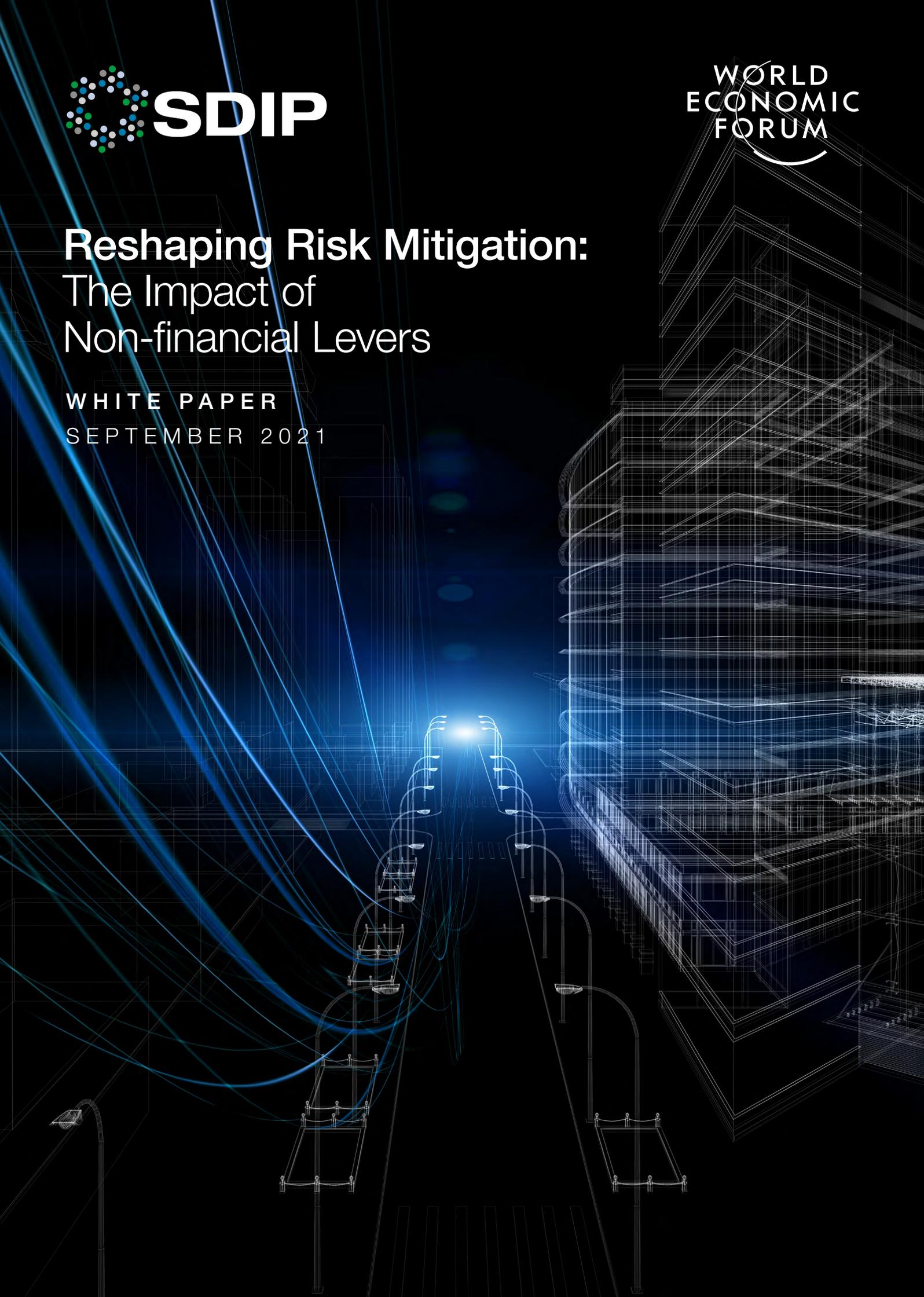




Reshaping Risk Mitigation: The Impact of Non-financial Levers

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Introduction

Scaling-up private-sector capital investment in emerging markets requires a renewed and concerted effort to address the barriers limiting investment flows to these jurisdictions. The decisions of private investors are hampered by their inability to adequately address risk issues associated with investing in emerging markets.

The COVID-19 pandemic has further squeezed financial flows to developing countries. During 2020, the annual funding gap to address the Sustainable Development Goals (SDGs) swelled by almost 50% from \$2.5 to \$3.7 trillion.¹ To close this financing gap, it is critical to address the concerns of private investors who are influenced by perceived risks and barriers in emerging markets.

Current approaches to risk mitigation have predominantly focused on deploying financial risk-sharing instruments to transfer part of the risk premium associated with specific transactions. While these mitigation products are being deployed more regularly in emerging markets, they impose a financial cost onto a transaction, which is invariably passed on to the end-user through higher tariffs. Sometimes, even public finance providers or impact investors consider the risks too high or too hard to assess. Adopting a broader, more comprehensive approach to risk mitigation is required to improve the attractiveness and business environment of countries, sectors and projects for private capital. Risk mitigation needs to be understood as going beyond just financial risk mitigation products, towards a broader concept of non-financial risk mitigation measures.

Financial de-risking instruments are specific in nature, focusing on addressing the risk issues of a particular transaction.² Examples include credit guarantees, first-loss funds and insurance. However, many of the risks that arise at a transaction level originate through broader regulatory and institutional constraints at a country or sectoral level; these risks are then priced into a specific transaction. A different approach to such

risks is required: non-financial de-risking measures, which are typically broader, early-stage macro or sectoral interventions to address the underlying barriers in the investment environment that impact the attractiveness of investments.³

This white paper starts by exploring the features of non-financial de-risking measures. It then analyses the potential impact these measures could have on lowering the overall risk profile of a country or sector and, in turn, how this could translate into lower project risk.

The principal messages from this white paper are the following:

- A key constraint to crowding private-sector capital into emerging markets at scale is the risk (perceived and real) associated with such investments.
- Risk mitigation has typically been dealt with on an investment- or project-specific basis through financial transfer measures; but given that risk barriers are often systemic, a broader approach targeting “non-financial” mitigation levers needs to be applied.
- Implementing non-financial risk mitigation levers has a powerful leverage impact in lowering the cost of financial risk mitigation products.
- Governments, development finance institutions (DFIs) and other key stakeholders should work collaboratively to design and implement non-financial de-risking measures.



1

The features of non-financial de-risking measures

Non-financial de-risking measures are aimed at addressing cross-cutting barriers that are a result of the inadequate institutional and regulatory structures required to support the project life-cycle phases.

The main characteristics of non-financial de-risking measures are as follows:

- They address and attempt to remove the underlying barriers that are the root causes of specific financial risks at a transaction level.
- They often have a wider focus on systemic market failures, whereas financial mitigation measures are tailored to specific transactions.
- While financial de-risking measures are effective immediately, non-financial de-risking instruments are often long-term in nature. They

require considerable amounts of time and effort to implement and then take effect.

- The costs incurred for such measures cannot be associated with a specific transaction and therefore cannot be ring-fenced or priced into a specific investment.

When considering non-financial de-risking measures, it is important to understand the nature of the intervention required, as well as the extent to which a broad versus specific lever will be more appropriate to implement. The development of the sector, the maturity of government processes and the nuances inherent in different investment needs imply that de-risking can be applied at different levels.⁴ It is important, therefore, to understand the distinction between non-financial and financial de-risking interventions, as captured in Table 1.

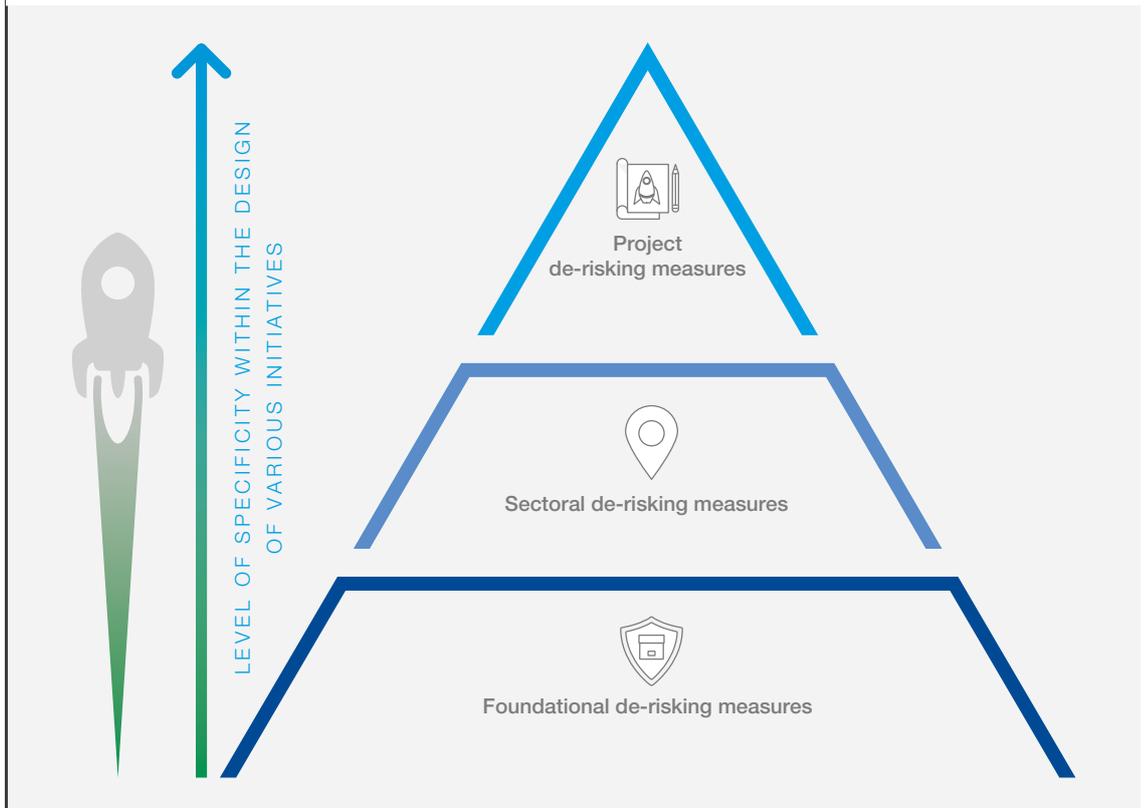
TABLE 1 Distinction between non-financial and financial de-risking interventions

Attribute	Non-financial de-risking measures	Financial instruments
Categories of risk that are addressed	Regulatory, institutional, governance-related	Financial risks, macro-economic & business risks
Nature of risk mitigation	Directly address non-financial risks through process improvement, institutional strengthening, policy enablement etc.	Financial instruments such as guarantees, insurance etc. that transfer the cost of risk to other parties, development partners etc.
Scope of risk measure	Broad and typically applied to entire sector or country	Focused on and specific to individual projects or transactions
Implementation horizon	Long-term horizon; addressing underlying barriers takes significant time	Shorter-term, e.g. duration of project/transaction financing period; implementable at project financing stage
Cost net effect	Positive; institutional changes have a knock-on positive effect on crowding-in private investment over the short-term	Negative; raises project costs that are borne by end-users

To further expand on the concept of non-financial de-risking, it is useful to categorize these measures based on when they are implemented. Three

categories of non-financial de-risking measures are proposed: **foundational, sectoral and project**. Figure 1 summarizes the proposed categories.

FIGURE 1 Non-financial de-risking categories



Source: Institute for Global Change and CrossBoundary, 2020⁵



Foundational de-risking

Foundational de-risking is the broadest concept of non-financial de-risking, targeting the most cross-cutting macro-economic risks a country faces, hence it is termed “foundational”. Such measures include clear and comprehensive national policy and legislative frameworks for investment facilitation, overarching institutional structures, and governance structures that provide investors basic confidence in

a market. These foundational measures provide the groundwork for establishing a conducive investment environment in a country. The measures are most applicable in emerging economies, many of which struggle to attract private sector investment at scale and have historically been more reliant on donor support through, for example, grants and highly concessional finance.



Sector de-risking

Non-financial de-risking measures at the sector level focus on developing the appropriate sectoral policies, institutional structures and legal systems that provide a clear strategic as well as structural guideline for the functioning of the sector. A clear

policy framework and institutional structure that underpin investment into projects in that sector will provide investors with greater confidence and evidence that the sector is a priority area.



Project de-risking

Lastly, de-risking at a project level reflects measures that deal with specific interventions that support a project’s development but are separate from financial risk mitigation products. Examples of such measures include: interventions such as a

clear framework and standardization of project contractual documents for private participation; management structures for public sector counterparts implementing projects; and an open, fair recourse system for any project failures.

The power of non-financial levers

The primary rationale for non-financial de-risking measures is that they serve to lower the risk perception of investors when assessing the investment attractiveness of a country and a particular sector they are seeking to invest in. More importantly, these early de-risking measures will have an impact on the risk profile allocated to actual project investments.

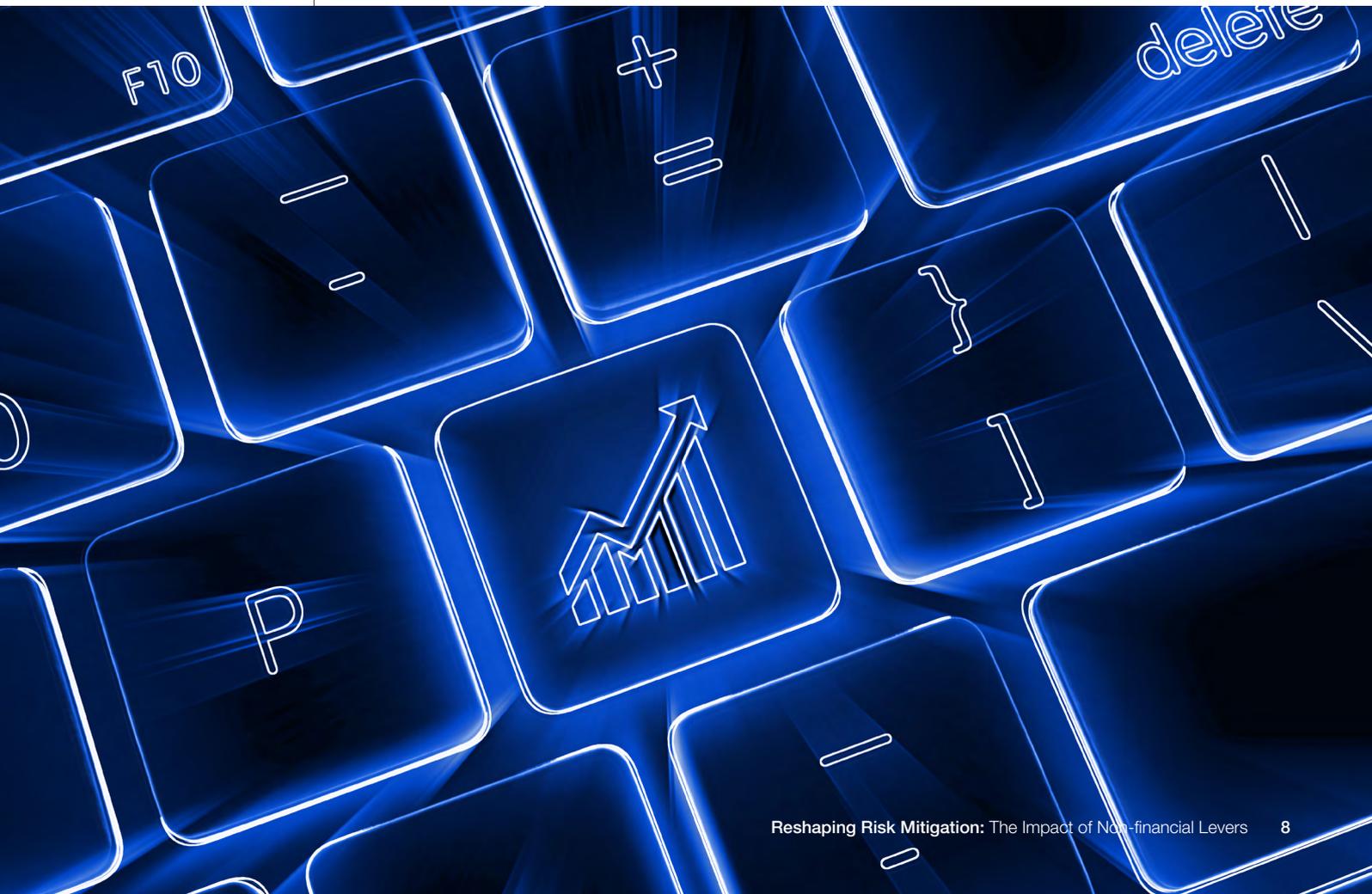
Implementing measures at an early stage to reduce such risks is, in the long run, expected to positively affect the risk premium of a transaction, reducing it overtime as the initiatives take effect. The implication of this is that adopting non-financial de-risking measures will lead to a lower financial risk mitigation requirement for specific projects. The important benefit of this is to lower the cost of the financial mitigation measures that are priced into a project.

Even where project-specific financial risk mitigation is undertaken, it is often somewhat limited or comes at a very high cost. This may be attributed to the difficulty in accounting for all risks inherent in a financial product, particularly broader systemic

risks. Where the enabling environment is not conducive to supporting the effective and efficient implementation of transactions, it will negatively impact investor confidence and therefore the appetite to invest significant capital into projects.⁶

On the contrary, where a clear and comprehensive framework of non-financial de-risking measures already exists, it not only boosts investor confidence, but also increases the potential and efficacy of those project-specific financial measures. This twofold effect emphasizes the need to engage non-financial de-risking means to mobilize more capital investment in emerging markets.

As a result, improvements in institutional capacity and related political processes would have the effect of catalysing the flow of private sector funding, as investors adjust to lower risk perceptions and investing becomes more attractive. In effect, these interventions should ideally support public sector actors to create a more transparent and efficient investment landscape.



What will it take to unlock non-financial de-risking?

The process of establishing non-financial de-risking measures requires a combination of stakeholders and greater collaboration between them, as well as detailed institutional support and planning. Such activities have associated costs, which cannot be attributed to a specific transaction, and thus may be more difficult to account for upfront. Public-public, public-private and private-private cooperation partnerships are vital to underpin further innovations and progress towards achieving the 2030 Agenda for Sustainable Development and the SDGs.

As far as a de-risking framework is concerned, governments, donor partners, DFIs and private sector players will need stronger collaboration at these early stages to help support the design and implementation of non-financial risk mitigation measures addressing the main risks. This in turn will enable investors to better address project-level risks. The figure below presents a conceptual overview of the stakeholders active at macro, sectoral and project levels that facilitate an investable regime, ultimately supporting investments into specific initiatives.

Governments have a responsibility to improve policy design, enable greater public-sector efficiency and provide consistent and visible support to drive the implementation of these non-financial de-risking measures. Leveraging public financing and following through on political commitments will result in improved investor confidence over time. Creating a forum for meaningful dialogue between government, development partners and the private sector will create greater transparency and progress in the implementation of these policy de-risking measures. Investments in building up institutional capacity and developing critical skills are integral to the process of alleviating market risk failures.

DFIs can leverage their credit ratings, experience, credibility and relationships with governments to spearhead policy de-risking implementation. DFIs have an important role to play in advising governments and public sector actors on the appropriate de-risking measures to employ. Given the expertise within DFIs, they can play a key coordination role between all stakeholders – particularly between governments and the

private sector – to drive knowledge sharing and capacity building in both financial and non-financial risk mitigation interventions. Multilateral DFIs, in particular, have a broad array of sovereign lending and technical assistance tools to support policy and institutional sectoral and macroeconomic reforms by governments, as well as risk-sharing tools at the project level. Systematic coordination between DFIs in deploying these tools would likely yield greater benefits in mobilizing private investment.

The role of private sector companies is to leverage their collective technical expertise to partner with governments in the formulation of best practices for sector investment strategies. At a project level, private sector expertise is also valuable in helping develop project documents, legal and procurement frameworks, and implementation structures that help reduce the perceived risk of private sector transactions in emerging markets.

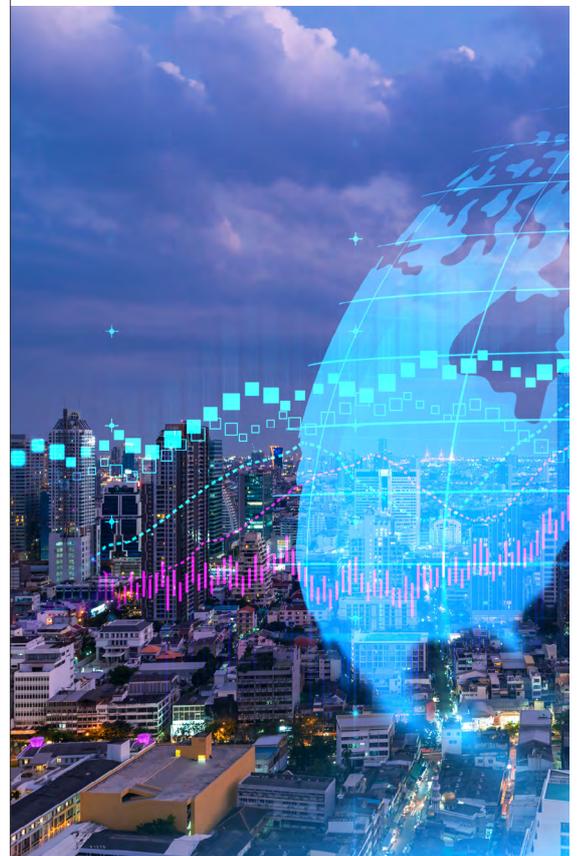
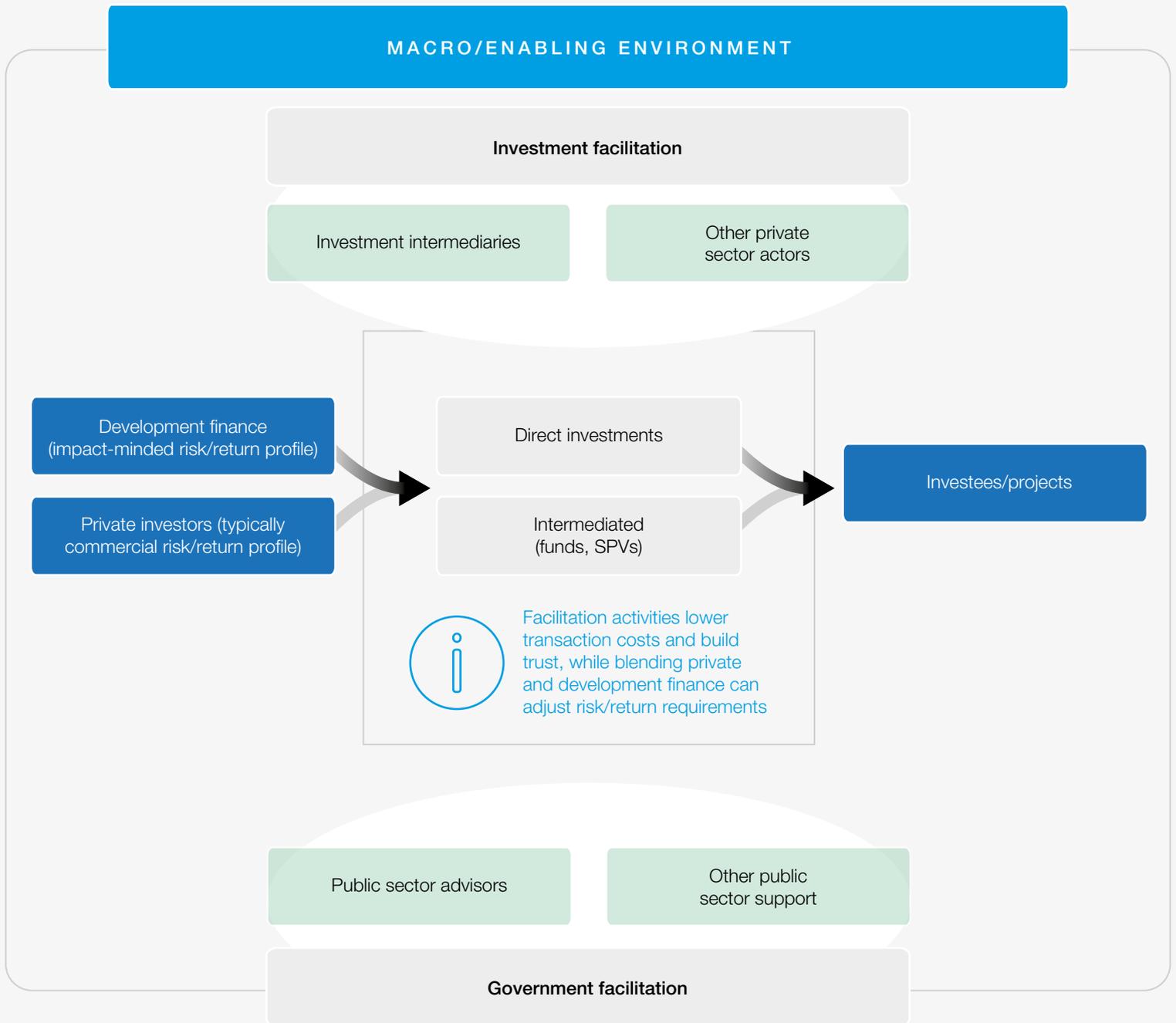


FIGURE 2 | Overview of an investment environment



4

Examples of non-financial de-risking measures

This section highlights two concrete examples where non-financial risk mitigation measures have supported successful project implementation:

- South African renewable energy programme
- Colombia roads PPP programme



South Africa's renewable energy programme

South Africa is one of the continent's most energy-intensive economies, with over 70% of its primary energy needs supplied through coal. Ongoing electricity supply constraints and growing concerns over climate change have necessitated a strategic reorientation and diversification of the country's energy mix by expanding the supply of renewable energy, thereby reducing reliance on fossil fuels.

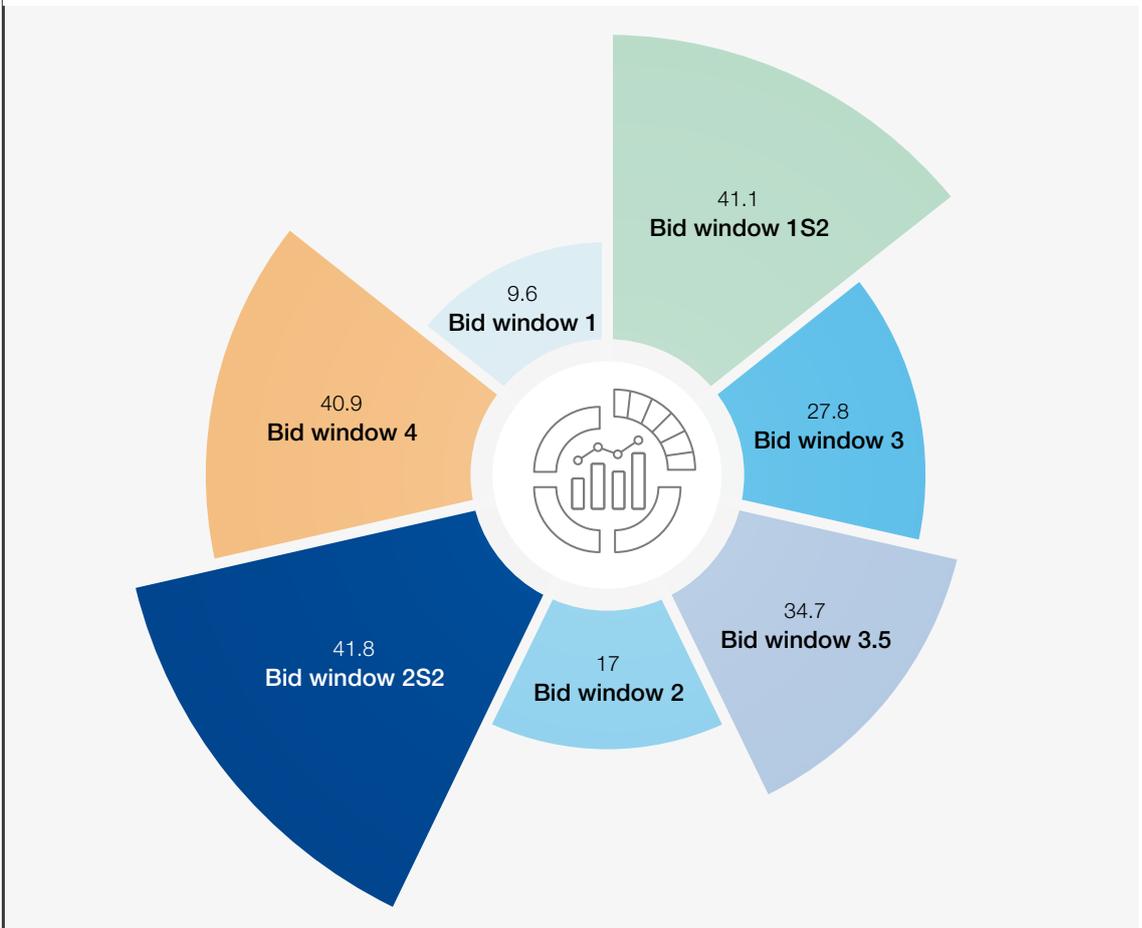
The Development Bank of Southern Africa (DBSA), the Department of Energy (DOE) and the National Treasury developed the Renewable Energy Independent Power Producer Procurement Programme (REIPPP) in 2010 to address South Africa's impending energy challenges. REIPPP channels private investment into South Africa's grid-connected renewable energy generation, increasing

energy supply while contributing to environmentally sustainable socio-economic development.

REIPPP is a series of single, closed-bid tenders aimed at generating 17,800 MW of electricity from renewable energy by 2030. By mid-2020, the programme had procured a total capacity of 6,422 MW and attracted approximately ZAR 41.8 billion (\$3.5 billion) in foreign investment (see Figure 3). By March 2020, total domestic and foreign investment amounted to ZAR 209.7 billion (\$17.5 billion).

Despite these milestones, institutional limitations, policy uncertainty and high transaction costs posed significant risks on the implementation and sustainability of the programme.

FIGURE 3 Cumulative total foreign investment attracted by REIPPP (ZAR, billions)



Source: IPP Projects⁷

Programme risks and de-risking measures

Institutional structure and capacity

REIPPP is the largest independent power producers (IPP) programme on the continent and, owing to its scale, it required access to local and international funding, partners and other resources. After previous failed efforts by the national utility, Eskom, to contract IPPs, the energy sector lacked the institutional capacity to design, implement and operate a large scale, multi-project initiative such as REIPPP.

The programme established an IPP unit to coordinate the procurement process. This unit comprises a team of legal, financial and technical experts from the DOE and National Treasury's public-private partnerships (PPP) division, even though the unit operates outside the government's formal institutional structures. The standardized, non-negotiable contracts (implementation agreements, power purchase agreements, transmission/distribution agreements and direct agreements) are key in ensuring a fair and transparent procurement process. Bidders are required to complete a standardized technical evaluation matrix with numerous compliance requirements. These standardized contracts are instrumental in creating an enabling environment and removing barriers to entry for IPPs.

The use of domestic and international advisers in the programme's design and management reduced the perceived risk that private investors often associate with government agencies in South Africa.

Policy and regulatory framework

Policy uncertainty remains a primary impediment to investing in the developing world. South Africa is no exception and it was within this regulatory context that REIPPP was developed. The renewable energy feed-in tariff (REFIT) initiative was South Africa's initial attempt at expanding renewable energy supply, but it was not implemented due to uncertainty in the project's procurement framework and process. Although REFIT had all the necessary policy targets and objectives in place, its policy instruments were unclear. Consequently, investors were reluctant to invest in projects where they felt the policy framework and the roadmap showing how targets would be met were both ill-defined. The electricity regulation act (2006) was crucial in creating an enabling environment for investors by facilitating the development of the integrated resource plan (IRP) which specified the energy capacity to be procured, from which sources and whether it would be procured by Eskom or by an independent power producer. The IRP established a clear policy and

regulatory framework on renewable energy which provided a clear roadmap for the REIPPP.

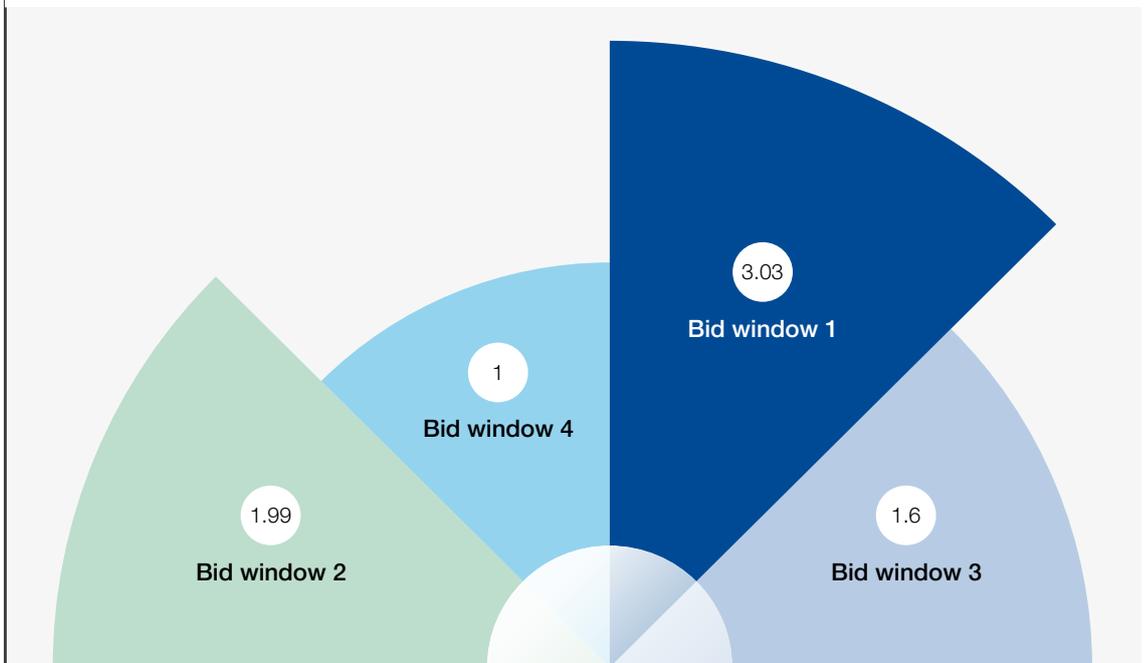
Procurement structure

The lessons learned from the shortcomings of the REFIT initiative were key in the REIPPP's procurement structure. REIPPP's success can be attributed to a procurement policy based on competitive tenders, with the transparency of the process effective in attracting investment. REIPPP is a two-stage competitive tender programme with a series of closed-bid rounds. The complexity of the competitive tender process imposed high initial transaction costs on both the government, in terms of designing and maintaining the programme, and bidders in meeting the stringent bid requirements.

The multiple bid-round design of the programme was crucial in reducing the high initial transaction

costs. In a multiple bid-round tender, sellers of a resource submit competitive bids for a contract offered by a single buyer who then selects the most attractive offer; the rolling series of bid rounds gives sellers multiple opportunities to bid for contracts. Transaction costs have fallen in subsequent bid rounds, as project sponsors and lenders become familiar with the tender requirements and specifications. Despite the high transaction costs, REIPPP has been successful in achieving low bid tariffs. The tenders have been highly competitive, with over 300 bid submissions received across four bid windows. This has resulted in lower prices, with average portfolio costs for renewable energy technology under REIPPP dropping with each consecutive bid window (see Figure 4). Eventually, the price of projects awarded under the fourth bid window indicate that solar PV and wind energy reached cheaper prices than the national utility

FIGURE 4 REIPPP prices expressed in April 2020 terms (ZAR cents/kWh)



Source: IPP Projects⁹

Eskom's average cost of supply, and were among the lowest-priced grid-connected renewable energy projects globally in 2015.⁸

Political support

The REFIT initiative received minimal support from the government. The DOE and National Treasury commissioned a legal opinion that concluded that the feed-in tariffs amounted to non-competitive procurement and were therefore prohibited by the government's public finance and procurement regulations. Unlike REFIT, REIPPP benefits from unambiguous political support, with South Africa a signatory to the 2015 Paris climate agreement and reinforced by government policy including the integrated resource plan of 2019. Moreover, the programme's development goals are closely aligned with the objectives of the country's national development plan.

Summary of key lessons from REIPPP

- Investors require an enabling policy and regulatory environment with clearly defined policy objectives, targets and tools.
- Multiple bid rounds are effective in reinforcing competition, lowering prices, refining the procurement design and building investor confidence.
- The procurement team should operate outside formal departmental structures of the government.
- The procurement team should be experienced and credible, to gain the private sector's trust.
- Government support and departmental coordination ensure sustainability and reduce authorization-based delays.

Colombia's 4G transport infrastructure programme

Historically, Colombian transport infrastructure has lagged behind that of other peer countries, due in part to the complex geographic and topographic context, but mostly to various problems in its institutions and economic policies which have resulted in high perceived investment risk. In addition, the prioritization of social expenditure lowered the public budget available for infrastructure. To bridge the gap, the government invited the private sector to participate in concession contracts, triggering three generations of concession contracts over the past two decades. Although important adjustments were made in the investment landscape to make the works possible, there were still multiple barriers that resulted in significant delays to work schedules, controversies, lawsuits and sanctions.

The situation remained unchanged until 2010, when the government launched the fourth generation of concessions, known as the 4G programme. This was an ambitious programme that embraced the construction and rehabilitation of 40 highways and more than 7,000 km of roads to connect the principal ports with industrial clusters in the main cities. This required an investment of approximately \$17 billion.¹⁰ The success of the programme demonstrated the country's improving competitiveness and eased its admission into the highly renowned Organisation for Economic Co-operation and Development (OECD).

Many crucial factors contributed to the success of the programme, but most important were the major reforms to build a strong legal and institutional framework that could help overcome the obstacles encountered by previous programmes, mitigate the risks and attract sufficient investment. In the end, the 4G programme raised almost five times the investment of the previous concessions combined.

Major obstacles

The major obstacles that prompted the legal and institutional reforms arose from disagreements that had led to multiple arbitration tribunals, lawsuits and fines for infringements such as: additions to contracts (in time and amount), property acquisitions, environmental cost overruns, controversies in bidding and award processes, and artificially low offers awaiting subsequent renegotiations.¹¹

In addition, there were a considerable number of corruption scandals linked with the early concessions, largely explained by misguided incentives, such as upfront payments not connected with effective construction milestones.¹² These scandals, which involved the sectoral public entities responsible for awarding and managing the concessions, destroyed the confidence of international players (both industrial and financial) to participate in Colombia's infrastructure sector.

Additional major constraints included the government's lack of institutional capacity to meet

sectoral needs in the design and management of infrastructure concessions, as well as the weak capacity of the domestic financial sector to provide project finance resources.

Key initiatives that helped de-risk the programme

Overcoming these systemic barriers and improving the country's reputation for long-term investment required a combination of non-financial de-risking measures, including the reform of regulatory and institutional frameworks to create a more stable macro-economic context, and the introduction of innovative financial leveraging instruments.

In 2011, a crucial reform to Colombia's institutional framework was the creation of [Financiera de Desarrollo Nacional \(FDN\)](#), a ground-breaking public-private financial development bank that specializes in infrastructure and focuses on transforming the financing and structuring of projects in the sector. Although the FDN is majority-owned by the government, the participation of multilateral financial institutions such as the International Finance Corporation (IFC) in its capital has enabled the bank to introduce a strong, independent governance framework which allows it to maintain autonomy beyond political cycles. For the 4G programme, the FDN worked with different sources of finance to understand their needs and concerns, and structured a series of innovative financial de-risking products to increase diversification of investment and to mitigate risks.

In the same year, 2011, a specialized national infrastructure agency, La Agencia Nacional de Infraestructura (ANI), was created as the entity responsible for structuring and managing the PPPs and traditional concessions required to construct, maintain and operate the country's transport infrastructure. The ANI replaced the National Institute of Concessions (INCO), which had been tainted by corruption scandals. Both new entities (the ANI and FDN) played a strong leadership role in the 4G programme.

Next, a clear regulatory and legal framework was needed to support the 4G programme's infrastructure contracts and provide assurance for investors. In 2012, the public-private partnership (PPP) law was created to define the guidelines applicable to the development of such partnerships. This law established rules as to which types of projects could be developed and how risks should be distributed between public and private entities. It also conceded rights to the government to assume certain risks with concession schemes that were not allowed in the past.

In 2013 came a more sector-focused de-risking measure: the infrastructure law, which accelerated the processes of acquiring land and environmental licences. Meanwhile, the government set in place procedures to handle tenders with greater

transparency, to avoid the risks of corruption that had arisen earlier. These procedures included the establishment of a public-private comparator that would promote the selection of projects offering higher value for money in the use of public resources. This in turn drove purchasing agencies to become more efficient and state organizations to become more transparent.

Another key part of the de-risking framework was an effort, led by the FDN, to elevate project finance lending contracts in Colombia to international standards and to ensure that these contracts could be used in a standardized way across all the PPP projects that the government awarded. With the other de-risking factors in place, the integration of international project finance standards facilitated the entry of multiple sources of finance, from local to international and from banking to capital markets. These regulations succeeded in their intention to create the right incentives between the public and private sectors, and to enable a transparent investment landscape.¹³

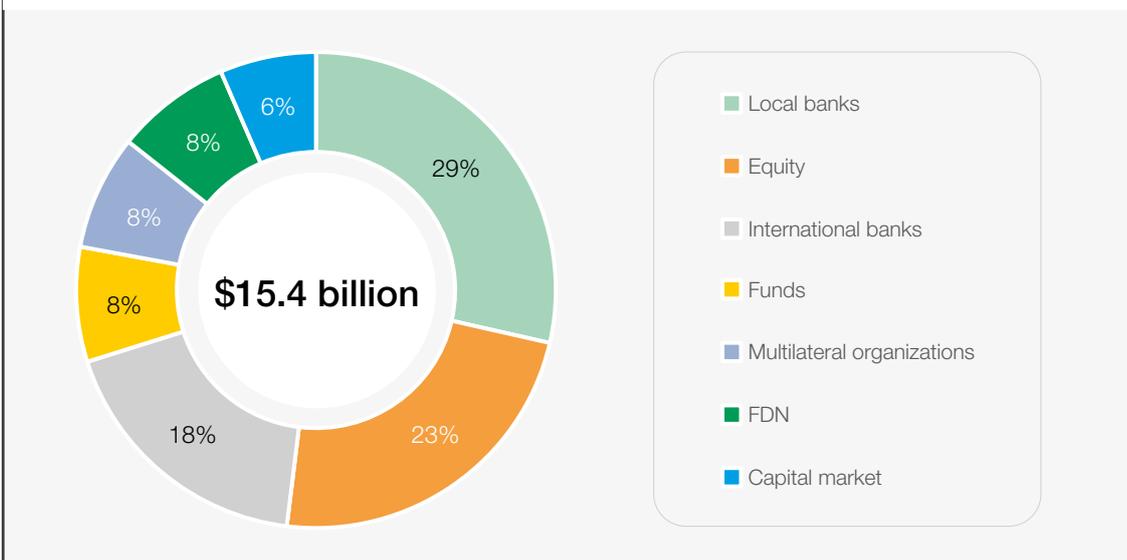
Colombia's entry into the OECD in April 2020 set the right macro-economic context for investment and enabled the government to embark on some foundational de-risking measures. One of them was the implementation of a fiscal rule on the central government's structural balance, which

sets debt ceilings for the state and maximum values the government is allowed to accommodate through PPP programmes. This helped Colombia to enhance its fiscal sustainability and regain its "investment grade" credit rating.¹⁴

By November 2020, 21 projects of the 4G programme had reached financial closure, mobilizing \$15.4 billion (85% of the debt needs) through the involvement of multiple sources of finance (see Figure 5). Since the programme could not rely exclusively on traditional sovereign guarantees to attract financing, as the government could not give direct guarantees to private concessionaires, its success has depended on the combination of non-financial de-risking mechanisms – applied through clear frameworks and stable, reliable institutions – and some innovative financial products, such as special guarantees, long-term financing lines and foreign exchange hedges offered to private participants through the FDN.

The 4G programme is the most ambitious infrastructure programme ever carried out in Colombia and the largest in recent decades in the Latin America and Caribbean region. It has become an important benchmark for upcoming infrastructure programmes, in terms of its sources of financing, plurality of instruments involved and the role of the state.¹⁵

FIGURE 5 Financing composition of Colombia's 4G programme



Source: Corficolombiana

Some key lessons from Colombia's 4G transport infrastructure programme

- A programmatic approach, which included a framework of clear laws and regulations, established the right incentives for investors and was translated into transparent and standardized PPP contracts; the adoption of international standards for project finance in the country supported this process.
- The new legal framework was accompanied by the creation of reliable, impartial government

institutions responsible for leading the implementation of the PPPs and project finance contracts; this further increased confidence among international investors.

- Ideally, these de-risking initiatives should be preceded by the pursuit of a solid macro-economic context that generates adequate fiscal and monetary conditions, to foster confidence among national and international investors in making long-term investments.

Conclusion

Non-financial de-risking measures are typically broad, early-stage macro or sectoral interventions to address underlying barriers in the investment environment that impact the attractiveness of investments.¹⁶ As presented in this white paper, these measures typically focus on policy, governance, institutional and regulatory initiatives to alleviate the actual and perceived risks to private sector investment.

When considering non-financial de-risking measures, there are a few key success factors to consider:

- **Obtaining high-level political support** for such measures, particularly foundational de-risking, is critical to their success. Political support ensures clarity on the government's position and strategic intent for specific sectors.
 - **Ensuring that sectoral strategies and guidelines align with national objectives further legitimizes de-risking measures**, such as policy reform, institutional restructuring and specific sectoral policy frameworks.
 - **Building the capacity of national and sectoral government actors** to be able to design, implement and manage policy responses is a critical requirement for the effective deployment of de-risking measures, at foundational, sectoral and project levels.
 - **A well-equipped, effective institutional setting, with champions to drive the required de-risking measures**, is necessary to further
- augment policy frameworks and strategies at a national level. Governments can help jump-start large investment initiatives by, for example, creating a sectoral project office to implement a particular programme (e.g. in the case of South Africa's renewable energy programme) or creating a powerful combination of a specialized sectoral organization and a financial institution (e.g. in the case of Colombia's 4G infrastructure programme).
 - **A transparent and fair legal/judicial system**, to underpin the institutional and policy frameworks, is an essential component of any successful set of non-financial de-risking measures. This provides further certainty to the market that such reforms have a solid legal basis and shows a clear pathway to recourse if required.
 - **Greater cross-sector and intra-sector collaboration between governments, donor partners, DFIs and private sector actors** in the design and implementation of these measures will ensure that they help address the main risks that investors face at the project level.



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