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**THE ROLE OF NATIONAL PUBLIC DEVELOPMENT BANKS IN FINANCING
THE WATER AND SANITATION SDG 6, THE WATER RELATED GOALS OF
THE PARIS AGREEMENT AND BIODIVERSITY PROTECTION**

EXECUTIVE SUMMARY



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EXECUTIVE SUMMARY

BACKGROUND

This report is a global assessment of national public development banks' (PDBs) involvement in the water sector in its broadest sense. It was commissioned by the Agence Française de Développement (AFD) in the context of the Finance in Common Initiative, which seeks to enhance PDBs' role in financing countries' commitments to the Sustainable Development Goals (SDG) and the Paris Agreement.

PDBs are banks located within the public sphere by mandate, ownership or governance. PDBs have a specific mandate to deliver on public policy objectives that support the economic and social development of a country or region.

Historically, national PDBs have played a significant role in water sector development in high-income countries such as France, Italy and the Netherlands. Whilst there are examples that PDBs play a similar role in middle-income countries, it also appears that their involvement in the water sector has not yet reached its full potential.

The main hypothesis of the assessment was that **national public development banks are underused and that they have the potential to raise finance for achieving both the SDG 6 and the water-related Paris Agreement goals.**

To test this hypothesis, this research assessed: 1) the nature and extent of PDB involvement in financing water-related investments, and 2) the drivers and constraints for PDB involvement in the water sector. Finally, the assessment sought to define recommendations for enhancing PDBs' role in water-related investments, to see if the hypothesis could be confirmed.

In particular, the study focuses on national PDBs (operating at national and local level), though also considers regional PDBs (operating at multi-country level). It also questions the role of international financial institutions (IFIs) in financing the water sector through national and regional PDBs.

This study is based on a literature review (Annex 4); the analysis of PDBs' datasets commissioned by AFD; and an **in-depth review of 13 national PDBs, 16 IFIs, development finance institutions (DFIs) and multilateral development banks (MDBs), that are known to be active in the water sector.** The selection was based on their geographic spread, size and availability (Annex 2). The reviews of the PDBs, IFIs, DFIs and MDBs were based on interviews with senior technical and financial staff and were complemented by a documentation review, particularly of PDBs' annual and strategic reports.

The study focused on PDBs that were involved in financing water-related investments and excluded PDBs that did not work at all in the sector. This means that the research cannot draw conclusions on the reasons why PDBs are not involved in some countries at all.

NATURE AND EXTENT OF NATIONAL PDBS' INVOLVEMENT IN WATER

The study confirms that national PDBs are key players, both historically and currently, in financing water in the countries where they operate. Europe and the Latin American and the Caribbean (LAC) region host a number of national PDBs that are very active in the water sector. In other regions there are also countries which have national PDBs that finance water-related investments, but these are fewer. The subsectors to which most of the financing goes depend on the historical mandate of the national PDBs and the level of development or maturity of the water sector.

National and regional PDBs included in this study have a strong focus on financing sanitation and water supply services. PDBs predominantly fund sewerage and wastewater treatment expansion as well as large water treatment and desalination works. They are involved to a much lesser extent in water resources management, including stormwater and flood management.

Ecosystem and biodiversity protection does not seem to be specific areas of investment of national PDBs involved in the sector. Rather, biodiversity protection is often considered through a ‘do no harm’ lens or as a positive side-effect of investments (e.g., in wastewater treatment).

Water sector investments (in the broad sense) represent on average between 5% and 15% of PDBs’ portfolio, though figures are not always available in a comparable manner. There are data limitations because PDBs’ lending activities are either not always tracked according to sector, or the definitions of sectors is not consistent across PDBs, especially when funds are channelled to municipalities and used for multiple sectors.

As a result, the extent of funding for water channelled via PDBs compared to other sources and channels is also not clear, including at national level. There is very limited data on the absolute amounts invested by PDBs in water and how they compare with investments directly made by other key actors, including central government, commercial banks and MDBs.

The nature of national PDB involvement in the water sector includes one or more of the following financial instruments and services.

- Providing credit for infrastructure investments in different forms: 1) balance sheet credit; 2) credit to local governments and utilities for specific investments; 3) project finance, usually directed to private sector entities, which may set up dedicated Special Purpose Vehicles (SPVs). This is the core set of financial products of all PDBs reviewed in this study.
- Structuring project finance – including co-financing mechanisms and private-public partnership (PPPs) for the operation of water and sanitation services. Whereas the previous point referred to providing the credit, there is often technical assistance involved in structuring the financing and co-financing of the more complex investments.
- Project preparation, either grant-funded, or through loans that are repayable if the project preparation leads to a bankable project. The extent to which PDBs offer this service depends very much on the extent to which they have non-repayable funds available for this.
- Technical assistance (capacity strengthening) to utilities and local governments, oriented at their technical and financial performance improvement. This is done with the dual aim of making the utilities and local government more creditworthy, and of strengthening the sustainability of the investments. Whereas this service is considered very important, not all PDBs have the ability to provide it, as this is usually funded through non-repayable finance.
- Influencing sector reforms and sector dialogue for improving regulatory frameworks and funding related studies. Only a few PDBs were involved in national level reforms.
- Channelling central government transfers to local governments and utilities (from taxes or sovereign loans). Only a few PDBs mentioned this role.
- Administering dedicated trust funds for the water sector. In some cases, these are trust funds set up at the request of national government or external financiers. The PDBs may or may not replenish these funds out of their own profits. This was mentioned by only two PDBs.

Loans are the main financial instruments deployed by PDBs in the water sector.

- Through loans, national and regional PDBs:
 - finance investments, such as the large expansion of sewerage and treatment networks, potabilisation and desalination plants and sewerage treatment plants;
 - finance mid-sized towns and utilities which are more creditworthy than smaller municipalities and rural areas, but which are not able to negotiate favourable loans directly with IFIs or commercial banks. In several countries (e.g. Ecuador, Philippines, Brazil), larger utilities can obtain loans from commercial banks or IFIs at more favourable conditions, whereas smaller municipalities (and their utilities) are not creditworthy at all, not even for PDBs.
- Channel sovereign loans from IFIs to smaller municipalities and utilities.

- Finance climate change adaptation investments, with financing sourced from climate funds as a few PDBs are accredited to manage such funds.
- Where both financial markets and the water sector are mature, PDBs also support utilities accessing international capital markets through bond issuance.

CONSTRAINTS AND SUCCESS FACTORS OF PDBS' ENGAGEMENT IN WATER

The main constraints for national PDBs involvement in the water sector can be grouped in the demand for PDBs financing to the water sector and the supply of financing.

On the demand side

Historically, utilities and municipalities in many countries rely on central and/or local government funding for investments, which may inhibit demand for regional or national PDB financing for the water sector. In some countries, as financial regulations and strategies within the water sector evolve, public finance may primarily be directed to the poorest municipalities, and the mid-sized and larger utilities may be incentivised to take on loans for investments.

There are many risks related to the financial and operational performance of municipalities and utilities. In several countries, utilities face low revenues from tariffs, as either tariff levels are too low, or non-revenue water levels too high. This means the revenue flow to repay loans is seen as insufficient. This has led some PDBs to dedicate financing and programmes to improving the performance of utilities and municipalities as prospective borrowers. This is not the case everywhere. In high-income countries, the water sector is seen as low risk, exactly because there are frameworks in place that ensure stable revenue flows from tariffs.

There are limitations on the extent to which local governments can take on debt or spend more in the sector (fiscal space). Treasuries often set the amount of local government spending and debt and this constrains investments in the water sector which does not generate immediate returns.

The time it takes for projects to originate and source finance is another constraint. The combination of limited skills, knowledge, data and studies in the sector and the limited capacity of utilities/municipalities to formulate projects, means that it can take 3-5 years for projects to originate and source financing. In order to address this constraint, several PDBs have dedicated financing to project preparation.

A final constraint is the limited capacity for project execution. Borrowers also need the capacity to execute the projects, have processes in place for tendering, contracting, procurement, supervision of works etc. This capacity may differ between borrowers, with smaller municipalities and utilities typically having less capacity than mid-sized and larger utilities. For this reason, PDBs don't only finance the investment, but also provide technical assistance in execution where needed. Where the borrowers have the capacity –for example in the Netherlands – the role of the PDB is limited to providing finance only.

On the supply side

There is internal pressure to prioritise sectors in which investing is easier and more profitable. Whilst national PDBs are mandated to implement government policy and take on risks, they also need to balance their books. This means that they can be less proactive in sourcing projects in sectors deemed riskier, such as water, or those that are they less familiar with. Several interviewees commented on the fragmented nature of the water sector, given its decentralisation with roles spread between utilities and local government. This makes it more difficult to finance than sectors that are more centralised and concentrated in fewer institutions.

Currency risk was not mentioned as a major constraint (compared with all of the above) and it is not specific to the water sector, however it is a limitation mentioned by some of the PDBs. For PDBs that get finance from external sources on a foreign currency, there is always currency risk. Some IFIs offset this risk by lending in the local currency, but most of the currency risk is managed by PDBs and their swap teams.

Other critical factors on the PDB supply side include:

- a clear mandate to finance the water sector;
- the financial means to implement this mandate; and,
- in-house water sector knowledge and expertise.

Other relevant drivers include:

- strong relationships with the client base and contributions to improvements in the water sector;
- engagement in national dialogues on policy or regulatory reforms; and,
- taking on the risks of early-stage project preparation and then bringing other private investors and service providers on board.

In general, the difference between PDB financing and domestic private bank financing is related to the conditions offered and the non-financial instruments made available by national PDBs. Technical assistance to local governments and utilities is an added value of PDBs, as are the conditions for loan repayment. One of the most relevant aspects to the water sector is that PDBs are instrumental in implementing multi-sector projects that are cross-subsidising in nature. This allows for the mutualisation of risk between lower (i.e. larger utilities) and higher credit risk borrowers (i.e. smaller municipalities) and lower and higher risk sectors, enabling smaller borrowers to access more favourable conditions.

The other relevant aspect – and difference with commercial banks – is that national PDBs use government and donor grants, concessional loans from IFIs and commercial loans from the local banking sector (blended finance). Moreover, they use specific funding tools for this purpose such as revolving funds. The blended finance is not only intended to increase financial resources to the sector, but also to lower the interest rates of loans to the local government and utilities.

IFI FINANCE TO THE WATER SECTOR THROUGH NATIONAL PDBS

IFI investments in the water sector through PDBs are not widespread. The channels of IFI financing to the water sector depend on how the water sector is structured. In many developing countries where the central government continues to play an important role in water sector funding, IFIs typically provide sovereign loans to a central ministry of finance, which then passes them on as grants/loans to line ministries and/or utilities and local governments. In other countries, where decentralisation is effective, some IFIs also provide sub-sovereign loans directly, typically to metropolitan utilities, local government and specific projects.

IFI financing for water through PDBs is conditional on the presence of national PDBs in the first place, and whether they have a clear mandate for water. Some countries either have no national PDB or only nascent PDBs. Some sub-regional IFIs operate in countries where there are no domestic PDBs. In these cases, IFIs provide loans directly to local governments or utilities. For example, none of the Central American Bank for Economic Integration's (CABEI) borrowing member countries have national PDBs that operate in the water sector. The same applies to most of the member countries of Fondo Financiero para el Desarrollo de la Cuenca del Plata (FONPLATA).

IFIs that do provide loans to national PDBs for the water sector, do so for on-lending to municipalities and service providers. Lending can be earmarked for water or for multiple-purpose municipal projects. The rationale for financing through PDBs is that they are able to reach a broader geographical scope and therefore reach more beneficiaries than IFIs. National PDBs can also target smaller municipalities and utilities and provide smaller loans while IFIs are often unable to provide loans under a certain amount. National PDBs can also provide credit lines in the local currency, which is often a limitation for IFIs.

Water sector loans provided through national PDBs are larger than other loans to the sector, with IFIs being able to shift most of the lending risks to PDBs, which are often backed by sovereign guarantees. PDBs manage the currency risk since most of the water projects are financed in local currencies while IFIs mostly finance in hard currencies.

Investing in the water sector through national PDBs provides value for money to IFIs in terms of outcomes achieved relative to the size of loans they provide. By working with national PDBs, IFIs can also put in less time and resources in water project preparation. In these cases, IFIs work upstream with finance institutions and regulators and not directly with municipalities or service providers. It is then national PDBs that take on the responsibility for project preparation and ensure all sub-projects comply with IFIs standards and procedures.

National PDBs also provide a good solution for investments in the sector when IFIs do not have local offices. National PDBs can actively contribute to project origination, preparation and monitoring on behalf of IFIs. Additionally, the collaboration with PDBs contributes to capacity reinforcement and increases the autonomy of the countries' financial systems in terms of processes and international standards – which then benefits many other sectors.

From a national PDB perspective, working with IFIs also has benefits. IFIs often have a good credit rating and can therefore attract capital at interesting rates, which allows national PDBs to on-lend at lower rates. Other attractive benefits include the potentially large size and long tenure of IFI financing. What common happens is that PDBs co-finance larger and complex projects jointly with IFIs.

However, in some contexts, national PDBs have access to cheaper finance from local capital markets. This is the case in some LAC and Asian countries (e.g. Brazil, Philippines) where local capital markets are well-developed. The combined effect of IFIs' lending procedures, conditionalities (which represent opportunity costs for national PDBs) and currency risks can incentivise them to seek finance locally, although size and tenure may be smaller.

CONCLUSIONS

The main hypothesis of the study has been confirmed. Namely, that PDBs are underused in the sector and that there is a potential to further enhance their role.

National PDBs can play an important role in achieving both the SDG 6 targets and the water-related Paris Agreement goals. Globally, PDBs are key players in financing investment, with PDB financing representing 8% to 10% percent of global investments. Financial data on the extent of financing for water channelled through PDBs is lacking, but there is historic evidence of the role PDBs have played to support water sector development at scale (and continue to do so) in some countries. In addition, current experience indicates a well-established role for national PDBs in the water sector in certain regions (Europe and LAC in particular).

National PDBs are able to provide a unique range of financial instruments and services. This study confirmed different types of loans that PDBs can provide for infrastructure investments. PDBs are able to provide these at better terms and conditions than commercial banks, particularly to mid-sized utilities and local governments that have a reasonable level of financial performance and capacity to formulate and execute projects. In addition, they provide a range of services for project preparation, performance improvement and technical support in project execution. They are also able to structure and provide co-finance mechanisms with commercial banks and IFIs. This has allowed them to cater for both financial and technical gaps in the sector, at least in certain segments.

Considering the large financing needs of the water sector, there is room for both national PDBs and IFI finance. The study suggests opportunities for IFIs to collaborate with PDBs to reach broader water sector development outcomes. In turn, IFIs' expertise, particularly on project appraisals, can help build PDBs' capacities. This is particularly needed for boosting investments in ecosystem and biodiversity protection.

There is also room for both commercial finance and PDB finance. As discussed, the products and services offered are different. PDBs, for example, can extend a range of technical assistance services and some also extend long maturity loans. There is also some evidence that PDBs can play an active role in mobilising private capital for water. They support the project preparation process – and take on very early-stage risks – and assist with financial transactions and bond structuring/issuance. More research in this area is needed to better understand the role PDBs can play in mobilising private capital for the sector.

There are still many countries where national PDBs either do not have a mandate in the sector or only have a nascent/limited role, suggesting an untapped opportunity for increasing finance for water. A number of key factors are determinant for enhancing their engagement in the sector, particularly a clear mandate with financial allocation and in-house water sector expertise.

Finally, national PDBs are well-placed to address some of the wider challenges in the water sector which limit the ability to mobilise finance. They can provide technical assistance and non-repayable finance for programmes focused at improved performance and enhanced creditworthiness of utilities and local governments. They can also play a significant role in project preparation and support the dialogue on tariffs and cost-recovery. As public institutions, PDBs are well-placed to engage in these types of dialogues, where they can bring compelling evidence to invest in the sector through their financial and technical expertise.

RECOMMENDATIONS FOR ENHANCING PDBS' ENGAGEMENT IN THE WATER SECTOR

The overall recommendations are for governments and IFIs to strengthen PDBs' capacity to prepare and appraise water sector projects and to allocate financing and funding to PDBs earmarked for water investments. At the same time, boosting PDBs' engagement requires supporting demand creation for water financing and addressing water sector inefficiencies and constraints. Specific recommendations are provided for three groups of actors: 1) national PDBs themselves (thereby differentiating between PDBs that already operate in the water sector and seek to enhance that role, and ones that are only involved to a limited extent); 2) governments; and, 3) IFIs. In addition, there are recommendations for further research.

Recommendations for PDBs that are investing in the water sector and seek to enhance that role are to focus on: 1) removing demand-side constraints at sector level; 2) removing demand-side constraints at PDB level; and, 3) increasing supply-side measures. Specifically, this study recommends PDBs to:

- contribute to policy dialogues on sector financing strategies;
- support consultations with clients and sector organisations to help lift some of the important barriers to project bankability;
- adopt a programmatic approach, including the standardisation of processes and contracts, and finance water projects with different risk levels; and,
- articulate an approach towards mitigation and adaptation in the water sector.

Recommendations for PDBs that have the mandate but are not, or only to a limited extent, investing in the water sector are to: 1) ensure that the water sector is seen as a sector of opportunities in the internal strategy of the PDB; and, 2) develop the capacity to finance water sector investments. Specifically, this study recommends PDBs to:

- recognise and map the specific needs and opportunities of the water sector. There are financing needs exist across the sector, from water to sanitation, and across geographical settings;
- articulate the contributions that financing water investments can make to SDG and climate-related targets;
- establish dedicated windows or programmes for project preparation, utility performance improvement and/or technical support in project execution; and,
- develop internal sector expertise, including through South-South cooperation.

Recommendations for national government entities, such as water sector line ministries and agencies, water sector regulators, as well as ministries and regulators in charge of finance are to: 1) enable PDB finance in the sector; 2) strengthen PDB capacity to engage in, and provide finance for, the water sector; and, 3) address water sector inefficiencies through regulatory measures. Specifically, the study recommends government entities to:

- formulate sector financing strategies and define PDB's roles in them;
- engage PDB staff in sector finance strategies;
- provide political leadership for guiding PDB's mandates in the water sector;
- allocate public funds to initiate PDBs to provide water sector investments;
- start with small projects, as a basis for standardising processes;
- have flows of non-repayable finance for certain segments and/or co-financing;
- develop policy and regulatory measures to improve the efficiency and performance of water sector institutions; and,
- develop regulatory measures that incentivise investment and enable private investments.

Recommendations for IFIs are to: 1) support PDBs and governments to implement the recommendations mentioned above for as far as it is within their power and mandate; and 2) direct their financing to the water sector in collaboration with PDBs. Specifically that would include:

- supporting the policy dialogues around sector finance strategies that include defining the role of PDBs;
- supporting evidence and narrative creation on the nexus between the water sector and climate change adaptation and mitigation;
- supporting capacity building in PDBs in the water sector, including by facilitating South-South cooperation;
- channelling loans via PDBs, particularly when PDBs are relatively new to the water sector;
- providing grants, concessional finance and technical assistance to overcome a number of water sector related constraints;
- co-financing larger investment projects with PDBs; and,
- channelling funds for water sector investments through PDBs in local currencies.

RECOMMENDATIONS FOR FURTHER RESEARCH


The findings of the study also raise additional questions. **This section lists important gaps that this report either did not address or did not find detailed answers for.** It is recommended that these be taken up in either country-specific research or more global research. These include:

- measures to increase PDBs' involvement in the water sector in specific countries;
- complementarities between PDBs and commercial banks in the water sector; and,
- attractiveness of ecosystem and biodiversity protection for PDBs.

This global report is accompanied by a stand-alone report on Latin America where PDBs have played an important role in supporting the water sector.


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