New study calls for global project finance reform

December 28 2008

The worldwide financial crisis puts a new emphasis on infrastructure spending, seen by many governments as a way to head off economic downturn, and as a way of holding on to achievements made in the developing world. Recent research by the Economic and Social Research Council finds that Project Finance (PF), one of the most commonly used methods of funding major infrastructure projects in the developing world, can pose potential risks in the communities in which it is deployed. In a study that has focused on the role of this financing technique in the developing world, the results point to potential damage to the environment, health and safety, and human rights concerns that can arise from the pressures that the funding strategy creates.

Project finance typically sees multinational developers reduce their exposure to financial risk by shifting responsibility for repayment of loans on a particular project to the subsidiary set up solely for the purpose of owning the assets of that project. With the lender's only recourse for reimbursement narrowed to revenue from the project, and not from the general revenues of the parent company, there is heightened anxiety to meet payment targets. This can result in tight schedules for project completion in order to start revenue flowing, with allocations of risk for failures to meet deadlines sometimes placed on contractors and sub-contractors who have limited capacity to meet the deadlines while taking the necessary precautions on safety; environmental protection standards; and human rights of workers and communities.

In order to address these risks, and others, the research proposes a code of practice that would accompany the existing social and environmental requirements made by private lenders and by the World Bank/International Finance Corporation. The code would encourage:

• Greater emphasis in financial planning on the prevention of damage rather than on compensation after it has occurred.
• Earlier consultation with contractors and local communities about project standards and completion schedules so that environmental and social concerns can be better incorporated into project design.
• Making compliance with environment and human rights standards a condition of eligibility for insurance against certain commercial losses
• Greater attention to possible moral hazards arising from project insurance, and
• Greater use of social and environmental impact assessment tools by rating agencies specializing in project finance, together with a widening of focus by these agencies to include an indication of the damage to lenders' reputations arising from a failure to meet social and environmental targets.

The research team, led by Professor Sheldon Leader of the University of Essex, conducted interviews with the full range of actors, including public and private lenders; borrowers; contractors; and organizations concerned with social and environmental impacts. The team also carried out three case studies in Central Africa, the Near East, and Latin America, and conducted an in-depth analysis of the wide range of literature on this financing technique.

The research indicates that key lenders of project finance in the public and private sectors are making increasing demands that projects be developed in a manner that is socially and environmentally responsible as a condition of their involvement, and so provide valuable leadership in the international investment community. However, Professor Leader warned that this leadership can be undermined by the policies of risk allocation that unduly insulate parent company responsibility; provide little meaningful prior consultation with or remedies for local populations affected by the project; and place responsibility on the shoulders of contractors that are thinly resourced and/or not involved in setting realistic targets for completion at the outset of project design.

Professor Leader commented "along with a code of practice, we have recommended changes to the legal instruments framing project finance aimed at improving their ability to deliver on social, environmental, and human rights objectives. These include strengthening developers' accountability to lenders; to the host state; and to individuals or groups of victims in the event of failure to meet project standards. This should make it easier for host states to meet their international environmental and social obligations; and can lead to recasting contracts so as to permit legal action by local individuals and groups damaged at the construction or operational phases of projects."

Source: Economic & Social Research Council

Citation: New study calls for global project finance reform (2008, December 28) retrieved 4 May 2024 from https://phys.org/news/2008-12-global-reform.html