

International Finance Institutions (IFIs) and Commercial Financiers

Water makes a critical contribution to all aspects of personal welfare and economic stability and prosperity. However, global water resources are coming under increasing pressure from growing human demands and climate change. Protecting water resources, maximizing their production and optimizing the use of water across personal and socio-economic activities all need to be a priority for international and private financing operations. Failure to respond to the extensive financing needs of water resource management, across many of the most vulnerable regions of the world, will jeopardize the future sustainability of water resources and reduce economic and social welfare below attainable levels.

Four sectors make up the bulk of water use - the production of energy, agriculture, industry and human consumption. Across all these activities, demand is growing. At the same time, climate change is expected to have a considerable impact on the availability of water. The main effects will be felt through an increasing variability of water supplies and growing extremes of climate. The frequency and impact of water-related disasters is likely to increase, including a greater incidence of floods and droughts.

Investment in water infrastructure is, therefore, a driver of growth and a key to poverty reduction. To achieve sustainability, protection and production of water resources and the supply of water services must be better funded than at present.

A range of development funds are available for climate change adaptation and mitigation projects, some created especially for this purpose, a few of which are available specifically for adaptation in water. However, much of the adaptation/mitigation effort will fall to private companies, farmers and households who cannot tap into these development funds. For them, commercial finance will be critical to enable them to fund these smaller scale investments from within their own resources.

Raising commercial finance for water has become more difficult due to the global financial situation since 2007 which has discouraged new private interest in water infrastructure projects and adversely affected the supply of risk capital and loan financing. The IFIs, offering longer term finance better tailored to the cash flow profiles of water projects, and other complementary financial products, have a particularly important role to play in the contemporary financial climate. A pragmatic and eclectic approach is required, especially for larger and more risky types of water infrastructure deals. Certain types of project, such as wastewater treatment, desalination and wastewater reclamation and reuse lend themselves to stand-alone commercial ventures funded from equity and other types of commercial finance.

Since most revenues arising from water services are in local currencies, foreign exchange risk is a potential drawback for water projects and providers, both private and public. Hedging against devaluation risk is not a practical proposition. The more sustainable long term solution is to generate more internal revenues from tariffs and to rely as much as possible on *local* financial and capital markets. A number of donors and IFIs offer risk sharing products to encourage the growth of local currency finance for water and other infrastructure, and such products should be promoted.



As a general principle, the risk of financial default can be managed by tailoring financial terms to the risk profile and expected cash flow of the project concerned. For large and complex projects it is becoming common to blend different types of finance (commercial loans, concessionary loans, grants, equity) to achieve an acceptable overall mix. Another risk management approach is to allow financial terms to adjust to the outcome of a project. *Convertible loans* can be converted into equity when cash flow would otherwise cause debt servicing problems. Insurance and guarantees can cover political, contractual, regulatory and credit risk from both multilateral and bilateral development agencies

IFIs and commercial banks can promote a systematic and pragmatic approach to financing water projects involving a mixture of efficiency measures, review of standards and technological options, improved revenue collection, better cost recovery from water users, more predictable government subsidies and ODA, and the intelligent use of these basic revenues to attract repayable funding sources using the array of risk-sharing devices now available.