

Contributing Paper

Note on Financial Instruments and Incentives

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For further information see <http://www.dams.org/>

This is one of 126 contributing papers to the **World Commission on Dams**. It reflects solely the views of its authors. The views, conclusions, and recommendations are not intended to represent the views of the Commission. The views of the Commission are laid out in the Commission's final report "Dams and Development: A New Framework for Decision-Making".

1.2 Rewards of Compliance: Private Sector Financial Services Mechanisms

One way in which projects that implement the WCD criteria can be rewarded is through mechanisms in the financial services industry. A project following the WCD criteria and guidelines is likely to be not only an economically, socially and environmentally sound/acceptable project, but carry with it reduced exposure to political risk (lowered chance of delay and completion risk) and other risk mitigation costs associated with project financing. While, ultimately how this changes a projects risk profile and its valuation by different participants must be evaluated by the financial services market, there is a need for novel mechanisms that can turn such characteristics into tangible benefits. An example of such a mechanism would be the linkage of corporate bond rating to a certification process (i.e. for dam projects). Thus, the second approach is directed toward the identification of incentive mechanisms (voluntary or imposed) that generate higher relative returns and improve access to capital for sustainable projects.

Financial mechanism of this nature my grouped as follows.

1.2.1 Access to Credit/Equity

The current growth in sustainability responsible investing (SRI) in both US and European Markets far outstrips “traditional” investment funds growth¹. Consumer pressure for such choice, following awareness raising from pressure groups is cited as the principal reason for this growth. When SRI first started the screening process for stocks operated on an exclusion, or pass/fail basis, for example, no tobacco, no armaments or no alcohol stocks allowed in the funds. More recently a “best in class” system has been developed and is now more widely accepted. Whilst some activities may still be excluded, others, including enterprises that were traditionally seen as heavy polluters such as oil and gas with their fossil fuel use, are an acceptable part of a portfolio. The financial research analysts use a series of environmental and financial benchmarks and adherence to a WCD guideline would be an additional criteria by which companies may be assessed.

Companies face increased pressure to demonstrate their non-financial performance² and the preparers of the Dow Jones Sustainability Group Index³ launched in Chicago 8 September 1999 advise that companies are approaching them to find out why they are not in the index.

Provided that a WCD guideline is accepted by a wide group of stakeholders then in the case of equity investment selection it represents a low-cost high-impact driver for change. Its application does not require specialised knowledge for financial analysts and is simple, comparable between companies and industries and is applicable over time.

Empirical evidence suggests that access to debt based project finance, including finance for dams, from the commercial private sector financial institutions is declining. These financial institutions do not have the additional mandate of the development institutions and will direct their risk capital towards the most efficient rate of return. The uncertainties surrounding dams financing have been previously described. By introducing a qualitative indicator, capable of being independently assessed, then the cost of administering such loan portfolios are reduced.

¹ IRRC US Research 1998 exact publication to be obtained (in Geneva office)

² WBCSD Report on Corporate Social Responsibility Sept 99

³ Web site: tba

Further study is required to explore the specific reasons for the private sector financial institutions withdrawal from debt based project finance. Only by understanding this aspect of performance is it feasible to consider whether the introduction of a WCD guideline will have a positive or neutral impact on the availability of finance for more sustainable projects.

1.2.2 Terms of Credit

- **credit at preferential rates** for projects which incorporate WCD criteria, preferential access to export risk guarantees and favourable premiums on insurance coverage, etc⁴. The favourable differential could be forfeited in the event of non-compliance with any essential part of the agreement, such that the credit rate would fall back to the normal market rate. In the latter case this, in effect, would constitute a sanction for non-compliance.

Export credit agencies (ECAs) provide guarantees and loans to private sector financial institutions for trade finance, including aspects of dam financing. ECAs are developing, or have developed, more comprehensive environmental criteria within their overall project finance assessment. The International Finance Corporation, and other multi-lateral and bi-lateral financial institutions are increasingly using financial intermediaries to deliver their objectives and stipulate the environmental criteria for access to capital. This leverage effect is enhanced because the multi lateral agency will take the top slice of risk enabling other financiers to assist at a lower level of risk exposure. This is enabling previously unbankable projects to be financed.

1.2.3 Insurance

- An example of the former would be a lower **cap on liability** for dam projects that are certified as respecting the established standard. It would be important, if this tool is to be used, to specify precisely in respect of which items or actions the liability is being limited. Exemptions from liability limits (liability release) could be agreed in egregious instances of non-compliance in certain key areas relating to the social or environmental aspects of a project.

Insurance rates are based on “what the market will bear” and the insurance cycle, as well as an assessment of the particular hazard associated with an insurable risk. The more sophisticated companies will use a captive insurer to smooth costs over the longer term, buying more cover at the bottom of the insurance cycle and using less cover when rates are high.

In the past the insurance industry has not differentiated on the cost of cover on environmental grounds, for example when insuring tailing dams⁵. However this is changing and the recent Esmeralda Exploration Ltd environmental disaster will accelerate this change.

1.2.4 Bond Rating Systems

- Another possibility is to set up a **rating system** for companies and investors on the model of the Standard&Poor rating for credit-worthiness. Such a rating system could be based on companies compliance with given commitments in respect of one or several projects or

⁴ Note that such financial incentives would have to rest of a fairly rigorous third-party system of certification.

⁵ UNEP Paris research 1998/9 Andrew Parsons from Australian Mining Coy details to be obtained.

contracts. A company that fully complied with the agreed norms would be given a higher rating; one which infringed these norms a lower one. The rating system could be used to rank companies in tender bids and in other forms of choosing contractors. Credit or insurance agencies could give preference to a highly-rated company over one with a poorer record.

In 1999 the growth in the US Corporate Bond Market exceeded 25% for the year. This form of capital raising is increasingly being used at the sovereign and corporate level for infrastructure projects. Such investments are sold on the public stock exchanges and priced based on the potential investor appetite. Investor appetite is driven by portfolio management and perception of risk. Risk perception is driven by the bond rating systems which by way of a simple alpha scale grade the likelihood (or predictability) of future cash flows arriving in the amounts projected and on time. This indicates the level of confidence for the potential investor that the investment will be repaid and dividends/interest payments met as they fall due. By introducing the WCD guidelines to existing rating system “owners” and having this factored into their risk assessment process (probably as part of a wider environmental/social impact of the financing vehicle) then a differential in favour of WCD compliant bonds will be established.

1.2.5 Accounting

At present there is no single international accounting standard that addresses all aspects of environmental costs and liabilities. In part International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets covers this area but is not as comprehensive as guidance disseminated by the United Nations Conference on Trade and Development (UNCTAD) in February 1998. This goes further than the IAS Standard in recognising the moral or ethical obligations of companies and describing how these should be accounted for and reported in a consistent way. It also outlines the methodology to be used to assess the current cost of future liabilities and specifies that it will only be on very rare occasions that estimations may not be made.

Projects that adopt these guidelines will present a more transparent picture to investors, and potential investors. It makes the scrutiny of proposals more straightforward and opens a number of assumptions to public view. For example, if a director of the board has acknowledged in public that it is the company's policy to remediate land disturbed in building works back to a pristine level, then this will be accounted for in the financial statements of the business even though there may be no legal obligation on the business to undertake such works.

This will be part of the assessment process used by the rating agencies who ascribe a risk rating to the corporate bond where finance is being raised by public offering. That is a measure of the likelihood of future cash flows arriving in the amount and period forecast. Factoring in such moral obligations will reduce volatility brought about by stakeholder activism in this area and lead to questioning of other projects that do not incorporate such costs."