of investors.

³⁷ Indeed some of the largest pension funds in Latin America, in particular in Colombia and Peru have invested in equity via infrastructure funds; while the South African pension funds have opted for direct investment and co-investment.

Table 4: Main mechanisms used by institutional investors to invest in infrastructure

| Instrument | Direct investment and co-investment | Unlisted equity funds | Project bonds | Unlisted debt funds | Sukuk |
|--|---|---|--|--|--|
| Supply | Large projects Greenfield and brownfield | Both large and small projects Greenfield and brownfield | Large scale project Currently used mainly for brownfield, but significant innovation is taking place | Both large and small projects Currently used mainly for brownfield, but there are some greenfield | Large scale project Currently used mainly for brownfield |
| Demand | Larger, more sophisticated institutional investors with in-house capacity to select and monitor projects Very few institutional investors in EMEs would have such capacity | Potentially all institutional investors, but initially probably only the larger investors in EMEs | Potentially all institutional investors | Potentially all institutional investors | Mainly Islamic institutional investors |
| Framework for the instrument | None | Framework for CIS, in particular closed-end funds | Framework for securitization | Framework for CIS, in particular closed-end funds | Framework for securitization |
| Framework for the offering | Institutional investors define information required | Institutional investors would usually require a term sheet | Will depend on whether done as public or private offering. Institutional investors would usually require a term sheet even if under private placement | Institutional investors would usually require a term sheet | Will depend on whether done as public or private offering. Institutional investors would usually require a term sheet even if under private placement |
| Corporate governance requirements | Negotiated with the institutional investors. Usually active participation, including in the board of the company | None. But the framework for CIS managers would have conflict of interest provisions | None. But the underlying contracts would have representations and warranties | None. But the framework for CIS managers would have conflict of interest provisions | None. But the underlying contracts would have representations and warranties |
| Institutional investors' investment framework | Must allow alternative investments | Must allow alternative investments | Must allow alternative investments | Must allow alternative investments | Must allow alternative investments |

| | | | | | |
|---------------------------------------|----|----|------------------|----|-------------------|
| Yield curve as reference price | No | No | Yes | No | Yes |
| Credit rating | No | No | Usually required | No | Might be required |

Source: WBG

Thus, for the majority of institutional investors in EMEs fixed income products might represent a good way to start their investment in infrastructure. There are several reasons for this, in particular these are instruments that (i) can deliver long stable yields higher than government bonds but less volatile than private equity, and (ii) that can be structured in ways that suit different risk-appetites including that of investors that require highly rated instruments. Further, as more EMEs implement Basel requirements, the interest for fixed income products that can complement bank financing would probably grow –as has been the case in AEs.

Below is a summary of the main categories of fixed income instruments that can be used for infrastructure financing, our assessment of their potential to mobilize institutional investors in EMEs and their current use in AEs and EMEs.

Project bonds

A project bond can be broadly defined as a fixed income security issued to finance, partially or in full, debt obligations of a single-asset infrastructure project. Expected income from the underlying project is securitized to ensure payment of the bond’s interest and principal, generally on a non-recourse basis. Proceeds from projects may be provided by the public authority as milestones or progress payments during construction, availability-based payments after construction, or market-based payments linked to user tariffs, or a combination of all three. The key feature that differentiates a project bond from a corporate bond issued by an infrastructure company is the fact that the payments are backed only by the income stream from the project, unlike a corporate bond which is backed by the full faith and credit of the issuing company.

Project bonds can expand the financing available to infrastructure. Project bonds can increase the financing capacity for governments, sponsors and banks given that they provide off-balance sheet financing on a non-recourse basis. They can also provide a refinancing option for bank lending so that banks can focus on the shorter and riskier construction phase period of projects. Once the construction and ramp-up phase is completed, banks could off-load their loans to institutional investors in the form of project bonds, which would allow banks to recycle their capital into new loans to finance the shorter but riskier construction phase of infrastructure projects. Research indicates that historically the all-in

cost of funding of project bonds has been lower than bank loans, given the stronger competition in capital markets.³⁸ However such results might not be replicable in many EMEs.

Further they can suit well the risk-appetite of institutional investors. Project bonds provide long-term and stable cash flows matching investors' long-term liabilities. Depending on how they are structured they can also provide income linked to inflation, which is important for investors with inflation linked liabilities. Project bonds can also be structured to support different risk-return profiles to accommodate the investment needs of a varied and broad range of institutional investors. Finally, there is a relevant track record of lower defaults, less losses and higher recovery rates of infrastructure assets when compared to corporate bonds of equivalent ratings.³⁹ However such results might not be replicable in many EMEs. Indeed, as will be further explained below, EMEs face challenges in connection with the quality of their infrastructure projects, as well as on creditors' rights which altogether could affect the default probabilities, losses and recovery rates.

Project bonds currently represent a small portion of the debt financing of infrastructure, at around 10 percent of total debt. However their use and importance in total debt financing is growing. Prior to the crisis most experiences with project bonds were in AEs, such as Canada, United Kingdom and United States, with the main exception of Chile. In most cases project bonds were issued with a full wrap guarantee from monolines; however their demise triggered the need to develop alternative models of project bonds. Post crisis, initiatives to develop new models have taken place mostly in the United States, United Kingdom and the European Union. The Project Credit Enhanced Bond Initiative (PCEBI) developed by the European Investment Bank (EIB) is a key example of a model developed post crisis in AEs. It provides guarantees to both greenfield and brownfield project.

Experiences with project bonds in EMEs are mostly concentrated in Latin American, although recent experiences with project bonds exist in other regions. In Latin America, Peru has developed a form of quasi-sovereign bonds which is currently under review due to the contingent liabilities that it entails, while in Brazil and Mexico the issuances have had some form of partial guarantee supporting them. At least in the cases of Peru and Mexico the majority of the issuances have been placed in the off-shore markets and in hard currency. This has been the result of a combination of factors including the size of the issuance, and the size and level of concentration of domestic institutional investors which resulted in an interest to expand competition in the investor base by using the off-shore markets. However, domestic institutional investors have been key investors even when the issuances have been placed in the off-shore markets. In addition, in Costa Rica and El Salvador, public entities and the government itself have issued project bonds in hard currency, via special purpose vehicles. The bonds have been

³⁸ See *Earnst & Young Mid-term evaluation report for PBCE* based on Initiative Infrastructure Journal, loan connector, Thomson Reuters.

³⁹ Moody's evaluated the performance of infrastructure bonds versus non-financial corporate issuers rated by them for the period 1983-2014. See Moody's (March 9, 2015), "*Infrastructure Default and Recovery Rates, 1983-2014*".

placed in the local markets among institutional investors from the region. A few recent issuances have also taken place in countries located in other regions, including in Kenya, Russia and South Africa.

Key lessons emerge from those experiences are the following:

- **First, project bonds appear to work better for brownfield projects, although significant innovation is taking place.** Greenfield projects are generally more difficult to finance through project bonds for a number of reasons that include: the lack of project revenues during construction; higher risks and uncertainty that institutional investors do not usually want to bear;⁴⁰ cost of carry as bond proceeds are generally disbursed upfront at the beginning of construction before funds are needed; and higher probability of debt contract re-negotiations. However, significant innovation is taking place in AEs and EMEs that could over time enhance the potential of project bonds both for the lower risk maintenance and operation phase, as well as the riskier construction phase, such as has been the case of the PCEBI which has already provided guarantees for two greenfield projects
- **Second, project bonds with bullet maturities can create significant refinancing risk.** The cash flow patterns of infrastructure projects can be difficult to tailor to the cash flow patterns of project bonds; some investors may find this feature unattractive. There are examples of some project bonds that have been structured with amortizing payments to reduce refinancing risk. Government support schemes such as refinancing guarantees and maturity extensions can also mitigate refinancing risk.
- **In addition, project bonds appear to work better in connection with larger scale projects.** There are several reasons for this. First, the scale of the project allows bonds to reach a minimum size to be liquid. Size is also important to allow pension funds to invest in a meaningful amount. Sizes that are too small are a disincentive for pension funds as they need to dedicate analytical resources for a very small investment. Finally, a small issue will only be purchased by a single investor, which reduces the scope for competition in pricing, and significantly reduces liquidity.
- **Finally, experiences point to the need for credit enhancements, to align the risk-appetite of institutional investors, even in brownfield projects.** Institutional investors have a large appetite for investment grade instruments and credit enhancements are usually needed to get infrastructure investments over this hurdle. Most credit enhancement instruments cover credit risk partially. They are generally being provided in the form of partial guarantees or subordinated debt taking a first loss over a certain percentage of the debt (e.g. 20-30 percent of total debt) in the event of default. Full wraps as were provided by the monolines before the crisis are not frequent. For North South investors' protection against country level risk might be

⁴⁰ Although as explained above, construction risk can vary significantly depending on the type of infrastructure.

needed. However the country risk rating for many EMEs is below investment grade, which would constrain the ability to bring these instruments to an investment grade.

Box 2: The use of capital markets for infrastructure financing: Selected cases

Chile: The use of infrastructure project bonds

Overview and Key Features

Infrastructure bonds were successfully used in Chile to mobilize domestic institutional investors to infrastructure finance, particularly for toll roads. Two types of interventions supported toll road infrastructure project bonds in Chile.

The first one was minimum revenue guarantees offered by Ministry of Public Works in the case the toll revenues did not meet an agreed level. This was done in exchange for sharing a percentage of the benefits (around 50%) with the government if they exceeded a certain threshold (generally 15% of the assets or equity). This feature also served to improve the rating of the bond issue.

The second intervention was a full wrap on the infrastructure project bond offered by international insurance companies. The latter were prepared to offer the full guarantee on the bonds on two conditions: the minimum revenue guarantee offered by the Chilean Government on the toll road projects and Chile's A- sovereign rating achieved in 1995. The full guarantee offered by monoline insurers automatically gave same credit rating of the guarantor to the project bonds that is AAA. In fact, virtually all infrastructure bond issues achieved a AAA rating; only two issues had a rating of AA- and A+.

For unprofitable but socially beneficial projects, the Chilean government has the ability to provide a direct subsidy to the concession company. The amount of the subsidy is established in the concession contract, indexed to inflation, and is paid no matter what, effectively eliminating the demand risk and replacing it with the government risk. The Variante Melipilla concession bond was issued in 2003, as a first bond that did not carry the guarantee of an international insurance company; instead it relied on the government subsidy and minimum revenue guarantee, as well as a performance guarantee during the period of construction.

Results

The first infrastructure bond in Chile, and in all of Latin America, was issued in 1998, followed by many others, amounting to an average of USD 1 billion a year during 1996-2001. The 2008 financial crisis resulted in a severe downgrading of monoline insurers. As a result, infrastructure bonds lost automatically the AAA rating and were downgraded to the new rating of monolines. This caused serious disruption to pension funds who could not invest in lower rated assets. A key challenge for Chile going forward is how to replace the monoline model.

Peru: The creation of quasi sovereign infrastructure bonds

Overview and Key Features

Peru developed an innovative model to facilitate financing for large-scale infrastructure projects through long-term funds raised in the capital markets. It created instruments called CRPAOs (*Certificados de Reconocimiento de Derechos del Pago Annual por Obras*, Certificates Recognizing the Right to Collect the Annual Payment for Works). CRPAOs were first used to finance the construction of the toll road projects associated with the Initiative for the Integration of the Regional Infrastructure of South America (IIRSA), an initiative adopted by a number of South American countries in 2000 to address the infrastructure gap.

CRPAOs are physical certificates that are issued to the concessionaire once it has completed a certain predefined milestone of a construction project, such as a toll road. They represent the right to receive a payment from the government for the cost of construction associated with the milestone completed spread out over a period of 15 to 20 years, depending on the concession. For each milestone a series of CRPAOs is issued. If a concession calls for the construction costs to be paid semi-annually over 15 years, then 30 CRPAOs would be issued upon completion of a milestone, providing 30 equal semi-annual payments on two determined dates each year over 15 years. If there were 10 milestones, then there would be 300 certificates issued in total.

CRPAOs are governed by New York law, can be enforced in New York courts, and are transferrable to third parties both inside and outside the country. They represent the unconditional and irrevocable obligation of the Peruvian government to make specified payments once a particular construction milestone has been completed regardless of whether the concessionaire ever completes the full construction of the project and begins operation.

This unconditional government guarantee made it possible for the CRPAOs to be securitized into a fixed income instrument issued to investors in capital markets. This was done by the concessionaire selling CRPAOs to a third party – an investment bank or a special purpose vehicle (“issuer”) – who would then issue the debt instrument backed by the CRPAOs to bond investors. The proceeds collected by the concessionaire from the sale of the CRPAOs to the issuer could then be used to finance the next milestone of the construction project, thus allowing the construction to proceed segment by segment until the entire project is completed.

Because CRPAOs, in essence, represented sovereign debt, the Peruvian government opted to use a modified model for subsequent projects, where possible, by introducing RPICAO instruments. RPICAOs are similar to CRPAOs in that they represent the right of a concessionaire to receive payment for construction costs incurred for a completion of a certain construction milestone. The difference is that the payments represent an unconditional and irrevocable payment obligation of a relevant governmental agency or state-owned company associated with a project, and thus are not direct obligations of the Peruvian government.

In this model, the payments for the service generated by the project (e.g., water consumption bills) are collected into a trust. The trust then uses these collections to make payments for the RPICAOs issued for the project. The RPICAO payments are supported by an obligation to pay by the state-owned company or government agency that issued the concession (e.g., state water company) and are backed by a conditional guarantee of the Peruvian government. That is, if the collections are not sufficient to pay for RPICAOs and the state agency does not cover the shortfall in the time frame required, the Peruvian government has the obligation to provide the necessary amount to cover the payments.

Results

Peru has been able to finance a number of large-scale infrastructure projects, such as toll roads and water treatment facilities, using these innovative instruments. The strong appetite for securitized CRPAOs and RPICAOs comes from the fact that the Peruvian government would honor them independently from the performance of the underlying project, even if it is never concluded. The fact that the certificates are relatively standardized also facilitates their securitization. The benefit for the project sponsor is that the initial financing requirement to start the project is significantly reduced, making it necessary only to arrange financing for the initial 1 or 2 construction milestones. It can also help to improve competition in the bidding process, as the financing is clearly defined and available. However, the instruments are currently under review in light of the excessive risk taken by the government, as well as their impact on the fiscal deficit, via contingent liabilities.

South Africa: The use of infrastructure debt funds

The Vantage GreenX Fund (GreenX) was launched as an infrastructure debt fund by Vantage Capital Group in South Africa in November 2013. The fund first close (Note I) raised ZAR 2.5 billion entirely from South African pension and provident funds. The fund invests in senior debt in energy and renewable energy projects in South Africa.

GreenX Note I focuses on deals that are structured along limited recourse project finance principles. Investments under Note I focus on projects that have been successful in the South Africa Department of Energy Renewable Energy IPP Procurement Process (REIPPPP). These projects include solar plants and wind plants in the provinces of Eastern Cape, Northern Cape and Mpumalanga. Note I focuses on refinancing of bank debt on the secondary market and is now fully invested.

Vantage Capital is now raising GreenX Note II, which will have a wider remit. In addition to projects under REIPPPP, Note II will also target investments in sustainable energy projects which will include natural gas and cogeneration projects run by the South Africa Department of Energy. By contrast with Note I, Note II is targeted at primary finance and aims to enter deals post

selection as preferred bidder but before financial close.

The projects in which GreenX invests are underpinned by a South Africa Ministry of Finance (MOF) guarantee to cover buyer payment default and/or political force majeure.

Source: WBG

Commonly referred to as an Islamic bond, sukuk represent undivided, pro-rata ownership rights to the underlying assets and/or income they generate. Under Islamic finance principles, money is only a medium of exchange and cannot be an investment or an income-generating asset in itself. Conventional lending at interest is not permissible. Sukuk therefore represent in principle a risk-sharing instrument where the investment is made toward specific underlying assets or real economic activities. The latter characteristic makes sukuk suitable for infrastructure financing.⁴²

The global sukuk market has grown considerably, although from a low base.⁴³ The majority of experiences with sukuk correspond to EMEs with an important Muslim population. Issuances have been highly concentrated in a few EMEs, in particular Malaysia both for Sukuk generally as well as for Sukuk used in infrastructure financing. Recent experiences show that sukuk can be attractive for other countries that want to support an Islamic finance sector by offering investment opportunities, or that wish to attract Islamic institutional investors' money. The issuance of sukuk by the UK Government was mainly influenced by the first objective. Examples of the latter approach are the South African sovereign sukuk, the Goldman Sachs sukuk, and the sukuk issued by the Islamic Development Bank (IDB) under its Medium Term Note Program.⁴⁴

So far this instrument has mainly catered to the risk-appetite of Islamic institutional investors, via structures that are more similar to corporate bonds than project bonds. Sukuk have been able to

⁴¹ For additional information in sukuk see: Kammer, Alfred, et al. (2015), *Islamic Finance: Opportunities, Challenges, and Policy Options.* IMF Staff Discussion Note, International Monetary Fund, Washington, DC; and Kusuma, Ketut Ariadi and Anderson Caputo Silva (2014), *Sukuk Markets: A Proposed Approach for Development.* Policy Research and Working Paper, World Bank, Washington, DC.

⁴² There are initiatives underway aimed at further exploring the potential use of sukuk, in particular a G20 initiative to examine the use of sukuk to finance infrastructure investment.

⁴³ The outstanding global sukuk market was estimated to be around US\$310 billion, with a growth trend and US\$110 billion in issuances in 2014. While still small, the relevance of Sukuk in financing infrastructure has been growing considerably over the last decade. In 2012, approximately 20 percent of sukuk issuance was infrastructure related, and a combined US\$95 billion of infrastructure sukuk have been issued.

⁴⁴ The IDB has arranged a dual listing of its issuance in United Kingdom and Malaysia. The IDB Sukuk is open to investors in most countries. Sovereign wealth funds, central banks, pension funds, insurance companies, Sukuk funds and investment banks are main investors of the Sukuk. Funds raised are used for financing projects mainly in the areas of infrastructure, agriculture and power sectors. For example, such financing has been provided for projects in Morocco, Egypt and Senegal. Further, IDB has also issued a 400 million Ringgit (US\$ 120 million) Sukuk in local currency in Malaysia during 2008. Proceeds were used for funding of a toll road in Malaysia.

provide an alternative financing avenue for issuers who are able to obtain financing from the conventional bond markets, tapping investors who for religious reasons cannot buy conventional bonds. However, the range of non-Islamic investors who aim to diversify their portfolios is expected to rise. Currently, most sukuk depend economically less on the relevant assets than on a commitment from an ultimate obligor. Thus, in practice they have been closer to conventional bonds than project bonds. However, they have the potential to be structured in ways akin to a project bond, where they can either bear the full risk of the project or stand alongside an equity financing tranche, depending on the risk-appetite of institutional investors. At the moment there does not seem to be a lot of appetite from such investors in the latter type of structures –i.e. structures closer to project bonds. It is possible that as the market evolves and investors become more familiar with sukuk, these other structures would be used more.

Infrastructure debt funds

Infrastructure debt funds are collective investment schemes whose underlying assets are infrastructure loans or bonds. The funds (i) buy existing loans made by banks to infrastructure project companies, (ii) make new loans to these companies or participate in syndications of loans along with banks, and/or (iii) buy bonds issued by these companies. Given their underlying assets, investors received as income the flows stemming from the loans and/or bonds (minus fees and operating costs). They are usually structured as closed-end funds, unlisted and placed through private offerings, exclusively to qualified buyers, mainly institutional investors.

Infrastructure debt funds share several of the benefits of project bonds in terms of their capacity to expand private participation in infrastructure financing. In particular, when their underlying assets are loans they can serve a refinancing role for banks. As they also invest in bonds, they could also contribute to deepening the fixed income markets.

In addition, these instruments can suit well the risk-return appetite of institutional investors in EMEs, as (i) they deliver as dividends stable cash flows with a higher yield than fixed income products, (ii) they allow the pooling of smaller scale projects for which project bonds might not be a suitable instrument, and in this way also provide further diversification to their investment in infrastructure, which could cater well to the risk-return appetite of many institutional investors in EMEs and (iii) they allow transferring of selection and monitoring functions to a specialized manager, an important feature that could make them particularly attractive to institutional investors in EMEs given their limited in-house capacity to assess infrastructure investments.

Mezzanine debt funds can close finance gaps in infrastructure projects and provide credit support for lead lenders. Mezzanine debt pays higher yields than senior issues and often includes equity participation or conversion options (such as payment in kind). In AEs, mezzanine lending is gaining interest amongst co-investment platforms and through investment funds. MDBs that issue subordinate loans or bonds can act as originators for mezzanine debt funds. In EMEs, mezzanine lending could be part of greenfield or brownfield project finance and appeal to both pension fund and insurance company investors.

Interest for these types of funds is growing; however their share of the asset management industry is still very small.⁴⁵ Most of these funds currently invest in infrastructure in AEs; however the number of funds targeting infrastructure in EMEs is also growing. Many of them follow a multi-regional investment strategy and are invested primarily in infrastructure assets in AEs in North America, Europe and Asia. More recently there has been an increase in the number of funds that target infrastructure in EMEs. In practice many of these funds aimed at providing exposure in EMEs' infrastructure assets to foreign institutional investors. In addition, a few examples exist of "domestic" infrastructure debt funds in EMEs, that is, funds constituted in EMEs to attract domestic institutional investors. Examples can be found in India, Peru and South Africa, while Colombia is currently exploring the constitution of such type of funds.

Two important lessons emerge from these experiences:

- **The funds have mainly been used for brownfield projects.** More recently a number of funds have ventured into the greenfield project finance space, providing construction loans and refinancing them through long-term debt, either through loans or bonds issued by project companies at the brownfield stage. These bonds may in turn be listed on the domestic market.
- **In many countries, the government and MDBs have participated in the funds via "capital commitments"** as a way to crowd-in private investors, including institutional investors.

Infrastructure covered bonds

Covered bonds are debt securities issued by a credit institution that are backed by a dynamic cover pool of high quality assets. Investors have double recourse to the issuer and to the cover pool, and thus the covered bond remains an on-balance sheet instrument. This is the key feature that differentiates covered bonds from asset backed securities, as the latter are only backed by the flows stemming from the securitized assets. Issuers are traditional deposit taking banks or in some cases specialized lending institutions primarily reliant on covered bonds for their funding. Theoretically different type of assets could serve as the underlying asset for covered bonds; however in practice mortgages have been the predominant collateral. In this regard, the increased interest in both AEs and EMEs in covered bonds stems from its role in housing finance.

Covered bonds do not seem to have potential for infrastructure financing. No specific covered bond has been issued with infrastructure loans as the underlying assets neither AEs nor in EMEs. The challenges in structuring an infrastructure covered bond are obvious in terms of the lack of liquidity of an infrastructure product where there may be no tangible assets or where cash flows are in the distant future. The lack of liquidity in particular is driven by the lack of heterogeneity in infrastructure projects

⁴⁵ Over the last six years, infrastructure debt funds have grown from 4 funds in 2009 to 20 funds by the mid 2014. Aggregate target capital increased steadily from \$400 million in 2009 to \$ 15 billion in 2014. By January 2014, a total of 54 infrastructure debt funds had held a final close, raising a cumulative \$28.6 billion. See Preqin, 2014.

where each one will differ and require separate analysis. In turn it means that infrastructure covered bonds would resemble individual project finance bonds, rather than creating a large pool of homogenous bonds backed by assets of similar or identical credit risk characteristics.

IV. Instruments to Mobilize Institutional Investors to SME financing

There are two potential ways in which capital markets can help SME financing: (i) by providing SMEs access to capital via issuances in the market, and (ii) by providing a refinancing facility to SME lenders. Each of these channels has suited differently the appetite of institutional investors.

Overall, individual SMEs issuances do not easily align with the risk appetite and prudential requirements of institutional investors. SME issuances can deliver higher returns than those of more established companies; however due to their small size, an investor's SME portfolio needs to comprise a relatively large number of companies for such higher returns to have a meaningful impact in the overall portfolio of institutional investors. At the same time, on the bond side, the lack of (easily available) transparent loan-level and performance information of SMEs makes portfolio selection and monitoring not worthwhile or not possible. In addition, the higher risk profile of these companies makes it unlikely that they could meet the risk rating required by many institutional investors. Investment is further compounded by challenges related to the management of SMEs, as many of them are still family owned and run in an informal manner, even though these challenges may be more pertinent for equity investors.

That explains the limited level of direct investment of institutional investors in SME issuances. Such investment has focused on high-growth companies, in which they take an equity stake via venture capital and growth funds that allows them to have a role in the management of the company. Investment in debt instruments issued by SMEs has been much more limited, and focused on the mid-cap companies.

In contrast, institutional investors have exhibited a strong appetite for debt instruments issued by SME lenders, in particular corporate bonds. Further, given the composition of SME funding, it is through their investments in this type of instruments that institutional investors have had the most impact in SME financing. In general, these instruments have (i) the size/scale necessary to attract institutional investors, and (ii) deliver long stable cash flows with higher yields than government bonds.

Post crisis there has been significant innovation in the type of instruments and mechanisms used by institutional investors in AEs to provide financing to SMEs. Their search for yield combined with credit tightening on the banking side has prompted institutional investors in AEs to look at new investment opportunities in the SME sector, mainly on the fixed income side. It is important to note, however, that the reasons that have triggered an expansion of institutional investors' investment in SMEs in AEs might not be present in many EMEs. Overall in Latin America, Asia and Africa liquidity in the banking system has not been a key constraint. Further in many EMEs the yields paid by government securities or even deposits are still attractive compared to other investments.

Tables 5 and 6 below summarize the key features and preconditions of the main categories of capital markets instruments that can be used to enhance SME financing. The tables include both instruments to provide SMEs direct access to capital markets, as well as instruments to refinance SME lenders. In

general, for both AEs and EMEs, the better the instruments address the size/scale problem explained above, the more aligned they would be with the appetite of institutional investors.

In practice the list of instruments that can suit the risk appetite of institutional investors in EMEs might be more limited. In practice the risk appetite of institutional investors in EMEs has been limited by regulatory and practical constraints that will be further explained in this Report. This suggests that their appetite for equity investments, in particular private equity, would be more limited than that of institutional investors in AEs, given its higher volatility. However, it could be expected that the larger and more sophisticated institutional investors in EMEs would have appetite for this type of investment – and there are some experiences in this regard. As institutional investors in EMEs become more sophisticated, their appetite for equity investment would grow. It is important to acknowledge however, that in practice the risk appetite of institutional investors can differ significantly across categories, from one country to another, even among the same category of investors. Thus, the emphasis of this Report on fixed income instruments.

Table 5: Mechanisms to provide SMEs with access to capital markets

| Type of instrument | Venture capital and growth funds | Issuances via private placement | Issuances via private placements to qualified investors | Issuances via public offerings in alternative markets | SME bond funds |
|---|--|---|--|---|--|
| Supply side | High growth SMEs (Gazelles) | Small and medium size SMEs, with certain level of formality | Larger, more formal and more solid SMEs | Larger, more formal and more solid SMEs | Pipeline of bonds issued by SME companies |
| Demand side | Mainly institutional and high net worth | Retail and potentially high net worth | Institutional and high net worth individuals | Mainly retail | Potentially all investors |
| Securities markets framework | Framework for CIS, in particular close-end funds (depending on the country this could also be a specific framework for private equity/venture capital funds) | Carve out from the public offering regime | Carve out from the public offering regime | Room for proportionate regulation in the public offering regime | Framework for CIS, in particular close-end funds |
| Other supporting legal framework | Usually framework for partnerships | Framework for corporations | Framework for corporations | Framework for corporations | Potentially framework for SME markets, and/or private offering |

| | | | | | |
|--|--|--|--|--|--|
| Disclosure requirements | Negotiated directly with investors | Typically none | Varies from limited to no information requirements by regulation. In practice institutional investors might demand information including an offering circular and a rating for debt products | In general it requires the same type of disclosure than a public offering in the official markets, but some adjustments are made, mainly: (i) the possibility to provide fewer years of financial information and use of local GAAP, (ii) periodic disclosure is required only semi-annually and (iii) deadlines for submission of reports are usually extended. | Depending on whether placed via public offering or not. For public offering, prospectus and periodic and ongoing information |
| Corporate governance requirements | Negotiated directly with investors | No | No | Yes, for equity issuers. In general the requirements follow those of the official markets, but adjustments are made, in areas such as the number of independent directors and the type of board committees required; the thresholds for disclosure of material holdings and for take-over bids. | Governance of the CIS |
| Framework for the institutional investors | Must allow investment in private equity. | Must allow investment in securities of private offerings. Frameworks usually require a minimum rating for debt securities | Must allow investment in securities of private offerings. Frameworks usually require a minimum rating for debt securities | This is a typical investment; thus no need for any special treatment. Frameworks usually require a minimum rating for debt securities | In some countries, investment funds are treated separately. Thus the framework must allow this type of investments. |
| Credit rating | No | Typically no, as this offerings are not typically addressed to institutional investors | Usually required by institutional investors | Usually required for debt | Not necessary, but some EMEs require rating of CIS |
| Taxation framework | Many countries provide a favorable | Typically no tax incentive | Typically no tax incentive | Some countries provide tax | Requires taxation as a pass through |

tax treatment

incentives

Source: WBG

Table 6: Mechanisms to refinance SME lenders

| Preconditions | Corporate bond issuances by SME lenders | SME securitization | SME covered bonds | SME loan and credit funds |
|--|--|---|--|--|
| Supply side | Banks, microfinance institutions, factoring and leasing companies | Pipeline of SME loans, with quality information | Pipeline of SME loans, with quality information | Pipeline of SME related assets, such as SME loans, trade receivables, with quality credit information |
| Demand side | Potentially all investors, but in particular institutional | Mainly institutional | Mainly institutional | Mainly institutional and high net worth |
| Securities markets framework | Usually nothing additional | Framework for securitization | Framework for covered bonds | Framework for CIS, in particular close-end funds |
| Other supporting legal framework | Depending on the issuer, legal framework for banks, factoring, leasing | Legal framework for SPVs | Nothing additional | Depending on underlying asset, framework for secured transactions, factoring or leasing |
| Framework for the offering | For public offering, prospectus and periodic and ongoing information, including at a minimum semi-annual reports with audited financial statements and material events | Depending on whether placed via a public or private offer. For both, best practice is to provide granular information on underlying pool of assets required | Depending on whether placed via a public or private offer. For both, best practice is to provide granular information on underlying pool of assets required. | Depending on whether placed via a public or private offer. For both, best practice is to provide granular information on underlying pool of assets required. |
| Corporate governance requirements | Not for the offering, but the respective institution might be subject to CG based on its own framework | Framework to address conflict of interest, including retention requirements and prohibitions of related party transactions | The covered bond law would have provisions related to the obligation of the bank to replace non performing portfolio | Governance of the CIS |
| Framework for the institutional investors | This would be a typical investment Frameworks usually require a minimum rating | In some countries, structured products are treated separately. The framework must allow investment on them Frameworks usually require a minimum rating | No experience in EMEs with the treatment of covered bonds. They would probably fall under the category of fixed income/corporate bonds | In some countries, investment funds are treated separately. Thus the framework must allow this type of investment. |
| Credit rating | Usually required | Usually required | Usually required | Not usual |
| Taxation framework | Typically no tax incentive | Require favorable treatment of the transfer of assets | Require favorable treatment of the transfer of assets – when moving | Requires taxation as a pass through |

assets in and out of the cover pool, and in case of insolvency of the issuing entity, when the cover pool operates like a SPV

Instruments to provide SMEs access to capital markets

Bond issuances by SMEs

In general companies can issue bonds by way of a public or a private offering regime. Each regime has different implications for SMEs. Public offers require companies to comply with a series of disclosure requirements at the moment of authorization and on an ongoing and periodic basis. As a result, in practice public offers can only suit the larger SMEs. Private offers allow companies to raise capital under significantly streamlined requirements, or even no requirements at all depending on the country and the exemption under which they are made. Thus, theoretically they can accommodate a wider range of SMEs.

Post crisis, several countries are making adjustments to these regimes to facilitate SMEs access to the capital markets, both in AEs and EMEs. First, alternative markets for debt have recently been created. These markets provide SMEs access to the public (retail) markets, under a proportionate framework that makes it easier for them to comply with disclosure requirements.⁴⁶ SME debt markets have been developed in countries such as Germany, Italy and United Kingdom in AEs⁴⁷ and China and Peru in EMEs.⁴⁸ In addition, the crisis has also prompted additional interest and use of private offerings, for example, across Europe in countries such as France, Germany and United Kingdom, and even the creation of tailor-made regimes of private offers for SME bonds, for example in Italy, with the so called “mini-bonds”.⁴⁹ In EMEs several countries have developed regimes for private offerings addressed to institutional investors, including for example Brazil, Mexico, Peru and Thailand.⁵⁰

However, these adjustments do not fundamentally alter the nature of SME issuances, and thus key challenges that limit institutional investors’ appetite for individual issuances of SMEs remain. In

⁴⁶ See table 5 above on “Mechanisms to provide SMEs with access to capital markets”.

⁴⁷ The United States has a public offering regime for small companies, which applies equally to equity and debt.

⁴⁸ The creation of SME bond markets that are open to retail investors has triggered challenges for investor protection: it appears that in some of the countries retail investors have not fully understood the difference in the risk profile of the companies listed in the SME segment vis-à-vis the more established companies that are listed in the official markets.

⁴⁹ In addition to lighter disclosure requirements the Italian mini-bonds enjoy a preferential tax treatment.

⁵⁰ A review of hybrid regimes developed to cater to qualified investors can be found in Loladze, Tamuna (2015), “*Select Country Practices in Offering Mechanisms Applicable to Corporate Bonds: Analysis and Impact of Hybrid Offer Regimes*”, World Bank Paper.

practice, only the mid-cap companies have the potential to satisfy institutional investors, as they can potentially meet the size and minimum rating required by them.

SME bond funds

SME bond funds are collective investment schemes that pool together bonds issued by SMEs. The underlying bonds could be issued via a public offer (on an alternative debt market) or via a private offering regime. As the underlying assets are debt instruments, investors receive as returns the flows owed by the SME companies (interest payments and principal at maturity) minus fees, taxes, and operating costs. Given that the bonds are of limited liquidity, these vehicles are usually structured as closed-end funds.

Three key characteristics of SME bond funds make them potentially suitable to the risk return appetite of institutional investors in EMEs: (i) this vehicle performs as a fixed income product and delivers to investors higher yields than those offered by issuances of more established corporates as the underlying assets are SME bonds which by their nature offer higher returns, (ii) it addresses the scale problem that constrains institutional investors' appetite for SME bonds and allows further diversification by pooling the bonds together and (iii) it allows sharing of selection and monitoring costs among a wider set of investors, given that these functions are transferred to a specialized manager.

Interest for these types of funds has grown recently in AEs, particularly in Europe; however their share of the asset management industry is still very small.⁵¹ EMEs are also starting to show interest for this product. Examples of SME bond funds can be found in countries such as France, Germany and Italy in AEs. In many of these cases the funds have been tailor-made to the needs of institutional investors, including for example, the obligation of the fund manager to select companies that meet a minimum rating required by the institutional investors. In EMEs an SME bond fund has recently been constituted in Peru to invest in bonds issued by Peruvian companies in its alternative debt market (see box 3 below).

Two main lessons can be derived from such experiences:

- **The Peruvian example highlights the importance of funds as a vehicle to pool SMEs and attract different types of investors.** Further, in EMEs where direct retail investment in capital markets is not strong, the success of an alternative market might depend on the existence of vehicles to pool SME bonds issued in this market and make them attractive to institutional investors.

⁵¹ Information about the size and other data related to SME funds is rather scarce, given their relative novelty, heterogeneous nature, and small share of available investment instruments. Based on a survey of US and EU fund managers conducted by the Alternative Investment Management Association (AIMA), it can be estimated that \$85 billion of a total of \$530 billion of assets under management (AUM) of the funds surveyed accounted for private debt investments in 2014. Of this, about 30 percent, or roughly \$26 billion, could be estimated to be directed toward SMEs. However, there is not sufficient information available to further disaggregate these data by type of funds. See European Investment Fund (2014), *"Institutional non-bank lending and the role of Debt Funds."*

- **Another important lesson from these experiences relates to the role of governments and MDBs to crowd-in private investors.** As these are relatively new instruments, MDBs are committing resources to them, in an effort to crowd-in institutional investors. In Europe this role is being performed by the EIB and the EIF, which have committed resources to many SME debt funds across Europe. In the case of the Peruvian Fund, the IFC performed a similar role.

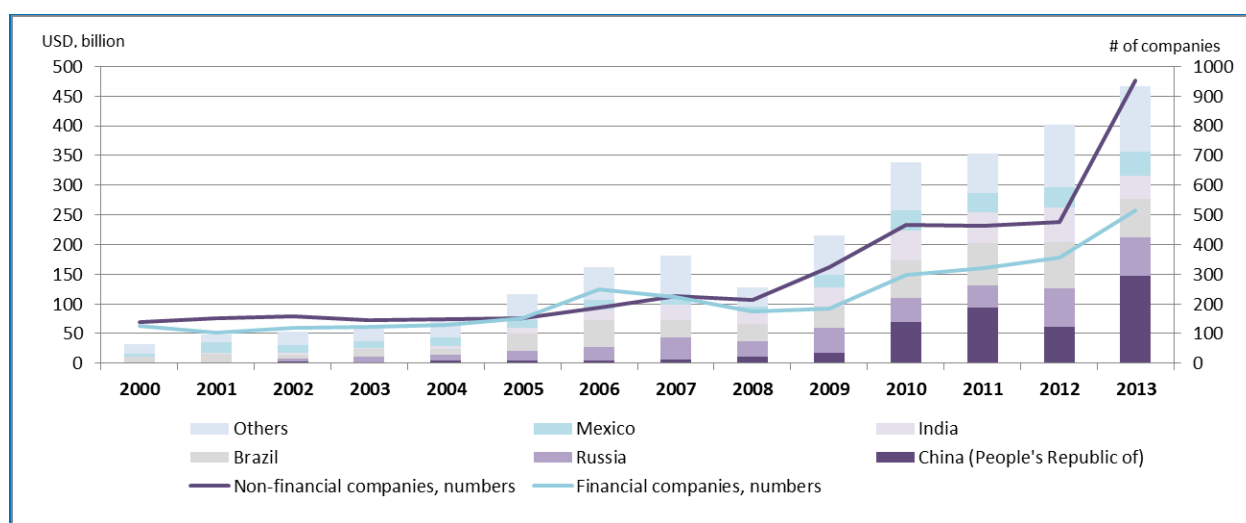
Instruments to refinance SME lenders

Bond issuances by SME lenders

In both AEs and EMEs refinancing of SME lenders is currently the key channel through which capital markets in general and institutional investors in particular are having the most impact in SME financing. Corporate bond issuances have been the main vehicle used by SME lenders to diversify their funding sources and/or improved the conditions of their funding.

Corporate bond issuances by financial institutions have experienced steady growth in EMEs. Bond issuance by EMEs companies has seen a monotonic and fairly steep increase since 2000, except for a crisis-related drop in 2008 (Figure 9), while the pattern in bond issuance in the US and EU has been more cyclical.⁵² Between 2000 and 2013, the total amount of money raised through bond issued by companies from emerging markets increased almost 15 times, reaching USD 467 billion. Both financial and non-financial firms contributed to this increase and their relative shares of total issues remained roughly unchanged during the period, with financial firms raising about 45 percent of all money and non-financial firms around 55 percent.

Figure 9: Corporate bond issuances by emerging market companies



Source: Çelik et al. (2015), OECD

Banks have been among the main issuers of corporate bonds in many EMEs; however increasingly other types of SME lenders are being able to come to market. Examples of issuances by banks can be found across a wide range of EMEs, from smaller EMEs such as Costa Rica and El Salvador to larger EMEs such as Kenya, Morocco, Peru and Turkey. In addition, increasingly other type of SME lenders, such as

⁵² Çelik, S., G. Demirtaş and M. Isaksson (2015), "Corporate Bonds, Bondholders and Corporate Governance", OECD Corporate Governance Working Papers, No. 16.

microfinance institutions, factoring and leasing companies are being able to come to market and get the benefits of more diversified and potentially cheaper or longer term funding which in turn has a positive impact on the availability of funding to SMEs. In the majority of EMEs, the latter issuances still constitute a small portion of the corporate bond markets. However the number of specialized lenders that are able to come to markets has increased over time, in particular in those EMEs where corporate bond markets have deepened. Examples of issuances by specialized lenders can be found in countries as varied as China, Colombia, Guatemala, India, Mexico, Morocco, Peru and Turkey. Most of these cases involve microfinance institutions; although in Guatemala leasing companies and in Turkey, leasing and factoring companies are recurrent issuers in the market.

Bank issuances have generally suited well the risk-return appetite of institutional investors given that they (i) deliver higher yields than government bonds, (ii) comply with the minimum ratings required by their investment frameworks, and (iii) have the necessary size to be attractive to them.

In contrast, to fit the risk-return appetite of institutional investors, in some cases issuances by other SME lenders have required credit enhancements. SME lenders usually have a higher risk profile than banks, and as a result a credit enhancement has sometimes been needed to get their issuances to the minimum rating required by institutional investors. In most cases, this credit enhancement has been in the form of a partial guarantee, provided by MDBs.

SME loan securitization

SME securitization allows the transformation of SME loans which are illiquid in nature, into tradable securities that are attractive to a wide range of investors, in particular institutional investors. Securitization allows the creation of a secondary market for SME loans, whereby a bank or SME credit institution (the “originator”) extends loans to SME companies (“primary market”), bundles them in a pool (“portfolio”), and sells the portfolio to capital market investors through the issuance of securities by a special purpose vehicle (SPV). The securities are backed by the loan portfolio (Asset Backed Securities, ABS). The asset-backed securities, classified by risk categories, represent tranches of the underlying portfolio.

There are several benefits of using SME securitization, including for the SME themselves. Securitization provides banks with an alternative source of funding in cases where they have either limited access to capital markets’ refinancing tools or unsecured bank bonds can only be sold at high cost. In addition it potentially allows banks to achieve economic and regulatory capital relief. From an SME perspective, SME securitization can have a multiplier effect in the funding available to them: as banks offload the SME loans, the same capital base could be used to generate additional loans.

Further, SME securitization can suit well the risk-appetite of institutional investors. They (i) can offer institutional investors access to assets that would otherwise not be available to them, (ii) which in turn can deliver to them long stable cash flows with higher yields than government bonds, and (iii) all this through structures that can support different tranches to cater to different risk-return appetites.

However, SME securitization markets remain a very small part of the overall securitization markets, even in AEs.⁵³ Only a few jurisdictions in AEs have established programs for SME securitization, the main ones being United States, Germany and Spain. Post-crisis other countries such as Greece, Italy and Portugal are relying on SME securitization. However the bulk of issuances in Europe are currently being made with the objective of securing collateral to obtain funding from the European Central Bank (ECB). Thus, since the crisis there is likely no expansion in SME lending as the issuing banks retain all tranches of those deals. The experience of EMEs with SME securitization is even more limited. Only Korea and India appear to have used SME securitization beyond one off transactions.

The relatively low level of SME securitizations in AEs has been partly due to the lack of economic viability. SME securitization becomes uneconomic if there is a mismatch of the yield required by investors and the return on the underlying asset for the issuer. Investors would seek a spread premium on SME securitization (over some comparable reference mortgage-backed security) to compensate for lower liquidity and (perceived) higher default risk of the underlying SME loans. Improved loan-level and performance data can help improve risk assessment and pricing and align the SME securitization spread (desired yield expected by investors) with spreads charged on SME loans by the originators, thus making SME securitization economically more viable and profitable. Often, guarantees are used to lower SME securitization risk spreads.

Indeed, experiences with SME securitization show the importance of guarantees to align the risk-return appetite of institutional investors, at least on a first stage. In particular in the larger jurisdictions in AEs such as Germany, Spain and United States, the approaches developed have incorporated some form of partial guarantee. Further, in Europe the benefit of guarantees as a key element to align the appetite of investors has prompted the EIB to put in place different programs for SME securitization whereby the EIB would provide partial guarantees to specific tranches of the issuances. Similar to the larger AEs, the program of SME securitization in Korea is supported by partial guarantees.

However, in EMEs, additional challenges have impacted the development of SME securitization markets. In particular, liquidity has not been a key concern of the banking system in many EMEs and as a result the incentives for securitization are lower. In addition, the level of development of capital markets has impacted the existence preconditions necessary for these markets to develop, as will be explained later in this Report.

SME covered bonds

As explained earlier, covered bonds are debt securities issued by a credit institution that are backed by a dynamic cover pool of high quality assets. Investors have double recourse to the issuer and to the cover pool, and thus the covered bond remains an on-balance sheet instrument. This feature creates asset encumbrance and limits issuance of covered bonds as compared to straightforward (off-balance

⁵³ SME securitization accounts for just two percent (\$34bn) of US asset backed securities outstanding, and seven percent (€105 billion) of total European securitization outstanding.

sheet) securitizations. As indicated earlier, the double recourse is the key feature that differentiates covered bonds from asset backed securities, as the latter are only backed by the flows stemming from the securitized assets. Issuers are traditional deposit taking banks or in some cases specialized lending institutions primarily reliant on covered bonds for their funding. Theoretically different types of assets could serve as the underlying asset for covered bonds; however in practice mortgages have been the predominant collateral. In this regard, the increased interest of both AEs and EMEs on covered bonds has focused on its role in housing finance.

There have been very limited issuances of SME covered bonds. In Germany, one bank recently issued covered bonds. More recently Italy created a parallel but separately branded product for SMEs, the *Obbligazioni Bancarie Collateralizzate (OBC)*, which are able to include a wide range of assets in their cover pools including SME loans, corporate bonds, commercial paper, shipping loans, lease and factoring receivables, as well as ABS tranches backed by the above assets. This is a work in progress. One of the reasons for this may be that Italy has a large SME sector together with an extremely sophisticated credit rating system for SMEs. However, those bonds are not subject to the same regulatory requirements and potential backing by the Italian central bank as traditional covered bonds are. There is only one experience with SME covered bonds in EMEs, in Turkey, where three local banks have placed a few issuances of SME covered bonds. The main investors in these issuances have been MDBs and public institutions.

The potential of SME covered bonds to fit the risk-return appetite of institutional investors in both AEs and EMEs is an open question. While SME-backed covered bond issuance is faced with the same inherent difficulties relative to credit risk assessment that are present at the SME securitization market, the strength of the covered bond system is anchored on the high quality of the 'cover pool', which is based on strict standards imposed by regulations. Indeed one of the key features of such regulations is the inclusion of precise definitions of eligible collateral. This helps to ensure the homogeneity of the cover pool, and the quality of the underlying loans, so that investors can be comfortable with the asset quality without the need for extensive due diligence on the underlying assets such as in the case of a securitization. In turn, this allows recurrent issuances, which enhances the liquidity of the instruments. Those rigorous standards do not yet exist for SME loans.

A fundamental question going forward is whether the best route to develop this product is by expanding the definition of covered bonds or whether a more innovative approach should be considered. A common argument against new asset classes being included in eligibility criteria for covered bonds is the quality dilution impact on the overall product. Thus, a different approach could be the development of a new instrument that could use some of the undoubted qualities of covered bonds but that could also use the benefits of SME finance loan assets to best advantage. The Italian collateralized loan obligations is a good example of a new approach using comparative advantages such as a good credit scoring system for SMEs. In either case, asset encumbrance should be properly monitored and if necessary, limits established to protect the position of unsecured creditors and depositors of the issuing financial institution.

SME loan and credit funds

SME loan and credit funds are collective investment schemes that pool together SME related assets, such as loans and receivables, and offer a participation in the returns of the fund to the investors. As the underlying assets are credit instruments, investors receive as dividends the flows owed by the borrowers (interest payments and principal at maturity) minus fees and operating expenses. Given that the underlying assets are illiquid, these vehicles are usually structured as closed-end funds that may or may not be listed on an exchange.

Similar to securitization, in general SME loan and credit funds have the potential to increase the availability of funding for SMEs, by allowing SME lenders to offload their SME related assets and thus free capital to use again in their SME operations. SME lenders in turn can achieve a more diversified and potentially cheaper source of funding. However, a key difference between securitization and fund structures is that in most countries the latter are usually structured as pass-through vehicles, with no financial engineering.

In general these instruments can fit well the risk-return appetite of institutional investors. They (i) can accommodate different types of SME related assets that can fit different risk appetites, (ii) provide scale and diversification on those assets, therefore removing key constraints to institutional investors' interest in SME related assets (iii) deliver long stable cash flows potentially higher than those of government bonds, (iv) and allow transferring of selection and monitoring functions to a specialized manager.

Interest for SME credit funds is growing in AEs, although their share of the asset management industry is still very small. In EMEs, SME debt funds are still at an early stage. In Europe the majority of these funds are specialized SME loan funds that target mid-cap companies; however examples of loan funds targeting SMEs exist in Netherlands, Germany, Ireland, and Poland among others. In EMEs, examples can be found of funds that invest in factoring companies as well as on reverse factoring, whereby the underlying asset is a set of invoices (IOUs) owed to SMEs by companies to which SMEs provide products and/or services, that is, accounts receivables on SMEs' books of certain SMEs' clients. The latter structures have been particularly attractive to investors as the credit risk involved is not the risk of the SMEs but rather of large companies that are SMEs' customers. The fund typically purchases these receivables from SMEs, providing them with immediate financing at an implied interest rate that is lower to comparable bank rates. Examples of this type of funds can be found in Chile and Peru (Box 3).

Box 3: SME funds in Latin America

SME bond funds: HMC Capital High Yield in Peru

HMC Capital High Yield is a newly established bond fund in Peru, supported by IFC investment, with plans to invest in local small and mid-size companies with local credit ratings of between AA- and BBB+. Its main strategy is to invest in companies issuing bonds through the Alternative Securities Market (Mercado Alternativo de Valores, MAV), although it is not exclusively concentrating on MAV and plans to also invest in regular public offer bonds of smaller size and lower rating.

MAV is Peru's alternative public offer regime for companies with no greater than S/.200 million (US\$ 70 million) in average

annual revenues for the last 3 years. It provides simplified disclosure requirements and lower costs to eligible issuers and currently focuses only on debt issues. Since its establishment in 2012, four companies have chosen to issue through this channel. The issuances have mainly been acquired by retail investors, with low appetite from institutional investors. The HMC Capital fund seeks to trigger institutional investors' interest in these companies by pooling several small bond issues together.

The fund is expected to have up to US\$ 100 million in capital, with US\$ 61 million already raised. It plans to make around 15 investments over 3 years with an average size of US\$ 7 million per investment. Investments will be made in both soles and dollars with two portfolios for each currency; the expected return is 8% in soles and 6% in dollars.

Though the success of HMC Capital is yet to be seen, given its very recent launch, it provides an interesting example from two perspectives. First, by standing ready to buy bonds issued through the MAV alternative market, including through networking with potential companies considering bond issuance, it is helping to stimulate issuance through the MAV, which otherwise has not proven to be viable. Second, by having IFC as a catalytic investor, the fund is able to attract additional investor interest, since IFC's presence is providing an implicit stamp of approval for the fund's investment strategy and expectations.

SME credit funds: Compass Fund in Peru

Compass Fondo de Inversion para PYMEs, a closed-end investment fund established in 2004, purchases from SMEs accounts receivables associated with their large customers and sells participation shares to capital market investors backed by the cash flow of these receivables. The underlying risk of the securities is, hence, of these large, creditworthy, sometimes internationally known, firms rather than of the SMEs themselves.

The fund operates with a 2-year term and has been renewed several times since its launch. It started with USD 55 mn in capital and has grown to USD 100 mn, with investors comprising local pension funds, the development bank Corporacion Financiera de Desarrollo (COFIDE), and the social security entity, the Oficina de Normalizacion Previsional (ONP). The fund has served over 2500 SMEs and around 32 registered corporations, whose receivables the fund purchases. The average maturity of the receivables portfolio is 60 days.

The scheme offers important benefits to all the participants. The SMEs are essentially able to transfer their credit risk to their high-quality customers and receive immediate working capital funding at more attractive cost – the implied interest rate is around 13-14% through the Compass factoring scheme, whereas that on working capital loans ranges from 18% to 30%. Participation is attractive for the large buyers because the fund offers them the opportunity to lengthen their payment schedule from 30 to sometimes 120 days. And capital market investors are able to access the SME asset class at an attractive return – 8-10% annual return – without being directly exposed to the SME credit risk.

SME credit funds: BTG Pactual Credito y Facturas Fund in Chile

BTG Pactual Credito y Facturas, is a Chilean fund that provides financing to non-bank institutions, primarily factoring companies that, in turn, extend financing to SMEs.

Chile has a well-developed factoring industry, which includes both bank and non-bank factoring companies. The success of the industry is anchored on a robust legal framework which provides certainty on the legal status and enforceability of receivables. Receivables are considered to be an "executive title" which means that they can be enforced in courts through an abbreviated proceeding.

The BTG fund focuses on the latter because they face the biggest difficulties in accessing funding, especially of longer-term.

Currently, the fund has four investments: Purchase of receivables from a pharmaceutical company, whose customer base is largely comprised of SMEs; Whole-business securitization of a factoring company; and direct loans to two factoring companies.

The instrument is structured as a listed closed-end fund that offers participation shares to investors who receive monthly dividends based on the income earned by the fund from the different investments. It was established in 2008 with a fixed maturity and has been renewed several times. The return to end-investors has fluctuated over the years but, on average, has been 350 basis points above the Chilean bank deposit rate

Source: WBG

V. Key Preconditions and Challenges Affecting the Development and Use of these Instruments in EMEs

The analysis above shows that there are a variety of fixed income instruments that can be used to mobilize institutional investors in EMEs for infrastructure and SME financing. Many of these instruments are already being used in some EMEs, which demonstrates that they can cater well to their risk-return appetite if they are properly structured. Furthermore, pioneer experiences are also taking place in a few EMEs. All these experiences provide evidence of the potential role that capital markets in EMEs could have in bridging the financing gaps in these sectors.

However, the role of institutional investors in bridging the financing gap of these strategic sectors has not yet fully materialized in many EMEs. To a large extent this is a reflection of the state of development of capital markets across EMEs. Indeed most of the examples found correspond to middle income countries where capital markets have already reached certain level of development, and where the institutional investor base has achieved an important size both in terms of AUM and in relation to the economy. As a result many of the preconditions necessary for these instruments to develop are present. However there is no predetermined cut-off size. Valuable examples of the role that institutional investors can play in financing strategic sectors have been found in middle income countries such as Costa Rica and El Salvador, whose capital markets can still be characterized as “modest” in terms of size and level of development.

This underscores the importance that EMEs governments identify the challenges faced in their respective countries and work on addressing them. In general such challenges affect (i) the enabling environment, (ii) the availability and offering of the instruments, and (ii) the demand of institutional investors for them. These challenges are explained below.

Challenges affecting the enabling environment

The state of development of the fixed income markets

In principle, the development of capital markets instruments for both infrastructure and SME financing requires that a fixed income market already be developed. As indicated earlier, there is a high level of correlation between country fundamentals, and in particular the income level of countries, and the level of development of their markets, including their fixed income markets. Thus, in general low income countries face larger challenges in connection with the key issues mentioned below:

- **The existence of a deep, liquid government yield curve.** This is key to supporting the pricing of these instruments. More generally developing government bond markets can be a catalyst for establishing and improving an appropriate bond market infrastructure, and broadening and deepening the fixed income markets. Significant progress has been made in government bond market development especially during the last twelve years. Indeed, in some of the larger EMEs a deep and fairly liquid yield curve already exists as the sovereigns have been able to fund themselves in the domestic markets in local currency and long term. However, for many of

them, there is still a broad agenda of issues to tackle that includes expanding the yield curve, reaching liquidity across a wider range of maturities, having a more active secondary market and a more diversified investor base, and developing hedging tools. For the smaller EMEs, whose markets are at an earlier stage of development, the agenda involves a more fundamental set of issues including, bearing the initial cost of market development when market-based instruments may be more expensive and of shorter duration than concessional financing and other non-marketable loans; developing the legal and regulatory framework, and institutional arrangements and capacity for undertaking market-based financing; supporting a regular issuance program in a range of maturities when cash forecasting and cash management capabilities are rudimentary; and more broadly, achieving the macroeconomic and political stability necessary to attract long-term participation in the domestic fixed income markets.

- **The existence of well-functioning money markets.** This is another building block fundamental for the development of both government and non-government fixed income markets. Reliable pricing at shorter tenors (of less than one year) is necessary to anchor the entire yield curve, and active trading of instruments, both outright and repo, support this price discovery. Money markets also serve as an important financing source for primary dealers and other market participants that invest in fixed income instruments. And the development of repos provides a very flexible tool for short-term lending/borrowing, monetary policy implementation, and cash management, making the development of the money market an important initial investment for well-functioning fixed income markets. Developing money markets is an area of challenge for all EMEs, for which coordination with central banks policies is extremely important.
- **The existence of key market infrastructure, including payment systems, central securities depositories and custodians.** In general in the larger EMEs robust infrastructure is already in place and the challenges lie more in securing seamless cross-border interaction, which is particularly relevant to attract foreign investors. Smaller EMEs still face challenges, in particular in connection with dematerialization of securities, achieving delivery versus payment to limit execution risk, and collateral management that is necessary for developing repos and securities lending products. Such infrastructure is initially developed for the government securities market, with expected positive spillovers for other fixed income markets.
- **The existence of credit information services, including credit ratings, and credit analysis on debt issuances.** Credit rating services are already in place in the larger EMEs. The priority for these EMEs lies now in implementing regulatory and supervisory frameworks aimed at strengthening the quality and increasing the transparency of processes and methodologies, and mitigating the inherent conflicts of interest of the CRA models, in line with the IOSCO Principles. However, such services are not available in the smallest EMEs, although potentially they could be provided by foreign rating agencies. In contrast, research analysis on debt instruments is usually lacking in the majority of EMEs.

A stable macroeconomic environment

A stable macroeconomic environment is key for long term investment. A strong policy framework and stable macroeconomic policy reduce uncertainty and boost investor interest.⁵⁴ Where inflation rates are high and currencies volatile investing over a long-term horizon is not possible. This is the case for both domestic and foreign institutional investors. Furthermore, qualitative information suggests that the macroeconomic environment is a key factor, that foreign institutional investors consider when deciding whether to make investments in EMEs. The governments of many EMEs have implemented the necessary reforms to build the foundation for a stable macroeconomic environment – although the crisis has put pressure on some of them. Some EMEs still have work to do to achieve the needed progress on the macro stability front.

The tax framework

Taxes can affect the financial viability of different types of instruments and influence institutional investors' choices. Indeed key to the financial viability of both securitization and fund structures is the tax treatment of these vehicles, in particular in connection with the transfer of assets to the vehicle. In both cases the key tax objective is to achieve tax neutrality. Yet, in many EMEs this remains a challenge particularly in the context of securitization structures. More generally the existence of favorable tax treatments for certain types of investments and/or vehicles can act as a powerful incentive for their use. However, it is important that any such incentive (even if it is directed towards long term investment) be adequately crafted and its potential impact assessed.

Finally, the clarity and stability of the tax framework is key to long term investment. Clarity around tax exemptions and stabilization of taxes over the life of long term projects are also among important factors that could increase the appetite of institutional investors. Sudden changes in tax policy will reduce investor confidence as it creates uncertainty.

The rule of law and the framework for creditors' rights

In general, respect for the rule of law is necessary for private sector engagement.⁵⁵ In general the basic principles that underpin the rule of law are in place across EMEs; however, specific challenges might

⁵⁴ Burger et al (2012) find that countries with stable inflation rates (a proxy for creditor-friendly policies) have more developed local bond markets. Similarly, Goldstein and Turner (2004) argue that economic policies and institutions are key determinants of bond market development in EMEs. Hale (2007) suggests that country risk is the key macroeconomic fundamental that explains a large share of the variation in corporate financing choices between bonds and syndicated loans in EMEs. See: Burger, et al (2012) *“Emerging Local Currency Bond Markets”*, Financial Analysts Journal, 68: pp.73-93; Goldstein, Morris and Philip Turner (2004), *“Controlling Currency Mismatches in Emerging Markets”*, Institute for International Economics, Washington, DC; and Hale, Galina (2007) *“Bonds or Loans? The Effect of Macroeconomic Fundamentals”*, *The Economic Journal* 117: pp. 196-215.

⁵⁵ The rule of law has been defined by the World Justice Project as a system in which the following four universal principles are upheld:

- The government and its officials and agents as well as individuals and private entities are accountable under the law.
- The laws are clear, publicized, stable, and just; are applied evenly; and protect fundamental rights, including the security of persons and property.

exist on a country by country basis. In particular the quality and expediency of the judiciary is an issue of concern for many EMEs, although it must be acknowledged that protracted judicial procedures are also of concern for many AEs.

Within this general framework, implementing a strong framework for creditors' rights, and in particular a robust insolvency system, is key to fixed income markets. An insolvency framework that promotes the reorganization of viable enterprises and gives honest entrepreneurs a second chance is critical to improve SME's access to finance. At the same time, expedite insolvency procedures mitigate investor and creditor risk, as they can lead to higher recovery rates. However, many EMEs still face challenges in connection with their insolvency frameworks. In many cases they do not include out-of-the-court arrangements, and they severely penalize entrepreneurs. In addition, insolvency proceedings are protracted.

The quality of regulation and supervision

Finally, the quality of regulation and supervision of capital markets can also impact institutional investors' confidence to participate in the market. It is generally considered that institutional investors have the capacity to understand the risks of the investments they made. As a result securities markets regulation and supervision has usually focused on market transparency and integrity and the protection of retail investors. However, institutional investors do not invest in a vacuum. Rather, the perception of the level of investors' protection of a country, and the degree to which the markets are fair and transparent, are key considerations that investors, in particular foreign institutional investors, take into consideration when investing in a jurisdiction. That is why a stronger regulatory and supervisory environment—including better protection of property rights, creditor rights and information—have all been shown to be positively associated with higher levels of financial development.⁵⁶

Further the crisis has also highlighted the importance of strong supervision for purposes of identifying emerging and systemic risk. As the types of instruments available to institutional investors in EMEs expand and become more complex, so does the need for supervisory agencies to enhance their risk analysis capabilities. The IOSCO assessments conducted post-crisis show that supervisory agencies are strengthening their process to identify and monitor risks, though this is still work in progress.

Challenges affecting the availability and offering of the instruments

The pipeline of investable infrastructure projects and SME related assets

-
- The process by which the laws are enacted, administered, and enforced is accessible, fair, and efficient.
 - Justice is delivered timely by competent, ethical, and independent representatives and neutrals who are of sufficient number, have adequate resources, and reflect the makeup of the communities they serve.

⁵⁶ Sahay et al., 2015.

The existence of a robust pipeline of underlying assets is a necessary precondition for the mobilization of institutional investors to infrastructure and SME financing via capital markets. Investors need the existence of a robust and continuous pipeline of instruments to justify the commitment of resources to enhance their risk-analysis teams. In practice EMEs face significant challenges in relation to both the pipeline of investable infrastructure projects and SME related assets as will be further explained below.

Infrastructure projects

The lack of a pipeline of high quality investable projects is repeatedly mentioned by institutional investors as the key impediment for their investment in infrastructure across the majority of EMEs.⁵⁷

Private sector investors are interested in well-developed PPP transactions supported by robust upstream prefeasibility analysis and other project related due diligence that can demonstrate the commercial potential for private sector investment. This includes ensuring cost recovery for a proposed investment in a PPP project, either through reformed sector tariff policies that allow for tariff adjustment mechanisms, or alternatively through government support in the form of availability payments or revenue guarantees. However, many EMEs lack such a flow of commercially viable PPP transactions, the capacity to prepare the projects is deficient and there is little or no experience with PPPs.

Furthermore the PPP frameworks in many EMEs are still deficient. Legislation and policies governing PPPs remain unclear, or its application is inconsistent. In many EMEs bidding processes are not perceived to be competitive or sufficiently transparent, and the tariff regimes are undefined or unknown. In addition, in many cases there are multiple agencies involved in PPPs, but a consistent strategy for engaging with the private sector across the different sectors/industries is missing. This often results in signaling a weak or uncertain government commitment to a PPP transaction. Compounding all these technical challenges is a perception of the potential for regulatory and/or political interference.⁵⁸

Over the last decade some EMEs have embarked in reforms to build a successful track record of PPPs, anchored in robust PPP frameworks. That is the case of some countries in Latin America; in particular Chile, Mexico and Peru, where such a positive track record already exists. Other regions, such as Africa are further behind, although countries like South Africa and more recently Kenya are also building a good track record with PPPs.

Regional and global initiatives are supporting the development of such a pipeline of projects. For example, the Africa50 Fund is seeking to develop a robust pipeline of PPP projects across the Africa region. At the global level, the Global Infrastructure Facility (GIF) recently created by the WBG, will facilitate the preparation and structuring of complex infrastructure PPPs to mobilize private sector and institutional investor capital. From the start to the finish of a project, the GIF platform will provide support, drawing on its array of technical and advisory partners, which will include private investors, to ensure well-structured and bankable infrastructure projects are brought to market. Both initiatives are

⁵⁷ Shendy, Riham et al (2011). *"Towards Better Infrastructure: Conditions, constraints and opportunities in financing public-private partnerships in selected African countries"*, A World Bank Study 63433.

⁵⁸ A recent survey conducted by Probitas Partner 45 percent of the respondents indicated a lower degree of interest in EMEs infrastructure due to political, economic or currency risk. The BLP-Preqin analysis indicates that the biggest threat perceived by 60 percent of the respondents to a sustained flow of deals in 2014 is government or regulatory interference/political risk. See OECD, 2014, *"Private financing and government support to promote long-term investments in infrastructure"*.

at an early stage; thus it is too early to assess the impact that they will have in addressing this key challenge.

However, even in countries with a good track record for PPPs, additional reforms to the PPP framework are needed to foster use of capital markets instruments. Currently bank loans appear to be better suited to finance greenfield projects, which constitute a key component of the infrastructure gap in EMEs. As a result, it is critical that EMEs work on developing ways to facilitate the transfer of projects from bank debt to capital markets instruments --such as project bonds or infrastructure debt funds-- as the project matures. This in turn would help banks free up capital that could be used to finance additional greenfield projects, thus overall expanding the capacity of EMEs to finance greenfield projects. One of such measures is the standardization of PPP contracts. That said, for many EMEs expansion of existing infrastructure is also an important component of infrastructure gap. While project bonds and other fixed income instruments can suit well this type of projects; the PPP bidding processes in many EMEs do not adequately account for the possibility of capital markets financing. Indeed, in many EMEs the bidding processes associated with PPPs have been designed with bank lending financing in mind and thus bidders might face difficulties when proposing capital markets financing, particularly if “certainty” of funding is required at an early stage of the process. Thus, such processes need to be reformed to provide room for capital markets funding.

SME related assets

The lack of a robust pipeline of SME related assets is also a key challenge for institutional investment in SME related instruments. SMEs in EMEs are likely to be smaller and more informal than those in AEs. In contrast, as explained earlier institutional investors’ appetite is limited to the larger SMEs with a more solid track record. As a result, for many EMEs the lack of a sufficient number of robust mid-cap companies that can be pooled together is a key challenge that limits the investment of institutional investors in instruments that provide SMEs with access to capital markets. A similar challenge exists in connection with some of the instruments used to refinance SME lenders, in particular SME loan securitization and SME loan funds. The financial viability of these structures depends on the existence of a sufficient volume of SME loans, backed by robust credit information. Yet in many EMEs banks and other SME lenders would argue that there are not enough “quality” SMEs (“bankable” SMEs) –as it is sometimes argued in some AEs. Theoretically multi-origination platforms can help mitigate this challenge; however, in practice, their implementation poses challenges. In addition, in many EMEs the level of liquidity of the banking system has operated as a disincentive for the development of securitization or SME loan funds, particularly when the pipeline of bankable SMEs is not robust.

In most EMEs the universe of bankable SMEs is constrained by challenges related to credit infrastructure. Indeed in most EMEs there are still challenges related to the credit information available to assess the creditworthiness of SMEs, as credit bureaus usually cover information on individuals and not firms, and even if firms are covered the information available on them is very limited. Further, in many EMEs, movable assets are not yet accepted as collateral by lenders, and collateral registries are not yet in place. These limitations not only affect bank lending but also asset-based lending by trade

partners, including factoring and leasing. Finally, challenges in the insolvency framework also remain, as in many EMEs they do not facilitate reorganization, nor provide entrepreneurs with a second chance. Finally, insolvency procedures are protracted.

Many EMEs are working towards addressing limitations in these areas; however the challenges are still significant. In particular progress is being made across EMEs to put in place the foundations for the use of movable collateral, by approving the corresponding legal framework and establishing collateral registries. For example, laws on movable collateral have recently been passed in EMEs as diverse as Costa Rica and Turkey. Progress is also being made in credit information, but mainly in the larger EMEs where credit scoring systems are being developed, in many cases based on the experience of AEs. For example, banks in Morocco have started to develop credit scoring systems with support from Italian counterparties. Other specialized services such as SME credit ratings have also developed in some jurisdictions, such as for example in India.

Box 4: The importance of credit infrastructure for SME financing

Credit information

Credit reporting systems are an essential tool to address the SME financing gap as they help to address the problem of asymmetry of information. While credit bureaus cover with a great level of granularity credit information for consumers (individuals), they frequently do not provide information on SMEs. Credit insurers, credit rating agencies, commercial credit reporting systems and credit registries may serve as an alternative and provide inputs on SMEs to those parties that provide financing.

The benefits of CRS depend largely on the size of the SMEs. For the smaller SMEs, which usually represent the bulk of SMEs in a country, reform efforts should be oriented to allow non-traditional typologies of data to be shared with credit bureaus. These data includes for example data on payments to mobile telephone companies, utilities, and public data. In the past few years these data has proved important to build a credit history for those who do not have it (the “informal”, non-bankable, micro/SME). For the larger SMEs, CRS such as SME rating systems would be a complementary source of information that could potentially be used also by capital markets as an additional tool to assess creditworthiness.

Collateral lending

The inability to use a firm’s most valuable assets as collateral is among the top reasons for difficulty in accessing finance. According to the World Bank’s Enterprise Surveys, assets owned by any given business are typically 75 percent movables (inventory, equipment, farm products, accounts receivable and intangibles) and only 25 percent are real state (land or buildings). Conversely, collateral required by lenders is typically 80 percent real estate and only 20 percent movables. Reforming the legal framework for secured transactions to allow the use of movable collateral to secure loans is critical to better balance the assets SMEs possess with those that banks can accept as collateral.

Further, the potential impact of other alternative sources of financing like movable asset financing cannot be underestimated. In China, between October 2007 and June 2011 the secured transactions reform cumulatively facilitated USD \$3.58 trillion accounts receivable financing, of which USD \$1.09 trillion were awarded to SMEs. In fact, as a result of the reform the total number of commercial loans involving movable assets grew by 21 percent per year in 2008-2010, versus a flat rate in 2006-2008. In Colombia, in less than one year more than 100,000 loans secured with movables have been registered in the movable collateral registry, of which 5,000 loans belong to MSMEs for a total aggregate amount of USD \$3.43 billion (compared to a few hundred per year before the reform).

Insolvency

Implementing a robust insolvency system that promotes the reorganization of viable enterprises and give honest entrepreneurs a second chance is also critical to improve SME’s access to finance. A reorganization-oriented insolvency regime plays a crucial role in mitigating investor and creditor risk, which in turn contributes to improved access to credit and lower cost of credit, as

well as to a more stable financial system.

Evidence from work in this area suggests that reforming an insolvency regime can help lower interest rates, making credit more affordable especially for SMEs. For instance, in Italy, the 2005 bankruptcy law reform that deeply reformed the liquidation procedure led to a decrease in interest rates⁵⁹. In particular, firms with higher numbers of bank creditors saw the most pronounced reduction in interest rates due to the enhanced coordination provided by the bankruptcy law. In Brazil, a study of the 2005 bankruptcy law reform reported a statistically significant increase in the Brazilian private credit market⁶⁰. At the firm level, the authors reported a 10 percent to 17 percent increase in total debt and a 23 percent to 74 percent increase in long-term debt.

Source: WBG

In addition, programs to enhance SME financial skills and governance are needed. Some EMEs already have such type of programs in place. Training, mentoring, and funding to access professional services are typically provided to improve the financial accounting and disclosure practices in SMEs, as well as the quality of business plans and investment projects. In some countries, such as Mexico, policy programs target mid-sized companies that have the potential and interest to issue bonds but are constrained by capacity gaps and a weak governance structure.

Box 5: Enhancing SME financial skills and corporate governance practices for accessing capital markets

Mexico's Debt Program

In 2011, Mexico's Ministry of Economy allocated MXN 50 million (USD 4 million) to launch the Debt Program in alliance with the Mexican Stock Exchange and AMEXCAP. Its aim is to enable companies to issue bonds that can be quoted on the Mexican Stock Exchange. The program offers middle-sized SMEs funding to carry out the necessary corporate governance enhancements, introduce an appropriate software infrastructure, and obtain legal and advice services for listing. In more detail, eligible costs are:

- Professional services: corporate governance, process documentation, corporate finance, tax, audit and legal services.
- Systems like ERP (Enterprise Resource Planning): software licenses, hardware and consulting (not CRM).
- Debt rating by one of the rating agencies recognized by the National Banking and Securities Commission (CNBV).
- Issuance costs.

The maximum amount to be financed per company awarded is up to 90 percent of the total costs of the working program or up to \$10 million pesos. The beneficiary company must provide at least 10 percent of the total cost of the working program.

Some 124 companies registered in the first call and 10 were selected. A second call was closed in 2012 with an additional MXN 100 million (USD 8 million) funding support.

Sources: OECD (2013), *Mexico: key Issues and Policies*, OECD studies on SMEs and Entrepreneurship, OECD Publishing, Paris; ICSA (2013), *Financing of SMEs through Capital Markets in Emerging Market Countries*, International Council of Securities Association

The legal and regulatory framework for the instruments

⁵⁹ Rodano, Serrano-Velarde, Tarantino (2012).

⁶⁰ Ferreira and Funchal (2012).

For securitization structures

Project bonds, sukuk and SME securitization are anchored on a robust legal and regulatory framework for securitization. Key elements of that framework include (i) a framework that allows the securitization of a wide array of assets, including future flows, (ii) a robust special purpose vehicle (SPV) that is bankruptcy remote and (iii) clear guidelines for the transfer of assets including what is considered a true sale.

However in many EMEs appropriate frameworks are not yet fully in place. In the larger EMEs where some sectors of the securitization market have already started to develop, this basic framework is likely to be in place. In the smaller EMEs some of these components are still missing, or if in place, are yet to be tested.

For covered bonds

Covered bonds are issued under a dedicated legal framework that provides for minimum quality standards for the collateral. The existence of such standards provides investors with confidence that the bonds are issued in a uniform way.

The majority of EMEs lack such a dedicated framework. As explained earlier, interest in covered bonds has spread beyond Europe, including to EMEs, but such interest has focused on the capacity of these instruments to support housing financing. As a result, the main collateral been considered are mortgages (and in a few countries commercial real estate). Outside of AEs, countries such as Brazil, Chile, India, Korea, Morocco, Poland, South Africa and Turkey have enacted or are in the process of enacting dedicated frameworks for covered bonds. Out of these countries, only Turkey has included SME loans as acceptable collateral. However, as explained earlier the use of covered bonds for SME financing is an open question.

For fund structures

Many of the pooling instruments described above rely on the existence of a robust legal and regulatory framework for closed-end funds. In practice key issues that such framework should include are (i) a robust vehicle (whether a trust, company, or fund) along with strong segregation requirements (ideally, the bankruptcy-remote sale of assets to the SPV); (ii) a framework that allows pooling of a wide array of underlying assets, including non-traditional assets such as loans and receivables; (iii) a prudential and investment framework that provides sufficient flexibility for funds that are offered to qualified investors; (iii) a robust framework for the fund managers that requires their registration based on prudential and fit and proper requirements and (iv) a robust framework for the management of conflicts of interest.

Some EMEs still have incomplete frameworks for collective investment schemes (CIS). The larger EMEs already have relatively complete frameworks for CIS in place. As a result, many of the elements described above are already in place. Nevertheless, in practice some countries have found it necessary to develop specialized regulations for particular types of funds, to adjust issues such as the type of

eligible assets, and the investment and prudential framework that would apply to them. For example, India developed specific regulations to specify the vehicles that could be used for infrastructure financing.⁶¹ In general, the key challenge lies in striking the right balance in the investment and prudential framework, particularly when the instruments are only placed to institutional investors. Smaller EMEs face additional challenges as in many cases their CIS frameworks are still at an early stage.⁶² In addition, in particular in the case of infrastructure funds, the limited knowledge of domestic managers about this asset class is an important challenge across all EMEs. In some EMEs, such as Peru, this challenge has been addressed via partnerships between local managers and specialized foreign managers or simply by using foreign managers.

The offering regime used to place the instrument and the information provided to investors

In AEs issuers would generally choose to place many of the instruments described above via a private offering as they are better suited to the appetite of qualified investors, rather than retail investors. As a result in many AEs they would be exempted from disclosure requirements vis-à-vis the public and from the regulatory approval of the offering by the securities regulator. This streamlined regime vis-à-vis the regulator can lead to important economies particularly in terms of time-to-market.

The use of a private offering regime for qualified investors does not mean however that sufficient information should not be given to investors. Indeed, in practice institutional investors impose information requirements adjusted to their specific needs. Thus, it is common that issuers provide an offering circular/term sheet to the investors at the moment of the offering. In addition, for particular products, investors are requiring also more granular information not just at the time of the offering but also on an ongoing basis and periodic basis. That is the case for example, with many securitization structures, whereby as a result of the lessons from the crisis investors are now requiring information on a periodic basis at the individual loan/asset level. In some jurisdictions, such as the EU and the United States, industry-led efforts are underway to standardize the information to be provided to investors.

In some EMEs these regimes are still not available and thus issuers do not have the choice of such a streamlined regime. It must be acknowledged that in recent years more EMEs have included offering regimes to qualified investors either as an exemption to the public offer regime, or as hybrid regimes that significantly streamlined disclosure requirements. That has been the cases in countries such as Brazil, Mexico, Peru and Thailand. A key issue, however, is whether, in line with the lessons from the crisis, in practice institutional investors are demanding and receiving sufficiently robust information not

⁶¹ India developed two different vehicles for infrastructure financing: a MF in the form of a closed-end fund under the oversight of the securities regulator and a non-bank financial institution under the oversight of the Reserve Bank of India. The investment and prudential frameworks applicable to each vehicle differ.

⁶² Indeed the assessments of the level of implementation of the IOSCO Principles undertaken by the WBG and the IMF as part of their Financial Sector Assessment Program show that many EMEs still have important deficiencies in the frameworks for CIS. While the assessments focused on CIS offered to retail investors, many of the features of such type of funds are applicable to funds offered to qualified investors.

just initially but on a periodic basis to properly monitor their investments. As part of such information, in the context of fund structures, it is key that institutional investors receive clear information on fees paid, and in particular the fund manager's fees, to be able to effectively assess their impact in the returns of the portfolios under management.

The economics of the transactions

Finally, financial viability might prevent the development of some of these instruments, at least in the short term. For infrastructure, it is likely that many of the projects would require the government to retain some of the risks involved (for example usage risk) or provide some form of support to make private participation via PPPs financially viable. However governments would need to carefully assess the direct and contingent liabilities that these commitments would fiscally entail, and whether such PPPs would still achieve value for money. In addition, for both infrastructure and SME financing, it is likely that some of the instruments would require some type of external credit enhancements to attract institutional investors, in particular given their preference for highly rated securities. However, the costs of these credit enhancements would need to be financially sustainable. There are also other costs associated with an issuance of capital markets instruments; including fees related to services provided by different participants in the issuance process (lead manager, underwriters, lawyers, auditors, etc) and costs associated with disclosure and other regulatory requirements.

Some of the costs might diminish over time. Indeed as experience with PPPs increases, and more quantitative data becomes available, so does the ability of governments to determine the precise level of risk sharing between the government and the private sector. Similarly, as institutional investors get more familiarized with certain instruments (and risks) the need for external guarantees might diminish, or at least experience can help to better determine the optimal level of such credit enhancements. Finally, the more issuances become standardized, the more the possibilities to save on issuances costs. The role of MDBs bearing some of the risk associated with first time transactions will be critical in EMEs.

Challenges affecting institutional investors' demand for these instruments

The investment framework

In many EMEs the investment framework for institutional investors is very rigid and might prevent them from investing in infrastructure and/or SME related instruments. Due to their mandates and fiduciary duties it is key that institutional investors are well regulated; including through the establishment of investment frameworks and other prudential requirements such as governance and risk management. In most EMEs the investment frameworks follow a rule-based approach, which includes the imposition of quantitative limits for particular types of instruments. Such limits seek to operate as a risk management tool. However, in some countries, the frameworks are overly prescriptive and certain instruments are subject to low limits or even bans, which in the end can affect the optimal allocation of the portfolios and disincentivize investment in particular asset classes. For example, in some EMEs "alternative" assets (which in many countries would include infrastructure), illiquid assets (including unlisted securities), investment funds, and structured products are subject to low limits and even bans. In many cases, the problem stems from the fact that one single "bucket" covers many

different types of assets, and as a result all such different types of assets “compete” against each other.⁶³

In addition, other provisions disincentivize long term investment. In particular, provisions on performance may cause institutional investors to focus on short term performance, which in turn may operate as a disincentive for infrastructure investment, given its long term nature. For example in Latin America and Eastern Europe, investment regulations that require funds to offer investment guarantees on a nominal basis or relative to peers have prevented diversification of pension funds into longer term assets.⁶⁴ Also, rules that allow affiliates to change their investments from one fund to another without penalties within very short periods of time have further exacerbated the short term behavior of pension funds, as they see the need to hold more short term instruments to face potential withdrawals. Finally, in many cases fees are also charged based on short-term performance. On the insurance side, there are concerns that the move to risk-solvency frameworks, similar to those implemented in AEs, may cause insurance companies to be unduly conservative in their investment approach, reducing their allocations to asset classes such as infrastructure. However, based on available evidence, infrastructure projects do often incur sizable risks, and therefore material deviations from a risk-solvency framework need to be carefully substantiated⁶⁵.


It must be acknowledged that in some EMEs, regulators are enabling more flexible investment regimes. Indeed, regulators have grasped the importance of further diversification in pension fund portfolios to improve investment returns and reduce risk. As a result, they have been open to expanding the universe of eligible investment asset classes over time as markets develop and the knowledge and experience of the funds and the regulator grows. Such more flexible regulations are being followed by stronger governance and risk management requirements. The history of Mexico’s investment framework provides a good example of such development and how a supportive regulatory environment can be created to allow pension funds’ assets to be invested securely in infrastructure and SMEs (Table 7).

⁶³ See IOPS, Op cit.

⁶⁴ For a discussion of the impacts of investment regulations see Stewart, F. (2014), “*Proving incentives for long-term investment by pension funds : the use of outcome-based benchmark*”, World Bank Working Paper 6885

⁶⁵ The European Insurance and Occupational Pensions Authority (EIOPA) has released for consultation the “Discussion Paper on Infrastructure Investments by Insurers” to gather more information on this topic. See IOPA-CP-15/003

Table 7: Evolution of Mexican Pension Fund Investment Limits



CURRENT INVESTMENT OPPORTUNITIES COMPRISE THE MAJORITY OF ASSET CLASSES USED BY INTERNATIONAL PENSION FUNDS

Currently there are six asset classes:

| Asset classes allowed within the Investment Regime of Pension Funds | | | | | | | | | | | | | | | | |
|--|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
| Debt | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Currencies | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Equity | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Structured Securities: CKDs (Mexican Private Equity) y FIBRAS (Mexican REITs) | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Securizations | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Commodities | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✓ |

Within each asset class, restrictions have been relaxed: international stock picking (thru mandates), international debt with investment grade, relaxed issuer limits for debt, etc.

Source: CONSAF

However, eliminating misalignments that incentivize short term investment has proven more challenging. A few regulators, such as those in Chile, Colombia and Lithuania, are currently working on the design of better benchmarks or reference portfolios as a way to align regulation with the long-term goal of delivering adequate pension income. These portfolios are designed to deliver a targeted pension income within the parameters of the greatest probability and the least risk. However this is still work in progress. On the insurance side, it is critical that as EMEs regulators move to risk-based prudential frameworks proper calibration of such frameworks is achieved.

Knowledge and capacity issues of institutional investors

A key issue in many EMEs is the limited capacity of domestic institutional investors to analyze instruments beyond plain vanilla products. In many EMEs changes towards more flexible investment regimes have been accompanied by stronger governance and risk management requirements. However, the risk assessment for some of these investments, in particular infrastructure investment is much more complex and might exceed their current capacity. In this regard, many institutional investors in EMEs might already have the capacity to analyze the financial risks involved in infrastructure investment. However as explained above this type of investment involves important non-financial risks whose analysis requires additional skillsets that many institutional investors in EMEs do not currently have. In addition, the structures and instruments used for infrastructure and SME financing can add complexity and require stronger risk analysis capabilities. That would be the case for example of securitization structures, particularly if complex tranching is involved.

Mechanisms to align the risk-return appetite of institutional investors

The current crisis has highlighted the importance of simple, transparent and comparable structures supported by high quality assets to align the risk-return appetite of institutional investors. Several efforts are underway in AEs to revive securitization markets by making securitization simpler and more transparent.⁶⁶ In particular, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) recently issued “*Criteria for identifying simple, transparent and comparable securitizations.*” Ideally, more precise definitions of high quality assets should follow, including for example for SME loans.⁶⁷ Standardization efforts are also being undertaken in the context of other markets and instruments, including those used for infrastructure financing.⁶⁸

Given the current concentration of their portfolios in plain vanilla instruments, it could be expected that institutional investors in EMEs would also prefer simple, transparent and comparable structures, supported by standards that (i) define high quality assets and define also (ii) a set of information on the underlying assets that would need to be provided to investors, to facilitate their understanding of the risks imbedded in the products and the comparability against different investment opportunities.

Having such type of structures readily available is a challenge for many EMEs. As most of these instruments are relatively new to EMEs neither the regulator nor the industry have developed high quality standards associated to them. EMEs could benefit from the work conducted in AEs. However, even then, an important challenge relates to the lack of data on infrastructure investments and of relevant data on credit history and the resulting difficulty for investors to assess the associated risks.

In addition, the experiences so far indicate that in many cases, external credit enhancements will also be needed to align their appetite. Indeed, institutional investors might not be willing and/or able to take some of the risks imbedded in a potential investment. Moreover, in general, institutional investors would only invest in highly rated fixed income instruments, not just because of regulatory limits but also because of internal limits and policies. That is why for many of the instruments discussed in this Report there would be the need for some form of external credit enhancement, such as partial guarantees, to transfer those risks and bring the instrument to the desired rating. Other type of public financing

⁶⁶ Such initiatives are being undertaken by public authorities and the private sector. For instance the industry-led Prime Collateralized Securities (PCS) initiative, the differentiation introduced in European regulation based on the concept of high-quality securitization for simple and transparent securitizations, the proposal by the Bank of England, the European Central Bank and the European Banking Authority on simple standard and transparent securitization transactions and the criteria by the BCBS and IOSCO for identifying simple, transparent and comparable securitizations structures mentioned above. See Nassr, I.K. and G. Wehinger (2015), *Unlocking SME finance through market-based debt: Securitization, private placements and bonds*, OECD Journal: Financial Market Trends.

⁶⁷ See criteria proposed by the IMF in IMF, 2015, *Proposed Attributes of High Quality Securitization in Europe (Annex II of “Revitalizing Securitization for Small and Medium-Sized Enterprises in Europe”)*.

⁶⁸ For example, the European Financial Services Round Table (EFR) has developed a framework for, among other things, standardized infrastructure disclosure, reporting and documentation.

mechanisms such as insurance options may also be used to cover risks and increase the appetite of institutional investors.

However, in many EMEs their fiscal position prevents governments from providing such type of enhancements. The extent to which EMEs government could provide risk sharing mechanisms including guarantees should be seen as a function of the government's ability to assess the risk and its fiscal position. Thus, while in some Latin American countries risk sharing mechanisms have been provided by the government, those countries may not reflect the typical situation of most EMEs.

VI. The Role of Governments and Multilateral Development Banks

The need for an integrated strategy

EMEs government must develop comprehensive policies and strategies aimed at addressing the financing gap in infrastructure and SME financing. Such strategies should include a clear assessment of the role that capital markets in general and institutional investors in particular can have, along with the measures necessary to realize such potential. In practice, the challenges to the mobilization of institutional investors to infrastructure and SME financing are complex, and addressing them requires the participation of many public entities in coordination with the private sector. Thus, EMEs governments must play a leadership role (i) developing such policies along with articulated strategies to support them, (ii) ensuring public and private sector participation in the design of such strategies, (iii) leading policy and institutional reforms, and (iv) participating actively in the design of risk sharing mechanisms to align the risk-return appetite of institutional investors with the financing needs of their countries.

MDBs can have an instrumental role to play supporting EME governments in the articulation and implementation of such strategies, by providing advice, offering risk-sharing mechanisms, helping to structure and underwrite instruments and even serving a catalytic role with their participation in strategic transactions. In this regard, MDBs already have programs in place to support EMEs efforts to develop their local securities markets. These programs range from providing advisory services to participating as guarantors or even investors in specific transactions or instruments that could have a catalytic effect in the market. Experience is showing that such interventions are more effective when they are delivered as an integrated package, where all types of services (whether advisory or direct market operations) are aligned to achieve a common objective and designed to support and complement each other. Ensuring that they can provide this type of comprehensive package of services will be key to helping EMEs as they embark in the development and implementation of strategies and actions plans to mobilize institutional investors to infrastructure and SME financing. (Box 6).

Box 6: The role of MDBs in infrastructure financing: The case of Colombia

The Deep Dive Initiative of the WBG

Starting in 2013, the WBG has sought to strengthen its impact to help develop local bond markets through a multipronged integrated approach known as the Deep Dive Initiative (DDI). Through the DDI, the WBG provides full support to EMEs as they build local currency bond markets (LCBMs) that can help address large scale financing needs in strategic sectors. Initially the DDI has focused on infrastructure financing.

The WBG is piloting the DDI in Colombia. Colombia was chosen for four reasons: (i) there were strong financial needs in infrastructure that neither the government nor the banks were able to meet, (ii) it already had a sufficiently developed bond market and institutional investor presence; (iii) empowered and motivated counterparties existed, and (iv) the development of a non-government bond market program was underway.

The Colombia Deep Dive aims to create the conditions needed to mobilize institutional funds through the capital markets to

finance USD 26 bn of toll roads (which is known as the G4 program). Traditional funding sources from domestic banks, the government, and multilaterals is not sufficient to provide this funding.

Delivering the DDI has involved nine units across the WBG working together on complementary elements of the program. The initiative requires a wide range of WBG products and services: advisory services, financial and financing expertise and products, and the WBG's convening capabilities. In practice it has covered:

- Advisory operations to develop local bond markets:
 - Non-government bond markets advisory services: The WBG securities markets advisory team has provided advice on a wide range of issues aimed at facilitating issuance of infrastructure bonds. Specifically, team advice included the development of a streamlined issuance regime for professional investors; advice on prudential regulations to increase banks' capacity to finance the construction phase of infrastructure projects, and to improve mutual and pension funds investment regulations. The team has also provided significant support to the national infrastructure development bank (FDN) for the design and rating of a model infrastructure project bond; applying best practices on infrastructure project bonds and different types of credit enhancement instruments. An ongoing project is supporting the FDN on capacity building for institutional investors (insurance and pension funds) to fund infrastructure through equity and debt instruments.
 - Government Bond Market Advisory Services: The WBG Treasury is working with the Ministry of Finance and Public Credit to strengthen debt management operations; while the securities markets advisory team is delivering targeted work to build a more liquid government bond market yield curve and to deepen the money market.
- IFC Transactions and Treasury: IFC has agreed on an equity investment in FDN and credit enhancement of bonds that could potentially be issued under the 4G program.
- End Users: The IFC infrastructure team has been providing advice to ANI (the concession agency) on a new PPP model and standard contract for 4G concessions. Support would also be given to FDN on structuring pipeline of PPPs.

The WBG is in the process of scaling up this approach. Implementation is initially being considered for one country per region. This would allow the WBG to gain additional insight and strengthen the approach prior to its application in other areas. Cooperation from other MDBs would be welcome as a means to further enhance the support provided to countries. The DDI is planned to become the "modus operandi" for WBG projects in other strategic sectors for growth and poverty alleviation (e.g. climate change, urban development and small business financing).

Delineation of responsibilities in developing and implementing the strategy

The appointment of a responsible authority might be needed. Indeed, the type of challenges that can prevent EMEs from developing these instruments might require actions by different financial sector regulators, governmental offices, sectoral regulators, the latter mainly in the context of infrastructure financing, and even the private sector. Thus, it is key that there be a high level governmental authority leading these efforts.

In addition, the constitution of high level committees to support the development and implementation of such strategies is recommended. Such committees would have representation from both the public and private sector and could support governmental efforts, by providing advice and ensuring consultation and buy-in from key stakeholders. Such types of committees have been established in many EMEs in the context of capital markets development plans.

To enhance accountability the strategies and action plans developed should be made public and the responsible authority should also publicly report on their progress on a periodic basis. Such periodic

reporting would also be useful to identify bottlenecks and persistent challenges and define ways to address them, including by requesting support from MDBs.

Developing risk-sharing mechanisms

As indicated, a key element of such strategies is the development and provision of risk sharing instruments to crowd in private investment via capital markets. In many EMEs, the governments might not be in the position to provide these instruments themselves given the contingent liabilities that they might entail. However even then they should actively engage in their design and encourage the development of risk sharing mechanisms that support optimal leverage of both banking and capital market solutions.

In this regard, domestic development banks and financial institutions and MDBs are revisiting their toolkits to enhance the use of capital markets for infrastructure financing. Direct loans (sometimes syndicated) and loan guarantees have been the key mechanisms used by development banks to support infrastructure financing. However, many of them are currently exploring ways to expand the use of capital markets. For example, the Brazilian development bank, the *Banco Nacional do Desenvolvimento* (BNDES) has recently announced a set of mechanisms to encourage the use of capital markets instruments as part of the debt financing portion of infrastructure projects. Further its strategy seeks to integrate banking and capital markets solutions so that each one is used where it can best suit the project' characteristics and risks and the appetite of investors. Colombia recently constituted a development bank specialized in infrastructure, *Financiera de Desarrollo Nacional* (FDN). FDN will use different types of risk sharing mechanisms to support infrastructure projects, including partial guarantees. On the MDBs side, the PCEBI of the EIB is a good example of a partial guarantee program that seeks to enhance the role of capital markets in infrastructure financing. Five projects have already been funded through project bonds that have an EIB guarantee.

A similar effort is needed in SME financing. Many EMEs have experience with guarantee programs to encourage bank lending to SMEs. In some cases these guarantees are provided directly by the government, while in others they have been provided by public financial institutions, such as Corfo in Chile or Nafin in Mexico. For the larger EMEs, where a robust pipeline of "high quality" loans might exist, the challenge and opportunity lies in further leveraging those programs to increase the availability of funding to SMEs via capital markets, for example by linking guarantee programs to securitization structures or even to SME bond issuances. The experience of Spain with SME securitization funds provides valuable lessons as to how to link guarantees in a manner that they provide "additionality", i.e. that they ensure an increase in the availability of funding to SMEs. The EIB has recently put in place two programs to support SME securitization that also offer important insights in regard to the design of the guarantees to crowd-in specific types of investors. Guarantees can also have a critical role in allowing specialized lenders to come directly to market via corporate bond issuances. Here also a change in approach is being implemented, whereby MDBs are seeking to rely more on partial guarantees to help them tap the markets than providing them with direct loans.

However, it is necessary that any program of guarantees be designed carefully and meet certain key requirements. In this regard, whether provided by the government, a public financial institution or a MDB, guarantees should be:

- Clear and transparent: the eligibility criteria should be clear, and periodic information should be provided on their use.
- Financially sustainable: guarantees must be properly priced and a framework of contingent liabilities must be developed, on sound accounting basis.
- Impactful: the guarantees must provide for “additionality”, in this particular case, guarantees must expand interest for the instrument to a wider set of investors (crowd-in investors); and criteria should be developed to ensure that their impact can be assessed.
- Designed to mitigate moral hazard: guarantees should be partial although the specific structure (whether pari passu, first loss, etc) might defer.
- Subject to periodic evaluations, to be conducted by an independent entity.

While critical, guarantees do not exhaust the universe of mechanisms that can be designed to crowd-in institutional investors to infrastructure and SME financing. Other type of mechanisms can be used, and depending on the instrument may be more effective. For example, insurance could be another option in the toolkit to manage certain risks imbedded in the instruments. In the context of fund structures, the participation of governments and MDBs as investors in new structures can play a catalytic role encouraging private sector participation. This is a role that governments and MDBs alike are already playing not only in AEs but also in EMEs. For example, the IFC committed capital as investor to the Peruvian SME Bond Fund, to crowd-in the participation of pension funds.

Finally it is important to highlight that the participation of MDBs in EMEs transactions, either providing guarantees or as investors, could bring additional benefits to the market. Indeed MDBs play a more general role in risk reduction through the imposition of higher standards in areas such as transparency, asset quality, oversight and even procurement procedures.

The need for coordination

There is value in sharing experiences and lessons, and in better leveraging the efforts of countries and MDBs. There is ongoing work across countries at different levels of development to address the challenges that hinder mobilization of institutional investors to infrastructure and SME financing. New structures and risk sharing arrangements are being developed and tested, and the lessons could benefit EMEs as a whole.

Different platforms have recently been created to allow sharing of experiences, but also to further leverage the technical expertise and financial muscle of different participants. They are all relatively new, and thus more detail as to their operations and potential impact is not yet available.

- **On the infrastructure side,** initiatives such as the Africa 50 Fund and the GIF mentioned earlier, are seeking to support the development of robust pipelines of infrastructure projects, drawing expertise and resources from different MDBs and donors. In addition, the Global Infrastructure Hub created by the G20 will help to ensure sharing of experiences among countries. The Hub

will drive progress on the G20's infrastructure agenda by moving engagement with the private sector beyond business as usual to lift quality public and private infrastructure investment. It will also assist in "developing a knowledge-sharing network to aggregate and share information on infrastructure projects and financing between governments, international organizations, development banks, national infrastructure institutions and the private sector".

- **On the SME side**, the SME Finance Forum created by the Global Partnership for Financial Inclusion of the G20 is bringing together financial institutions, technology companies, and development finance institutions to share knowledge, spur innovation, and promote the growth of SMEs.

VII. Conclusions and Recommendations

Traditional funding sources remain key for the financing of both infrastructure and SMEs in EMEs; however the experiences found show that institutional investors can complement such financing.

- **On the infrastructure side** bank lending currently appears to be better suited to finance greenfield projects which constitute a key component of the infrastructure needs of EMEs. Thus, the key challenge and opportunity lies in finding ways of integrating such source of financing into a strategy that allows banks to offload loans into capital markets instruments that could appeal to institutional investors, once they mature, thus freeing capital that can then be reinvested into greenfield projects. Project bonds and infrastructure debt funds appear to be well suited for this, provided that appropriate risk sharing mechanisms are designed. Sukuk appear to have similar potential, but catering initially to Islamic institutional investors. That said, in many EMEs there is also a need to enhance and/or expand existing infrastructure. All such capital instruments are well suited to directly finance brownfield infrastructure.
- **On the SME side**, the characteristics of SMEs (small, informal, with limited ability to provide information suited to capital markets) make them better suited for bank lending and complementarily asset based lending by trade providers. That is why actions to enhance the bankability of SMEs should remain a key priority for all EMEs. However, the experiences show that institutional investors can play a key role in SME financing mainly by providing financing to SME lenders, thus ensuring that a steady flow of funding remains available to SMEs. In the short to medium term such refinancing will continue to take place via plain vanilla instruments (corporate bonds). As markets develop the challenge and opportunity will also lie in finding additional ways to integrate bank and asset backed lending with capital markets, such as SME or bond structures into which SME loans or other assets can be offloaded. However, that is more of a long term endeavor. The role of institutional investors as direct providers of funding to SMEs via SME issuances appears to be much more limited, with focus being on the larger, more formal SMEs.

It is important to highlight, however, that significant innovation is taking place in product design that can potentially change the role that institutional investors can have in financing these strategic sectors. For example, on the infrastructure side, new structures are starting to allow the use of projects bonds for greenfield projects. On the SME side, new instruments and “lending” mechanisms, such as joint SME bond issuances and electronic applications such as electronic platforms for lending seem to be addressing the scale/volume problem that limits institutional investors’ appetite for SMEs. However, it is still too early to assess the impact that such innovations will have.

However, in many EMEs the role of institutional investors in infrastructure and SME financing has not yet fully materialized. To a large extent this is a reflection of the level of development of capital markets, including the institutional investors’ base. In general in low income countries there is very

limited space for capital markets to take a role in financing these strategic sectors. In contrast, the role of capital markets would be greater in middle income countries, where many of the preconditions related to the enabling environment are already in place and the institutional investor base has already reached an important size both in terms of AUM and vis-à-vis the size of the economy. There is no predetermined cut-off size. Valuable examples of the role that capital markets can have in bridging the financing gap in strategic sectors have been found in middle income countries such as Costa Rica and El Salvador. In both cases, their capital markets can still be characterized “modest” but the institutional investor base is already starting to play a role in financing strategic needs.

That is why EMEs governments must properly assess the potential of capital markets in general and institutional investors in particular, as part of their comprehensive strategies to address the infrastructure and SME financing gap. This assessment can be supported by the OECD’s Effective Approaches to Implementing the G20/OECD High-Level Principles on Long-Term Investment Financing by Institutional Investors and the Local Currency Bond Markets Diagnostic Framework developed by the IFI group.⁶⁹ In this context, the list of recommendations provided below seeks to assist EME governments in devising plans of action to tackle key challenges that EMEs are facing as they try to mobilize institutional investors to infrastructure and SME financing, including challenges affecting the enabling environment, and the supply and demand side.

As challenges are country specific, the list of recommendations provided below is intended to serve as guidance that country authorities must tailor to their specific circumstances, including the type of investors that they want to target. The list of recommendations is most useful for middle income countries where the institutional investor base has already achieved certain minimum size and importance. The key for these countries is to work in parallel on addressing the challenges identified in different areas so that the potential of capital markets can be realized in a shorter timeframe. In the case of low income countries, the recommendations could serve as a long term working plan. For them, working on the enabling environment should be the priority; while the other sets of recommendations would become more important as the institutional investor base develops.

- **Actions to enhance the enabling environment:**
 - Continue developing the fixed income markets, in particular by (i) developing a deep and liquid government bond market yield curve to serve as a price reference, (ii) supporting the development of credit information services, including credit ratings and research analysis, and of (ii) basic infrastructure, including payment systems, central securities depositories and custodians.

⁶⁹ OECD (2014), *Report on effective approaches to support the implementation of the G20/OECD High-Level Principles on Long Term Investment Financing by Institutional Investors*; and IMF, WBG, EBRD and OECD, (2013) *“Local Currency Bond Markets: A Diagnostic Framework*.

- Continue ensuring the existence of a stable macroeconomic environment, a clear and stable tax framework, a robust framework for creditors' rights and robust regulation and supervision of securities markets.
- **Actions to ensure the availability/supply of the instruments:**
 - Continue working on the development of a robust pipeline of investable infrastructure projects, by (i) identifying strategic projects and conducting the necessary feasibility analysis to transform them into a credible pipeline of PPP projects and working on (ii) the development of robust legal and institutional arrangements for PPPs, and on (iii) operational aspects to facilitate proper leverage of banking and capital markets solutions, including standardization of PPP contracts and ensuring that bidding procedures provide equal footing to capital markets and banking funding.
 - Continue improving the bankability of SMEs mainly by (i) strengthening credit information, (ii) allowing movable assets as collateral along with the establishment of the corresponding collateral registries, (iii) enhancing SME skills for accounting, financial and risk planning, and (iv) improving SME corporate governance and quality of investment projects.
 - Encourage the development of multi-origination platforms and instruments that help address the scale problem of SME related assets.
 - Work on completing the legal and regulatory frameworks for the instruments, in particular securitization and close-end funds, with particular emphasis on (i) the vehicles that can be used, and (i) the provisions on eligible assets. For fund structures ensure also a proper licensing framework for the fund managers that is based on fit and proper requirements.
 - Develop an offering regime for qualified investors, by simplifying regulatory requirements while ensuring that such investors have mechanisms to avail themselves with sufficient information about the offering at the moment of placement and on a periodic basis, and in the context of fund structures, also about fees.
- **Actions to ensure that the instruments suit the demand of institutional investors:**
 - Review the framework applicable to pension funds and insurance companies to (i) ensure that institutional investors can invest in "alternative" assets, and consider the creation of a separate bucket for "infrastructure" (ii) eliminate disincentives for long term investment imbedded in the performance benchmarks and the rules that allow affiliates to change funds; and (iii) calibrate prudential frameworks so that they make proper distinctions between different asset classes and/or tranches (i.e. high quality loans or senior tranches should in principle have a better capital treatment).

- Require strong governance and risk management arrangements from institutional investors and encourage capacity building.
- Ensure that high quality instruments are available to align the risk-return appetite of institutional investors: in particular by working on the development of ii) high quality standards for the structures to be used which should relate to the quality of the assets, the use of simple structures and the availability of standardized information and (i) risk-sharing mechanisms, including guarantee schemes. Ideally, these two elements should work in tandem, that is, the provision of risk-sharing mechanisms should be linked to conditions on the type of structures used (simple, clear and transparent).
- Ensure that a robust framework for the provision of guarantees is in place, in particular that guarantees are (i) clear and transparent, (ii) financially sound, (iii) impactful, (iv) designed to address moral hazard issues, and (v) evaluated on a periodic basis.

The development and implementation of such strategies will require strong leadership and accountability. To this end, a high level government authority should be given the responsibility for the development and implementation of the strategy. In addition, the constitution of high level committees with broad representation of key stakeholders to provide advice, ensure proper consultation and buy-in is recommended. Finally EMEs governments should commit to report on progress with the implementation of such strategies on a periodic basis.

MDBs have an instrumental role to play supporting EME governments in the articulation and implementation of such strategies, by providing advice, offering risk-sharing mechanisms, helping to structure and underwrite instruments and serving a catalytic role with their participation in strategic transactions. In this regard, it is critical that they be in a position to provide an integrated solution to EME governments, where all types of services (whether advisory or direct market operations) are aligned to achieve this common objective of mobilizing institutional investors to infrastructure and SME financing, and designed to support and complement each other. In this context they should also continue to reassess the instruments through which they have provided support to infrastructure and SME financing, and develop strategies that integrate the use of both banking and capital markets solutions in ways that ensure the optimal use of all types of funding.

Efforts to share experiences, and to coordinate and leverage the technical expertise and financial muscle of different participants, should continue. On the infrastructure side, different structures have been created at the regional and global level such as the Africa 50 Fund in Africa, and the GIF and the GIH, at the global level. On the SME side, the SME Finance Forum is becoming a platform to share relevant experiences on SME financing. They are all relatively new, and thus it is still early to assess their potential impact. Such platforms could, alongside other international groups and organizations already engaged on these topics, periodically inform the G20 on good practices and valuable experiences that have the potential to be replicated across EMEs. Relevant regional and international organizations including MDBs could also share relevant experiences in the context of the IFI group (ADB, AfDB, EBRD,

IADB, IMF, OECD, WBG) for LCBMs. When appropriate, further dissemination through seminars and workshops could be considered.

Finally, it is important to highlight that any expansion of institutional investment in these sectors should be aligned with their mandates and fiduciary duties. Thus, such investments need to be done based on a clear understanding of the risks imbedded in different instruments, so that investors only take those risks that they can adequately managed. To this end, robust regulatory and supervisory frameworks must be in place, and institutional investors must enhance their risk analysis and risk management capacities. Further, active supervision from the supervisory authorities is needed to ensure that any emerging and systemic risks are identified early on and addressed.