Enabling environment for rule-based business and investment

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Excellencies, ladies and gentlemen, good afternoon.

Established in 1919 by private sector representatives in five countries, ICC is the largest, most representative business organization, encompassing 6.5 million businesses in our global network, with national committees and direct members in 130 countries, as well as, active presence in over 230 countries though ICC's World Chambers Federation. Private sector leaders and experts drawn from ICC's networks establish the business stance on broad issues of trade and investment policy as well as on vital technical, sectoral and regional subjects. ICC has three main activities: rule setting, dispute resolution, and policy advocacy.

The United Nations development agenda beyond 2015 calls for a renewed global partnership to foster transformative changes that will apply to all countries, including: poverty eradication, tackling exclusion and inequality, women and girls' empowerment, managing environmental challenges, inclusive and sustainable growth and decent employment, peace building and effective governance. We are now engaged in a critical discussion of development goals and the associated financing framework. The new framework for development cooperation should provide means to improve the mobilization and allocation of resources for sustainable development. The UN Secretary General's HLP report noted that "financing must be understood as one component of a strategy that includes private sector efficiency and public sector productivity improvements".

ENABLING ENVIRONMENT

One critical and over-arching pre-condition for sustainable development is good governance and an enabling environment. At all levels – domestic markets, foreign investment and international trade – private enterprise requires an operating environment conducive to growth and development, including: peace and stability, the rule of law, good governance with accountability and transparency, the absence of corruption, adequate infrastructure, an educated workforce, clear property rights and enforceable contracts.

Business has a critical role to play in accelerating progress towards sustainable development as an engine of economic growth and employment, as a key contributor of government revenues, and as a driver of innovation, capacity building and technology development.

Creating the right conditions for private enterprise may require strategic reforms to long-standing regulatory practices to unlock the full potential of private enterprise and open markets in a way that can promote economic growth, environmental protection and social development.

Financing a transformative development agenda will require that available resources be used more effectively and strategically to catalyze additional financing from official and private sectors. Developing countries will need to increase efforts to finance their own development by improving domestic resource mobilization including by strengthening tax administration, better harnessing natural resource revenue, and curbing illicit financial flows.

The ability to mobilize domestic revenues reduces aid dependency and can raise country creditworthiness. Broadening the tax base, improving tax administration, and closing loopholes could make significant difference in lower-income countries where tax revenues account for only about 10-14 percent of GDP, one-third less than in middle income countries. Lower income country tax bases tend to be quite narrow, reflecting the smaller share of the formal sector in employment and business activity. Large informal economies and agricultural are rarely taxed. How can reforms in tax policy and administration best be achieved? International organizations and bilateral aid agencies have provided technical advice for many years. Looking forward, it will be essential that tax reforms are seen as egalitarian, socially just and fair in distributing the tax burden. This will also require that challenges posed by informality are addressed, including by identifying ways to tax the informal sector.

EMERGING SOURCES OF FINANCING – BOND FINANCING AND LOCAL CURRENCY BOND MARKETS

In a recent report, the World Bank notes that international bond flows to developing countries with maturity of at least five years began to increase around 2009 as conditions for bond financing became more favorable for middle income countries. The surge in bond issuance was partly the result of policy-induced low interest rates and quantitative easing in high income countries which prompted a search for yield by global investors. It also rose from the recognition of the economic potential of many developing countries with improved credit-quality. The World Bank expects bond financing to grow rapidly as a source of development finance for countries securing a credit rating at or above investment grade. In emerging market and developing economies, local currency bond markets (LCBMs) present a potentially important vehicle for developing the domestic investor base and mobilizing domestic savings to support public and private sector investment in productive assets. The development of LCBMs can help promote a deeper and more efficient financial sector reducing transaction costs and facilitating risk management. The viability of LCBMs for long term investment depends critically on policy credibility and commitment, including through the establishment of the right macroeconomic, institutional and regulatory preconditions.

CRITICAL IMPORTANCE OF RULE OF LAW

A government structure is dependent on the consistent and systematic applications of legal rules. The lack of universal protection for private property and contractual rights constitutes a substantive constraint on economic freedom by inhibiting or disincentivizing investment and trade. As such, the rule of law and the protection of private property and contractual rights constitute an important prerequisite for private investment-driven economic growth and high productivity.

A functional legal system is not only key in building economic foundations, it is also crucial in safeguarding democratic values. Without an integrated system of institutions that create order and facilitate daily transactions of all types – from traffic flow to business contracts – true rule of law and true democratic governance are lacking.

When property rights are not properly documented and property market institutions remain weak – as is the case in many countries – the informal sector dominates the economy and inhibits inclusive growth. Widespread informality leads to weak rule of law and corruption; in the absence of legal protection, that comes with property rights and the livelihood of informal entrepreneurs depends on the whim of local officials. When legal protection is out of reach for the majority of the population and when rules are enforced arbitrarily, abuse thrives and democracy cannot flourish.

RECOMMENDATIONS

The promotion of consensus-building through stakeholder dialogue – notably between governments, business and civil society – is vital for designing effective solutions and for implementing them in practice. They create a shared sense of accountability and responsibility. Such multi-stakeholder co-operation may take place for example in the context of creating an enabling business environment.

Improved state-business relations can be assumed to contribute to a better understanding of private sector needs by the government and thus to a more efficient allocation of resources in the economy. A government that is informed through regular meetings with the private sector about investment climate problems will usually have stronger ownership for reforms. Being in constant dialogue with private investors is also necessary to enable public officials to assess where markets can be expected to work and where they are likely to fail and offer or withdraw public support accordingly. This can create trust between the public and private sector, make policies more predictable, and thus minimize the risks for the private sector. It can also lead to jointly planned, financed and implemented public-private initiatives to deal with coordination failures and public goods.

Business will continue to engage respectfully and openly with communities, governments and other stakeholders around the world in pursuit of the of sustainable development objectives. ICC and the Global Business Alliance look forward to bringing the vast real world experience of its business members to this effort.

ATTRACTING PRIVATE Infrastructure Investments

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Financial Engineering Cannot Fix

Poor Project Economics

or Poor Policies for Infrastructure

Key Project Finance Lessons

- Projects should be economically viable -- provide essential services on an affordable and a profitable basis
  - Only possible within a framework of sound sector strategies, good policy planning and a long-term commitment to improving country ratings
  - Requires willingness to uphold legal contracts, even in adversity
    - E.g., Philippines and Thailand did so in power; Indonesia generally did not
- But poor project economics enhance pressures to renege on policy protections , e.g., take or pay contracts and commitments to raise rates
  - Poor project design / poor public policy can hurt (Maylinad)
  - Even good documentation cannot offset weak demand (Meizhou Wan)
  - Poor projects may exacerbate direct / indirect public contingent liabilities
- Financial engineering / risk mitigation (PCG, PRG, full wrap) can help
  - Attract foreign investors, extend maturities, reduce costs, etc.
  - But no substitute for project fundamentals

Where are We Going?

- Infrastructure investment is recovering
  - For some countries, e.g., those rated investment grade (China, Malaysia, Thailand)
  - But still difficult in non-investment grade rated countries and non-viable projects
- Rising role of regional sponsors - should be welcomed
  - But as niche players, unlikely to fill the void left by retreating international sponsors
- Domestic banks (e.g., in China and Thailand) provide long term project loans
  - Reduces FX risks, but may not be sustainable if loan demand strengthens
  - May be risky, with significant maturity mismatches and large concentrations
- Increasing role for policy and non-policy risk mitigation
  - To make projects viable
  - To distribute risks to a wider investor base
- Local capital market financings could reduce FX risks and better distribute risk

What Makes a Project Viable?

- Predictable country risks, with transparent legal / business environment
  - Sound infrastructure sector strategies and policies
  - Acceptable country risk (could be measured with credit ratings)
  - Willingness to abide by contracts and enforce arbitral awards
- Sound deal economics
  - Experienced and reliable sponsors
  - Secure supplies with agreed or acceptable price expectations
  - Adequate demand at affordable prices generating attractive ROI
  - Sensible, transparent, affordable PPAs or other support payments
  - Exit options via IPOs or sale to strategic investors or a handover to the government after expiration of the concession period
- Adequate local / international financing and risk mitigation
  - No substitute for sound policies and sound project economics

Risk Mitigation Can Help Viable Projects

- In mitigating policy and non-policy risks
  - With PRI, PRG
  - With PCG, monoline or multiline guarantees, etc.
- In extending maturities for domestic and offshore debt with maturity and partial credit guarantees
  - e.g., for EGAT, Telecom Asia
- In reducing currency and interest rate mismatches
  - Via better FX indexation, liquidity, currency and rate swaps
- In attracting a wider investor base and reducing costs
- In distributing lenders' risks post-construction via pooling
  - e.g., Hong Kong tunnels and bridge financing

Ratings Can Help Reduce Perceived Risks

- Benefits of ratings
  - Investment grade ratings are necessary for many investors
  - Even non-investment grade ratings can help access capital
  - Ratings can expand universe of potential investors
- Ratings are an independent opinion of the creditworthiness of a country
  - Well accepted by international investors in bond markets
  - Growing use in loan markets, bank regulation and domestic markets
  - Impose a market discipline on country leadership
- International rating agencies rate both FX and LC obligations
  - Local market rating agencies are also making progress

A Sample Transaction

The Transaction

- 144A bonds issued in the international markets to finance construction of two new power plants in a Chinese Province
  - Plants have a 20-year PPA with Provincial and Municipal power authorities
- Offshore vehicle issued bonds
  - With a grace period coinciding with the time for construction
  - Debt service payable after plants commenced operation
- Before paying construction costs, a "Debt Service Reserve" equal to one debt service payment is funded from issue proceeds
  - This ensures that the next semi-annual debt service payment of principal and interest can be made, giving extra comfort to international investors
  - Account is replenished with revenue from power sales
  - Any money in this account plus accrued interest is returned to the issuer when the debt has been paid off

Transaction Risks and Mitigants

Risk Factor	Risk Mitigants Used	Other Risk Mitigants (Not Used)
Project Design	Project provided needed power at reasonable tariffs	
Construction risk	Experienced EPC contractors; plants were finished ahead of time	Could get liquidated damages or construction bond
Approvals	Ministry of Electric Power gave a "comfort letter"; Approvals from SAEC, MOEP and other relevant ministries	Need to know local environment, be plugged into local partners since comfort letter not enforceable
Legal risk	Indenture governed by New York law. Comfort letter not enforceable	Some parties prefer that the country accepts New York Convention
Off-take agreement	Cash flow from the power plants was backed by 20-year PPA with provincial power authority	Could potentially get a PRI / PRG to cover contract abrogation
Debt Service Reserve / Liquidity	Debt service reserve account was one P & I payment kept in offshore bank	Could have additional liquidity guarantee to cover devaluation risk
Credit risk	Transaction rated investment grade based on fundamentals and implicit state support. Used a monoline guarantee (full wrap) for secondary market purchase	Wrap could be used in investment grade country (was used in a private deal for one investor)

What Should Countries Do to Attract Private Investment?

(with implications that are consistent with the ideas presented by Dr. Barbara Samuels to the Committee in December 2013)

Develop Local Capital Markets

- Local capital market financings can reduce FX and other risks
  - Need to develop corporate and municipal bond as well as equity markets
- Develop investor base along with better regulatory frameworks
  - Covering pension funds, insurance companies, mutual funds and non-bank finance companies
- Review and improve disclosure standards for issuers
- Extend maturities with “take out” financings and maturity guarantees
- Fix local rates with domestic currency interest rate swaps
- Develop / improve local credit rating agencies
- Increase transparency and legal basis for inter-governmental fiscal and service arrangements to promote municipal financings
- Improve currency swap markets to better hedge FX risks

Reduce Real and Perceived Risks

- Establish predictable policies for key sectors:
  - E.g., telecoms, power, water, piped gas, etc.
  - Deficient in such countries as Vietnam, Indonesia, etc.
- Abide by the rule of law
  - Accept enforcement of external judicial and arbitral awards
  - Accept New York Convention
  - Reduce corruption
- Improve credit culture of state-owned financial institutions
  - Use ratings for asset quality assessments to enhance risk management and bank supervision
- Reduce perceived risk through better sovereign ratings
  - Improve existing sovereign ratings
  - Obtain and use new sovereign ratings

Implications for the Public Sector: Improve Poor Project Economics

Blockage	Key Public Sector Enabling Interventions
1. Lack of Projects with Good Design	-Increase public sector funding for project preparation support -Create “Project Design Toolkit” of best practices (noted earlier) -Disseminate enabling information on best practices and available grant support (e.g, portals such as www.infradev.org)
2. Insufficient User Fees limit bankabilty	-Technical support of improved tariff structures to ensure cost-recovery (market tests, cross-subsidies, etc.) - Increase use of targeted subsidies for poor users of services
3. Underutilized Risk Mitigation Instruments & Solutions	-Scale up funding for financial advisors who can link project sponsors and finance providers to risk mitigation instruments and design solutions -Disseminate enabling information on best practices and available risk mitigation solutions (portals such as www.infradev.org)
4. Lack of Country Capacity	-Provide training for local consultants and local providers of finance on deal structures, techniques, and instruments -Provide virtual coordination tools for government PPP and infrastructure programs enabling identification of projects, issues, and solutions -Map out and create country-specific financing mechanisms (e.g., demonstration projects, linkages between instruments, etc.) -More effective coordinated donor support at project level (i.e., catalyze new paradigm of “project-centric development for aid effectiveness”)

Implications for the Public Sector: Improve Poor Policies for Infrastructure

Blockages	Key Public Sector Enabling Interventions
1. Lack of Knowledge of Best Practices for Mobilizing Private Finance	-Set up country level meetings between senior government decision makers and experts to diagnose investment impediments and devise pragmatic roadmaps to addressing them; integrate results into political decision-making processes -Identify and implement demonstration infrastructure projects that can serve as "proof of concepts" showing how thereby to create tangible country benefits -Design a series of workshops targeted on identifying finance blockages and devising realistic roadmaps for implementation solutions
2. Lack of Policy Frameworks for Private Sector Engagement	-Set up systematic ways for the private sector to provide input on impediments and possible solutions -Empower PPP and Infrastructure Programs with virtual consultation networks and enabling information (www.infradev.org)
3. Lack of Incentives for Adopting New Approaches	-Launch country programs aimed at improving the enabling environment for infrastructure projects -Set up processes that facilitate the support of priority projects (e.g., with working groups of development partners, etc.) -Set up Performance Benchmarks to track deals, including impact and finance -Support open portals to disseminate project pipelines, performance benchmarks, success stories, failures, and public and private sector leaders

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