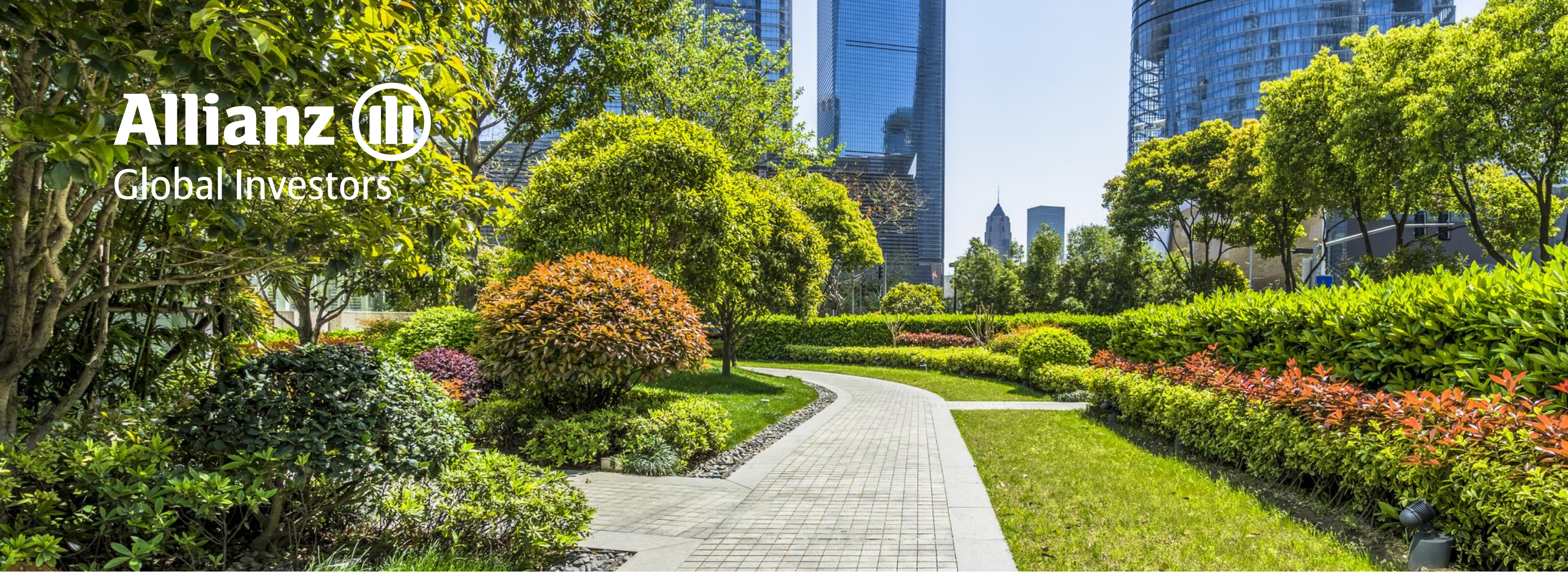


ACHIEVING SUSTAINABILITY

March 2023

Infrastructure Financing for High Impact Development

More and more pension funds and insurance companies are financing infrastructure projects in developing countries. New financing vehicles have been set up to focus on sectors with the highest impact on social and economic growth. As an approach to development finance, "blended finance" vehicles can allow institutional investors to access a new asset class of high impact investments.

Financing of infrastructure: no longer just the task of government

Three main factors have favoured the development of infrastructure financing (also known as "infrastructure debt") as an asset class since the outbreak of the global financial crisis in 2008:

1/ Falling investment from banks
The global financial crisis has led to the acceleration and intensification of banking regulation, prompting banks around the world to switch out of classic, very long-term project financing.

2/ Dwindling state budgets
The sharp rise in government debt has reduced budgets for state-funded infrastructure and development aid projects, and caused many countries, particularly in the West, to look for new sources of financing.

3/ Stagnating interest rates
The low interest rates that have followed in the wake of the global financial crisis have led to changes in the investment needs and behaviour of institutional investors.

The banks were subsequently joined by institutional investors such as insurance companies and pension funds, which were looking for investments that would offer a yield mark-up compared with government or corporate bonds, for example, as well as having terms that matched those of the liabilities of these two groups of investors.

Financing of essential infrastructure that is largely independent of demand, with public-sector operators with top-quality credit ratings (governments, cantons/federal states and other regional authorities or state-affiliated companies), has at least partially replaced other asset classes such as government or corporate bonds.

Intermediaries with their own departments that structure project financing have become established partners of many large asset managers. This trend has been further boosted in recent years by favourable regulatory treatment of this financing under the EU-wide regulatory standard Solvency II.

However, this development has taken place mainly in OECD countries. For a very long time this financing was exclusively in the investment-grade range, and it is only in the last few years that it has gradually begun to shift out of this range.

The idea of mobilising private, institutional capital into emerging markets

While this development has occurred, supranational and specialist development banks have had increasing difficulty in recent years performing their official duties in areas such as the financing of infrastructure projects in emerging markets. Demand far exceeds the funds made available to the development banks.

This demand gave rise to the idea, in 2015 and the following years, of mobilising capital from private, institutional investors for financing in general, and infrastructure projects, in particular, in emerging and even frontier markets. However, institutional investors are dependent on providing **financing in the investment-grade range,** if possible, particularly when it comes to very long-term financing, if not for economic reasons then often for regulatory reasons.

The obvious solution therefore seemed to be for development banks, with their many years of experience and access to emerging markets, as well as the capacity to bear risk, to assume only part of this financing in future, and for private investors to take over a secured portion. This has an advantage for both sides, as development banks will increase their financing capacity, while institutional investors will receive a structured investment with high-yield potential that also offers diversifying characteristics compared with the classic interest-rate portfolio.

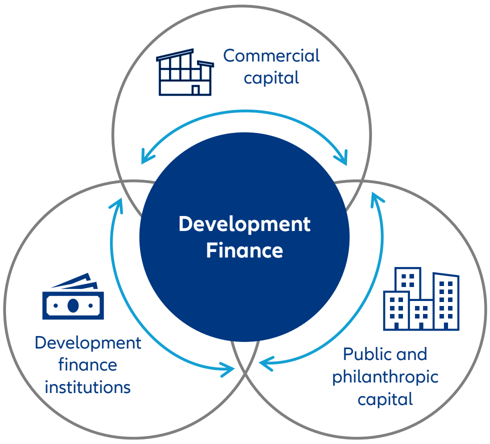
However, the main focus is on the benefits for project sponsors and funding recipients in emerging markets. Without these expanded financing opportunities, some funding and infrastructure projects in emerging markets in the last six years would not have come about at all.

Last but not least, the conclusion of the Paris Climate Agreement in late 2015 not only added climate protection to the agenda, but also brought up the question with respect to emerging markets of how, for example, the United Nations' 17 Sustainable Development Goals can also be applied to these countries in this way.

New financing vehicles

In the light of all these considerations, new financing vehicles, in some cases worth billions, have been set up in the past few years through collaboration between various supranational and national development banks on the one hand, and large institutional investors on the other (Figure 1). A new asset class has emerged over time: "**Development Finance**".

Figure 1: Development finance, set up in partnership


Commercial capital
Development Finance
Development finance institutions
Public and philanthropic capital

Source: Allianz Global Investors Sustainability Report 2020

Depending on which side we look at this type of financing from, we can describe it as **indirect infrastructure financing (infrastructure debt) in emerging markets** or assign it to ESG-oriented investments as "impact investments". There is justification for both. This asset class is expected to develop further, and to become accessible to other groups of investors in the coming years, partly for the reasons mentioned at the beginning of this article.

The Covid-19 pandemic has also accelerated this development, which has been further intensified by the rapidly growing trend over the last two to three years towards ESG-compliant investments.

A Development Finance vehicle allows a development bank to supplement with private capital each dollar it has available for financing projects in emerging markets by a factor of four to eight, and at the same time to agree ESG goals with both borrowers and lenders. Ultimately, that benefits all parties involved – and others besides.

Blended finance: de-risking via blending

An approach known as blended finance is used in structuring risk-tiered vehicles that bring together public and private funding and mobilise scalable amounts of commercial capital into high impact projects (aligned with UN Sustainable Development Goals) in emerging and frontier markets.

Its risk-tiered structure tends to include a combination of a senior capital tier and a junior capital tier, where commercial or private capital ranks senior to the publicly funded junior tier. The junior investors absorb the first losses in the portfolio, offering investors of the senior tier capital loss mitigation (see Figure 2).

The presence of the first loss structure de-risks the investment for institutional investors at a senior position to achieve an investment-grade credit profile. For insurers, the vehicle-level de-risking with the first loss provision allows for a more favourable treatment under Solvency II capital requirements.

Co-investing alongside development-focused institutions is key to achieving the sustainable impact. The partnership helps the blended finance portfolios to focus on sectors with the highest impact on social and economic growth, such as infrastructure, energy and agribusiness.

Blended finance in practice

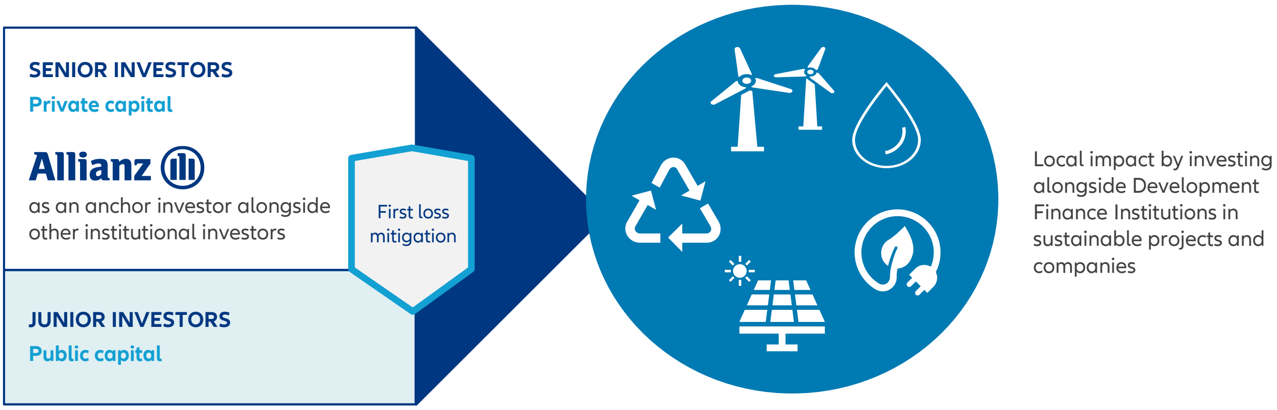
In 2017, Allianz Group and the International Finance Corporation (IFC), a member of the World Bank Group, launched a partnership under the Managed Co-Lending Portfolio Program (MCPP).

The new program, MCPP One Planet, is the world's first cross-sector portfolio of emerging-markets loans aligned with the Paris Agreement. The program combines institutional investor contributions with IFC's own funds to scale up climate-responsible financing in emerging markets.

As depicted in Figure 3, Allianz insurance companies committed USD 500 million in a vehicle to co-invest alongside the IFC in infrastructure projects in emerging markets worldwide. The vehicle has preferred access to invest in all IFC loans which fulfil a strict set of eligibility criteria.

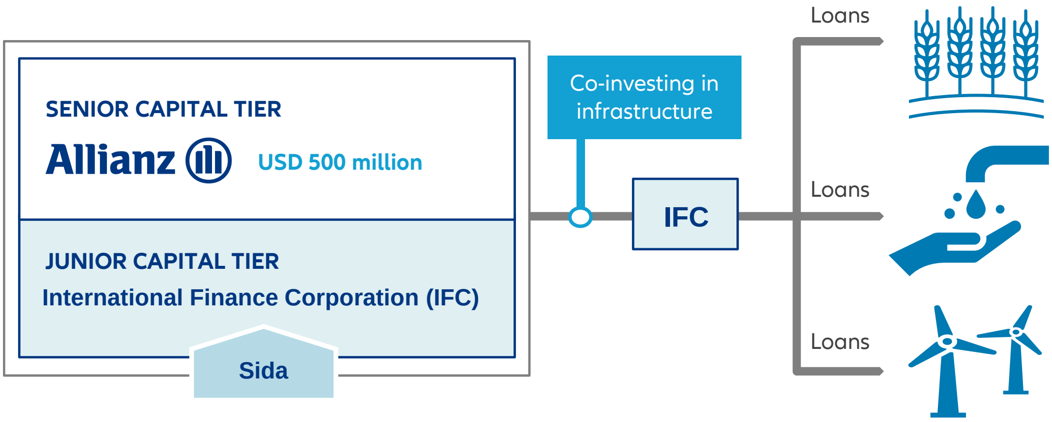
The vehicle is risk-tiered, set up by AllianzGI. IFC takes the first loss on investments up to their committed capital. Furthermore, the Swedish International Development Cooperation Agency (Sida) provides a guarantee to IFC for part of the first-loss funding.

Figure 2: Blended finance – an example


SENIOR INVESTORS
Private capital
Allianz
as an anchor investor alongside other institutional investors
First loss mitigation
JUNIOR INVESTORS
Public capital
Local impact by investing alongside Development Finance Institutions in sustainable projects and companies

Source: Allianz Global Investors, 2021

Figure 3: MCPP One Planet – providing emerging-market loans aligned with the Paris Agreement


SENIOR CAPITAL TIER
Allianz
USD 500 million
JUNIOR CAPITAL TIER
International Finance Corporation (IFC)
Sida
Co-investing in infrastructure
IFC
Loans
Loans
Loans

Source: Allianz Global Investors Update Magazine I/2022

The document is for use by qualified Institutional Investors (or Professional/Sophisticated/Qualified Investors as such term may apply in local jurisdictions).

This document or information contained or incorporated in this document have been prepared for informational purposes only without regard to the investment objectives, financial situation, or means of any particular person or entity. The details are not to be construed as a recommendation or an offer or invitation to trade any securities or collective investment schemes nor should any details form the basis of, or be relied upon in connection with, any contract or commitment on the part of any person to proceed with any transaction.

Any form of publication, duplication, extraction, transmission and passing on of the contents of this document is impermissible and unauthorised. No account has been taken of any person's investment objectives, financial situation or particular needs when preparing this content of this document. The content of this document does not constitute an offer to buy or sell, or a solicitation or incitement of offer to buy or sell, any particular security, strategy, investment product or services nor does this constitute investment advice or recommendation.

The views and opinions expressed in this document or information contained or incorporated in this document, which are subject to change without notice, are those of Allianz Global Investors at the time of publication. While we believe that the information is correct at the date of this material, no warranty of representation is given to this effect and no responsibility can be accepted by us to any intermediaries or end users for any action taken on the basis of this information. Some of the information contained herein including any expression of opinion or forecast has been obtained from or is based on sources believed by us to be reliable as at the date it is made, but is not guaranteed and we do not warrant nor do we accept liability as to adequacy, accuracy, reliability or completeness of such information. The information is given on the understanding that any person who acts upon it or otherwise changes his or her position in reliance thereon does so entirely at his or her own risk without liability on our part. There is no guarantee that any investment strategies and processes discussed herein will be effective under all market conditions and investors should evaluate their ability to invest for a long-term based on their individual risk profile especially during periods of downturn in the market.

Investment involves risks, in particular, risks associated with investment in emerging and less developed markets. Any past performance, prediction, projection or forecast is not indicative of future performance. Investors should not make any assumptions on the future on the basis of performance information in this document. The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested.

Investing in fixed income instruments (if applicable) may expose investors to various risks, including but not limited to creditworthiness, interest rate, liquidity and restricted flexibility risks. Changes to the economic environment and market conditions may affect these risks, resulting in an adverse effect to the value of the investment. During periods of rising nominal interest rates, the values of fixed income instruments (including short positions with respect to fixed income instruments) are generally expected to decline. Conversely, during periods of declining interest rates, the values are generally expected to rise. Liquidity risk may possibly delay or prevent account withdrawals or redemptions.

AdMaster: 2787790

© 2023 Allianz Global Investors