



G20/OECD Guidance Note on Diversification of Financial Instruments for Infrastructure and SMEs

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This document contains the fifth and final version of the G20/OECD Guidance Note on recommended policy steps to diversified financing instruments for infrastructure and SMEs. It reflects comments provided by the members of the G20 Investment and Infrastructure Working Group (IIWG) and the G20/OECD Task Force on institutional investors and long-term financing. This version was considered by the G20 Finance and Central Bank Deputies at their meeting held in Xiamen, China, who agreed to transmit it to the G20 Finance Ministers and Central Banks Governors and the G20 leaders for endorsement at their July and September meetings, respectively.

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G20/OECD GUIDANCE NOTE ON DIVERSIFICATION OF FINANCIAL INSTRUMENTS FOR INFRASTRUCTURE AND SMES

1. The global economy requires around USD 90 trillion of investment in infrastructure (e.g. buildings, transport, energy) between 2015 and 2030 to support economic growth and the broader development agenda.¹ There is a need to reverse years of underinvestment in infrastructure and promote enhanced economic productivity while addressing challenges highlighted by the UN Sustainable Development Goals such as ending poverty, preserving the environment, combatting climate change, and increasing resilience. In advanced economies, many ageing infrastructure networks for water, energy and transport need to be replaced or upgraded. In emerging and developing economies, most of the infrastructure required to meet development goals is still to be built, particularly in urban settings.

2. Given the constraints on government budgets and the considerable need for long-term investment now and in the future, particularly for infrastructure, it is essential that countries improve the efficiency of the resources used and partner with the private sector to meet some of these investment needs. In fact, several governments and utilities have decreased the provision of capital for infrastructure projects in light of fiscal consolidation and weaker balance sheets, respectively. Meanwhile, the capacity and relevance of the banking sector to predominantly finance infrastructure projects is not set in stone. This suggests the need for authorities to work more closely with alternative sources of finance such as pension funds, insurance companies, sovereign wealth funds, the asset management industry, and capital markets more broadly – while also realising synergies with traditional financing models through commercial banks and national and multilateral development banks (NDBs and MDBs).

3. At their Shanghai and Washington 2016 meetings, the G20 Finance Ministers and Central Banks Governors supported, under Pillar 3 of the programme of work of the Investment and Infrastructure Working Group (IIWG), the development of a guidance note on recommended policy steps that could contribute to diversified financing instruments for infrastructure and SMEs with special attention to equity financing, by promoting capital market² development, engaging institutional investors, and promoting infrastructure investments as an asset class. Working together with the WBG, IMF, GIH and other relevant IOs, the OECD has been mandated to lead the related supporting work and provide related draft notes.

4. The selected voluntary policy recommendations provided below seek to assist governments in tackling key challenges linked to mobilising private financing for infrastructure and SMEs, in particular from institutional investors and capital markets and diversifying financial instruments with special attention to equity financing. As challenges are country-specific, the recommendations are intended to serve as guidance to country authorities in their effort to cope with their specific circumstances, including targeting particular type of investors. They take into consideration existing international instruments and analysis³.

5. Further details are provided in the supporting documents which provide for each section further analysis and further details of the recommendations contained in the guidance note.

¹GCEC (2014), Better Growth, Better Climate: The New Climate Economy Report, The Global Commission on the Economy and Climate, Washington, DC, October, available at: http://newclimateeconomy.report/wp-content/uploads/2014/08/GCEC_GlobalReport.pdf.

² Public and private.

³ Including the G20/OECD High-Level Principles on Long-Term Investment Financing by Institutional Investors and their related Effective Approaches, the G20/OECD investment strategies and the G20 Diagnostic Framework for Local Currency Bond Markets, the G20/OECD High Level Principles on SME financing and the G20 action Plan on SME financing.

PREAMBLE⁴

Amongst the pre-conditions to set the stage for higher levels of private sector finance for infrastructure and for diversification of infrastructure and SMEs financing instruments, countries may consider the following selected actions.

- *Ensure that financial, fiscal and monetary regulatory policies are supportive of economic activity and create a stable long-term investment environment free of financial vulnerabilities.*
- *Promote strong public investment management institutions and sustainable public finances and use of international guidance⁵.*
- *Establish a strong legal and institutional framework that supports an efficient microeconomic environment, transparency, well-functioning capital markets and ensures regulatory certainty and stability.*
- *Encourage the formation of pools of long-term savings.*
- *Promote the development of local currency capital markets (including equity, bonds and derivative markets), and their integration with their international counterparts.*
- *Establish a national infrastructure roadmap and long term government strategy, develop a robust and transparent pipeline of investable infrastructure projects, and enhance infrastructure connectivity.*
- *Ensure sound governance of infrastructure investment, including the integration of Environmental, Social and Governance (ESG) factors and lifetime deployment.*
- *Promote Sustainable Development Goals, including resilient, quality⁶ and connected infrastructure.*
- *Promote awareness and financial literacy on the variety of financial instruments and risk allocation mechanisms.*
- *Promote implementation of existing pre-conditions and international instruments and guidance related to the financing of infrastructure and SMEs⁷.*

⁴ It is also reminded that further details on all the guidance provided hereinafter can be found in the related “Supporting Notes”.

⁵ such as the IMF’s new infrastructure policy support initiative and OECD Framework for the Governance of infrastructure.

⁶ Including cost benefit analysis.

⁷ such as the G20/OECD High-Level Principles on Long-Term Investment Financing by Institutional Investors and their related Effective Approaches, the G20/OECD investment strategies, the G20 Diagnostic Framework for Local Currency Bond Markets, the G20/OECD High Level Principles on SME financing and the G20 action Plan on SME financing.

PART A: THE FINANCING OF INFRASTRUCTURE

I. DIVERSIFYING INSTRUMENTS AND OPTIMISING RISK ALLOCATION

As many governments seek greater levels of private finance in infrastructure reflecting their fiscal constraints, efforts are underway to be more innovative in how they fund projects and use new financial instruments and techniques, and optimise risk allocation amongst the respective stakeholders.

Infrastructure can be privately funded when revenue streams from user charges can service its financing costs during the greenfield or the longer term brownfield phase, or by governments when user revenues are not available or sufficient⁸.

The capital structure appropriate for a project may vary over its lifetime. Depending on available revenues, infrastructure can be financed using different capital channels and involve different structures and instruments. Some, like listed stocks and bonds, are market-based instruments with well-established regulatory frameworks. Banks, which have a long history of financing infrastructure projects, have traditionally been providers of infrastructure loans.

Countries may consider the following selected actions:

- Promote cooperative, targeted and transparent risk allocation mechanisms amongst the various financial stakeholders active on the infrastructure spectrum, including MDBs and NDBs, banks, companies, institutional investors and governments, positioning the different actors depending on their risk profiles and institutional objectives and favouring joint actions, securitisation and balance sheet optimisation.
- Develop innovative governance and contractual frameworks⁹ to enable infrastructure sustainability and facilitate private financing. Strengthen institutions to ensure adequate design and transparency.
- Promote governmental support to innovative financial approaches, such as asset recycling, land value capture, special assessment districts, and tax increment financing.
- Promote reliable long-term funding basis of infrastructure projects (including through relevant cash-flow structures) so as to ensure flow of revenue streams is adequate to attract private investment.
- Encourage diverse channels of debt financing for infrastructure projects, in particular through non-bank channels, including syndication of bank loans through capital markets, the development of a robust project finance market, revival or innovative use of local currency infrastructure project bonds and of sub-sovereign bonds, securitisation and the formation of lending consortia. Promote the development of alternative instruments for de-risked stages of projects or hybrid investment vehicles.
- Encourage the formation of transparent and robust secondary market for infrastructure, and the development of specific products to improve access to capital market financing for infrastructure,

⁸ While the private sector is still exposed to revenue risks as well

⁹ including innovative forms of Public-Private Partnerships (PPP) and Islamic Sukuk financing

including new vehicles to foster investors participation (equity or debt, public and private) in infrastructure projects and recycling of capital through securitisation.

- Review the financing needs and instruments of small-scale infrastructure projects, which may be different from large-scale infrastructure. Promote project pooling, social and development impact investment instruments, and building networks of investors with local authorities and partners.
- Review the capacity of corporations (including public utilities and state-owned enterprises (SOEs)) to invest equity and debt capital in infrastructure projects adopting more efficient structures (i.e. through corporate governance reform) or increasing their access to local and international debt markets (i.e. improving corporate capability to obtain a credit rating).
- Address and take into consideration the nature of investment (greenfield/brownfield, domestic/foreign) and its risk/return characteristics in the identification of relevant financing and funding mechanisms.
- Monitor the impact of financial reforms on infrastructure financing.

II. EQUITY INSTRUMENTS FOR THE FINANCING OF INFRASTRUCTURE

Projects that have a greater degree of revenue risks, operating risks, or construction risks that limit the capacity to borrow capital may face financing gaps and equity can be used to provide financial backing. Equity capital occupies a first-loss position in the capital structure of an infrastructure asset; and the use of equity can be crucial in order to catalyse infrastructure projects. Equity also provides support for the issuance of debt, helping to achieve higher ratings when assets are sufficiently well capitalised by loss-absorbing positions. Equity instruments also demonstrate stronger and longer commitment from investors and should benefit the quality and sustainability of infrastructure investment.

Countries may consider the following selected actions:

- Facilitate the establishment of robust unlisted infrastructure equity markets. Review the ability of equity funds to access infrastructure assets in the local market, including the suitability of greenfield assets for existing business models, and also the local laws that govern such vehicles.
- Review the availability of qualifying assets for diverse listed equity instruments, including existing equity business models such as Real Estate Investment Trusts (REITs), Master Limited Partnerships (MLPs), trusts and open- and closed-end funds.
- Encourage the formation of investment platforms and partnerships where government, NDBs and MDBs can leverage private sector investment.
- Review risk mitigation and incentives that especially encourage equity investment.
- Promote synergies between MDBs and NDBs and the broader equity market base, including through co-financing facilities, insurance pools, wider range of currency hedging tools, and asset securitisation.
- Review the efficiency of tax policies for infrastructure finance, noting the tax treatment of debt and equity in the capital structure.
- Promote equity culture in infrastructure investment.

- Exchange experience in relevant fora on successful initiatives in other jurisdictions.

III. ENGAGING INSTITUTIONAL INVESTORS AND CAPITAL MARKETS

Over the past decade institutional investors, such as pension funds, insurers and sovereign wealth funds, have been looking for new sources of long-term, inflation protected returns. Asset allocation trends show gradual globalisation of portfolios, with increased interest in emerging markets and diversification into new asset classes. Diversification benefits and higher return expectations are increasingly driving investors to emerging market infrastructure, and even to consider investments in greenfield assets. To increase the number of infrastructure projects that are suitable for capital markets financing and promote institutional investor participation, different funding modalities and financial instruments can be made available.

Countries may consider the following selected actions:

- Foster collaborative mechanisms between investors and the creation of pooling of capital especially for smaller investors and between investors and other stakeholders such as banks and MBDs and NDBs.
- Consider risk mitigation instruments and incentives specifically focused on investors in general, including guarantees, coverage of political and regulatory risks, credit enhancements, and more diversified insurance offerings, while ensuring their efficacy as well as taking due account of the impact on public finances.
- Review financial regulations that may potentially pose unintentional barriers to infrastructure investment by institutional investors, taking into account prudential, investor protection, and overarching financial stability objectives.
- Bundling assets to reach relevant scale, appealing for institutional investors, including consortia of small scale PPP projects.
- Promote the development of project infrastructure bonds to mobilise further financing by institutional investors.
- Promote the setting of objectives for using NDBs (and MDBs through countries participation in their governance) balance sheets to catalyse private investment, taking also into consideration compliance issues related social safeguards etc; define measurements and criteria to assess the impact of initiatives that leverage private sector capital in infrastructure.

IV. ADDRESSING THE INFORMATION GAP AND DEVELOPING INFRASTRUCTURE AS AN ASSET CLASS

Improving data and information could support more diversified and innovative financing of infrastructure, and also broaden its appeal to a larger base of investors institutional investors need relevant data to analyse the performance of these infrastructure investments and the confidence to then make proper allocations. It is also necessary for policy makers to be able to understand and monitor such allocations in order to be able to make appropriate policy responses.

Countries may consider the following selected actions:

- Promote international infrastructure data collection, including with the consideration of a template for a preferred set of information to be collected (macro and micro level) and

quantitative data on historical cash flows and performance at the project level and qualitative data covering project characteristics and sustainability issues¹⁰.

- Promote standardisation and harmonisation of project documentation¹¹ and of approaches to infrastructure valuation and analysis.
- Consider a definition of sustainable and quality infrastructure investment to facilitate data collection on sustainability and resilience factors in infrastructure investment.
- Support initiatives to create infrastructure benchmarks which will in turn help to describe infrastructure as an asset class. Benchmarks should describe the investment characteristics and properties of infrastructure debt and equity instruments, helping investors complete their strategic asset allocation and liability benchmarking processes.

PART B: THE FINANCING OF SMEs

While bank lending is the most common source of external finance for many SMEs, it poses challenges to some categories of SMEs and may not be the most appropriate form of finance at specific stages in the firm life cycle. Capital gaps may exist in particular for newer, innovative and fast growing companies with a higher risk-return profile and few pledgeable assets, as well as for companies seeking to effect important transitions, such as ownership and control changes, or to de-leverage and improve their capital structures, or SMEs growing into larger enterprises.

Recognising the complementary nature of the role of banks and other financing channels, the *G20/OECD High-Level Principles on SME Financing* call for improving SME access to a broad range of financing instruments. In particular, capital market financing can open the possibility to tap into different sources of funding, including institutional investors, to support SME innovation and growth, provided an appropriate and transparent measure and management of associated risks are conducted. At the same time, not all financing instruments are suitable and of interest for all enterprises, depending on their risk-return profile, stage in the business life cycle, size, scale, management structure and financial skills.

Countries may consider the following selected actions:

- Improve understanding of the diverse financing needs of SMEs and statistical information on SME financing, through the collection of statistical data on SME access to bank and non-bank finance, micro data and micro-level analysis, SME surveys and regular consultations with stakeholders (both financial and non-financial).
- Improve bank capacity and incentives to lend to SMEs with affordable and diverse credit products, including among others, through credit guarantees, trade receivables, securitisation and credit insurance and by reinforcing bank resilience (adequate provision for loan losses and better capital positions). Consider enabling SMEs to use a broader set of assets beyond fixed collateral such as movable assets.

¹⁰ Building on current work developed by Global Infrastructure Hub (GIH), EDHEC (Ecole des Hautes Etudes Commerciales) and the OECD, and on note circulated to the G20 in 2015 on Addressing Data Gaps in Long Term Investment.

¹¹ Building on GIH PPP Risk matrix.

- Promote effective and predictable insolvency regimes, to ensure creditor rights and strengthen the confidence of a broad range of investors in SME markets.
- Support multiple and competing sources of finance for SMEs, including asset based finance (e.g. factoring, leasing, asset-based lending), alternative forms of debt (e.g. corporate bonds, private placements, debt funds),crowdfunding, hybrid tools (e.g. subordinated loans, mezzanine finance) and equity instruments with special consideration for venture capital and private equity financing, including business angels.
- Enhance the information infrastructure for credit risk assessment, including through providing the conditions for the development of credit bureaus, credit rating agencies and data warehouses with loan-level granularity, the standardisation of credit risk information and its broader accessibility and support the development of specific SME credit-risk management skills.
- Support financing of start-up and innovative SMEs (that lack both the credit history and the collateral needed to mitigate a typically high risk profile), including, where possible and appropriate, through regulatory approaches and fiscal incentives to retail and institutional investors.
- Foster standardization of regulation and documentation, and diffusion of best practices in order to promote the development of new markets and instruments (e.g. private placements).
- Promote a level playing field for debt and non-debt financing instruments, by addressing legal, regulatory and taxation biases that may place alternative instruments at a disadvantage with respect to traditional debt.
- Enhance the financial skills of SME management, by raising awareness and understanding about the risks and opportunities offered by different financing instruments, legislation and programmes for SMEs, and by developing advisory services to improve accounting and financial management.
- Raise awareness and improve knowledge by diverse financial providers about investment opportunities in SMEs, by raising the profile of the public debate about SME finance market development and investors' advantages from diversification in the SME asset class, by improving visibility of successful transactions and platforms for alternative instruments and by facilitating information sharing between investors and SMEs.
- Taking into consideration the firms' profile, support the development of specific ecosystems for SMEs in (public and private) equity markets and non-debt financial instruments and foster market liquidity.); support the development of SME advisory and research services as well as a reduction of disparities that create arbitrage opportunities (e.g. differential tax treatment). An emphasis on standardisation and homogenisation, when possible and relevant would be useful.
- Promote a regulatory and supervisory approach that facilitates access to public equity for suitable SMEs, without compromising financial stability and investor protection. Facilitate the participation in SME equity markets by retail and institutional investors, including by enhancing the development of risk mitigation instruments and by promoting the development of asset management vehicles or funds.
- Foster connectivity between investors in (public and private) equity markets for SMEs and across investment segments, such as by facilitating information sharing and co-investment to enhance

information flows and transparency, to increase market liquidity and to improve exit options for investors.

- Improve SME linkages with the investor community by encouraging formal and informal networks that link entrepreneurs with investors and larger companies, and by supporting matchmaking services, involving public authorities as appropriate, including supervisors, with the intent to get a better understanding and awareness of the financing needs of SMEs and objectives of investors investing in such firms.
- Improve the overall quality of investment and entrepreneurial projects, including through investor-readiness programmes that enhance SMEs' ability to approach different types of investors and meet their information requirements.
- Use public programmes to leverage private resources and competencies and develop appropriate risk-sharing and mitigating mechanisms, for example through co-investment/guarantee schemes and private-public equity funds, in order to enhance the resilience of SME financing.