Expert Workshop on
Water Related Risk Management Guidelines
for Financial Institutions

Day 1, 19 April 2006:

Welcoming remarks and presentations:

Walter Amman, Swiss Federal Snow and Avalanche Institute (SLF), welcomed participants and gave an introduction to SLF's work.

Ulrik Weuder, UNEP GPA, presented the objectives, overall scope of the workshop and its importance within the water arena.

Johan Kuylenstierna, Stockholm International Water Institute (SIWI), presented information on the following areas:

- The economic and social impacts of water scarcity
- The rate of depletion over the next 20 years
- The UNEP FI-SIWI water project, engaging the financial sector in addressing water related issues
- The risk and challenges that water related issues pose to financial institutions

Koko Warner, SLF, provided background information on the purpose of the risk management guidelines and the role of the participants in its development.

Alberto Pacheco Capella, UNEP Finance Initiative, presented a process flow chart of the intended water-related risk management guidelines and background information on the current UNEP FI Principles for Responsible Investments (PRI) and how these guidelines could feed into sector specific PRI.

Kajetan Hetzer, SNS Asset Management, presented the SNS Reeal Water Fund, including the following:

- Challenges for investments in water
- The SNS Reeal Fund's overall mission
- Key themes and sectors of investment in water
- Key values and leading principles of the SNS Reeal water fund
- The roles of various stakeholders involved in the water fund

James Winpenny, Wychwood Consulting, gave a presentation on financial mechanisms for water and infrastructure. Key points included:

- Water related risks for lenders and investors
- Types of financing in water
- Back ground information on the Camdessus Panel and the Gurria Task Force

- Private financing models for public projects

Peter Börkey, OECD, gave a presentation on the access to local credits and capital markets in Eastern Europe. Some points highlighted included:

- The lack of access of municipal companies to local capital markets in Eastern Europe.
- Lack of information to encourage financial sector engagement.
- Insufficient measures to develop capital markets.
- Relationships between utility and municipality ambiguous.

Group session 1 topics: Identify key risks and barriers to investing in the water sector

Group 1

Jim Winpenny, Consultant, Wychwood Consulting
Ceema Namazie, Senior Consultant, ICF Consulting
Ulrik Weuder, Programme Manager, UNEP/GPA
David Rankin, VP Programs, Great Lakes Protection Fund
Vanessa Celosse, Executive Secretary, EU Water Initiative Finance Working Group /DFID
Heidi Mayhew, Associate Project Manager, UNEP Finance Initiative

Group 2

Koko Warner, Research Scholar, Economist, SLF
Kajetan Hetzer, Sustainability Analyst, SNS Reaal Group, Asset Management
Peter Börkey, Programme Manager, OECD
Johan Kuylenstierna, Project Director, Swedish Water House
Terry Jeggle, Senior Officer, UN/ ISDR
Alberto Pacheco, Project Manager, UNEP Finance Initiative

1. **How can good practice be defined with regards financial sector engagement in water?**

   Group 1

   In order to define good practice, it was agreed that the following questions must be considered:

   - How do water projects differ from other projects, what are the specific characteristics linked to water projects?

     Sector specific issues that were identified include:

   Cash flow issues, public vs. private good, essential use/right to use, ownership prejudice, water scarcity, many different values (not financial), high transaction costs, urban-rural divide, high political risk/volatility.

   - What is the financial sector's role in relation to other stakeholders, i.e. Governments, NGOs, donors?

The following points were raised:

Good practices

- There are a range of "sectors" and a range of water projects to be considered, a matrix can be used to identify these.
- SNS Reaal Fund's due diligence process is an example.
- Identifying the water intensiveness of the project.
- Internalise price water-related risks.
- Some institutions can provide assistance in managing or mitigating water related risks whilst others will decide to consider participating or not participating.
- Forming cooperatives is a way to share and exchange information on best practice.
- Experts and bankers need to sit down together to create a business plan.

Group 2

The following points were raised:

- Perspectives vary on what best practice means. There are different values according to different stakeholders, i.e. Banks/financial institutions in general tend to focus on numbers, profit, and track record.
- Each country has to find its own balance between different values with regards to both short- and long-term expectations i.e. short-term financial return, long-term ESG issues.
- The guidelines should be sector specific. Specify between types of financial institutions i.e. insurance practices, bank's practices, investor's practices, etc.
- Is there a business case to demonstrate that integration of ESG issues is good for sound financial outcomes in the long-term? Where should we look for "best practices" or to do a good job?
- Look at a set of generic base guidelines, examples include; SECO - Swiss Re Guidelines on Public Private Partnership in the water sector, IFC's Equator Principles, UNEP Finance Initiative's Principles for Responsible Investment. Once the basic guidelines have been identified, financial institutions can then narrow down, by looking at sector specific business cases that consider issues linked to water, such as its political and socially sensitive nature, cultural importance, and differing values in the sector.
- The SNS REAAL Asset Management's six leading principles, which consist of the following; 1. Sustainability (people, planet, profit & governance), 2. Equity (access and acceptance), 3. Functionality (quantity and continuity), 4. Stakeholder engagement: participatory decision-making, 5. Affordability, 6. Accountability, ownership.
- The following elements are important for financial sector engagement in this area; profitability, not ad-hoc, brand building, CSR, affordability, fulfil market expectations (varies), return on investment, prudent resource management and risk management.

2. What experience has been gathered about existing water related management practices?

Group 1

The following points were raised:

- There is a weak demand for risk sharing products.
- There is a lack of governance in place for applying practices/products/services.
- There are country specific institutional barriers to water management practices.
- A lack of experience is not an issue, the problem lies in integrating water related management practices/financial products and services.
- Receiving governments tend to prefer cash to guarantees.

Examples of financial instruments that were given include:

- EU Cohesion Fund offering 50% or more grant to water projects remove an incentive for sustainable cost recovery. Output-Based Aid is intended to be performance-based, in that it gives an incentive to deliver the project output to the target groups.
- European Investment Bank (EIB) can offer long-term loans that are given over 15-20 years with subsidised interest rates.
- Municipal pooled bonds, incorporating mutual guarantees, backed by risk-sharing with an external agency such as USDCA.
- Guarantee programmes are a possibility, however there is a lack of up-take, due to supply-side restrictions by development banks, amongst other factors.

Group 2

The following points were raised:

- Examples of existing guidelines for managing water related risk include; The guidelines on Private Public Partnerships by SECO and Swiss Re, national guidelines such as GEMI, ISO.
- Examples of existing products and services include; Exa Derivatives to cover flood and drought water, forestry funds delivering water shed management, water funds investing in equities and bonds, Netherlands CSD business development plan group micro water financing facility.
- There is a general lack of expertise from financial institutions in water.
- There are issues surrounding private sector engagement in water and debates on whether water is a public or private good.
- Regulators can play a key role in developing frameworks and enabling environment that allow functional business models in water.

3. **How do financial institutions assess water related risk and address water related issues? How do financial institutions integrate these risks in their due diligence-process?**

Group 1

The following points were raised:

- The way in which financial institutions assesses risk varies according to the type of institution e.g. commercial banks, insurance, etc.
- Financial institutions should not outsource Environmental Impact Assessment (EIA), but should try to internalise outcomes and processes.

- Most financial institutions have their own checklists for managing risk and tend to take a project by project approach.
- It was pointed out that different types of financial institutions have different types of practices.
- It was suggested that we should be clear as to what we want them to assess in water, i.e. potential social impacts, environmental impacts, quality, quantity etc. This should be done by giving a list of criteria.
- The point was raised the level at which financial institutions address risk depends on their involvement in a project, and their level of exposure.
- It was recommended that financial institutions should measure risks that can be internalised i.e. focus on risks related to financing

Group 2

The following points were raised:

- Cost benefit analysis is an example of how FIs could integrate risk in their due diligence process.
- Re-insurance/insurance companies' processes could also be used as a structure approach to risk management.
- Sector specific investments are a factor that can make water issues more prominent.
- Data sharing is an effective way to manage risk. Insurance companies are an example of where there is good co-operation in sharing information to assess risk.
- An effective method would be to take a demand-driven, bottom-up approach. Pre-feasibility studies are a way to ensure that capacity exists to implement projects.
- Country risk profiles would provide a useful tool for looking at risks specific to the region in which the investment/loan is to be made.
- Regulatory frameworks must also be considered; the government can play an important role in mitigating risk thus fostering more investments.
- Co-operate with other organisations, using the expertise from those on the ground, who deal with risk directly i.e. UN agencies, NGO's etc.
- Consult value advisors to carry out project evaluations.
- Identify set of criteria for evaluating projects i.e. SNS Water Fund, Pictet Water Fund, SAM Water Fund, etc.
- Employ credit rating agencies i.e. Moody's, Standard & Poors, etc.

4. **What are the main barriers to investors a) Proactively adopting good practice and b) channelling investments in water and sustainable social and economic development?**

Group 1

The following points were raised:

a) Adopting good practice:

- Investor can lose clients if terms and conditions do not adequately meets their expectations.
- There are high transaction costs for meeting best practice conditions.

- The political culture plays a role. The government can put pressure on the private sector to apply best practice/ provide incentives/ discourage best practice e.g. economic instruments.

- Private public partnerships considered as too risky.

b) Channelling investment:

- High transaction costs. Many water projects are less than the threshold.
- Lack of awareness of local conditions- deterrent if unknown. Overall lack of information.
- Weak demand for investment in this area given rate of return.
- Lack of governance/ accountability- no trust in the institutions.
- Legal internal/ country barriers to taking on board the loans.

Group 2

The following points were raised:

a) Adopting good practice:

- Quick or low returns on investments given the levels of risks.
- Economic analysis is short sighted and focused on short-term gains instead of broader long-term perspectives.
- Absence of shared dialogue or policy- processes.
- Limitation of financial cost-benefit. Lack of acknowledgement of long-term gains.
- Lack of adequate financial analysis to quantify potential risks.
- Good practices/ extended analysis becomes too complicated to pursue.
- Water perceived as a public good, thus seemed as complicated business.
- Setting out scope for precision and proper identification of market segments.
- Banks have risk guidelines but lack sector specific guidelines.

b) Channelling investment:

- Basin requirements vs. national sovereignty and jurisdictions.
- There are uncertainties and difficulties concerning transboundary "water moves" through investments.
- Banks do not like, nor seek risk. They are risk adverse.
- Dichotomy of risk analysis/ reduced risk is beneficial to insurance but this is different from banks/ investors.
- Translate ideas into business plans. Look at the role of regulator vs. role of the "market".

5. What are the main perceived risks deterring financial sector engagement in managing water risks?

Group 1

The following points were raised:

- Lack of awareness from banks on local policy frameworks.
- It is not possible to take the assets in case of loan default.
- Pricing volatility linked to other factors, i.e. cost of energy.
- The projects are often low scale, incurring high transaction costs.
- A high reputational risk as water is considered a "sensitive" sector.
- There is a geographical limitation of engagement. Financial institutions tend to focus on urban and peri-urban environments and avoid engaging in rural projects, where there are higher perceived risks.

Group 2

The following points were raised:

- Depends on investment strategy. Is the investment strategy defensive, innovative, proactive or protective?
- Risk attitudes vary according to FIs, i.e. insurance (risk seeks insurance) banking (risk averse), investment (balances risk and payoffs).
- Vary depending on the phase of the project cycle, but can be linked financial risks, environmental risks, transaction costs.

6. What are the main barriers to financial sector engagement, linked to local and national policy? I.e. insufficient legal frameworks, uncertainties linked to political frameworks.

Group 1

The following points were raised:

- Absence of clear legal title linked to legal status of land/ lack of legal status of the ownership of the municipal infrastructure.
- Sub-sovereign entities may not have the legal entitlement to borrow/ they could borrow but there are limits on borrowing avoiding debt.
- Legal systems and the courts are weak in enforcement of contracts. There needs to be a concrete legal framework in place.
- Devolution of powers to locally elected officials who may only be elected on a short term basis, thus conditions of contract may change over a short time.
- Good independent regulators are rare.
- There is often a ceiling on tariffs and policies of low tariffs.
- Water is generally absent from PRSPs (Poverty Reductions Strategy Papers). This may influence the allocation of funds in the sector by finance ministers.

Group 2

The following points were raised:

- Definition of water allocations between industrial use and household i.e. public good, commodity a human right?
- Examples of investments in public goods include forestry, fishery, etc.
- A reluctance to pay for water, despite its needed for almost everything.
- Legislation is often outdated, ideological, and varies according to the cultural setting.
- Timing and manner of communication with the relevant stakeholders- identifying and creation of commitment- i.e. Cochabamba.
- Translation in to economic terms. Willingness to pay and willingness to accept by consumers.
- Lack of measurement, valuation and recognition
- Lack of clarity on land tenure, ownership and related risks in certain sectors, i.e. mining, farming.

Day 2, 20 April, 2006

Summary of key points from day 1

Issues to consider:

- The definition of the financial sector as a whole is too broad; we need to specify which type of financial institutions we are targeting i.e. commercial banks, development banks, micro-finance institutions. We also need to consider the type of investments we are looking at, i.e. equities or loans.
- Which group is it important to target? Most banks already have guidelines, although not specific to water, however, the more appropriate target audience would be those who are just jumping on the band wagon
- What incentives are needed for financial sector engagement?
- Risks vary according to stage of project cycle and they depend upon the stage at which the financial sector comes in. Risks can include financial risks, environmental risks, transaction costs, etc.
- What are the critical success factors? Success factors in investments that contribute to sustainability can be general across all projects or there are variables that can be demonstrate through case studies of individual projects.
- When considering CSR, it is important to ask; how far should companies go in involving themselves in the vacuum of bad government? To what extent do the responsibilities lie with the financial sector, and how proactive can the sector be?
- If guidelines set by banks are too complicated, companies will go else where for financial support. It is important to get the right balance of incentives and constraints.
- What are key considerations to look at according to the stakeholder, i.e. the core principles relevant to banks will be different to those of donors?

Recommendations:

- A matrix is needed to show what guidelines are out there. One possibility would be to develop two sets of guidelines. One set where water is the main focus, the second set where they may have an impact on water, a 'water footprint', but where water is not integral to the project.
- Identify ways in which water can be a resource in investment sector, i.e. through innovative private equities, venture capital, micro-finance, etc.
- One way of engaging financial institutions who are aware of the opportunities that are out there, but are not sure how these work in practice, would be to identify the success factors in investor engagement in water and make a business case around this.
- Build a database of shared information as a tool that may help to answer potential questions that financial institutions may have in this area.
- Introduce standardised fast track procedures for lower costs.
- Identify what existing practices are there? From there, look at what they have and compare common points that make it work.
- Look at other issues that are already on the ESG agenda, i.e., micro-finance, institutional investors (PRI) and add water component to these.
- Incorporate all aspects in project design, i.e. commercial, economic, environmental, social, and assess the level at which these apply along the sector.
- Guidelines should concentrate on three main areas: (1) Governments, (2) Financial institutions, and 3. Scope what is relevant to both.

Group Session 2: Ways of addressing risks and barriers

Group 1:

Terry Jeggle
Alberto Pacheco Capella
Ulrik Weuder
David Rankin
Vanessa Celosse
Kajetan Hetzer
Peter Börkey

Group 2:

Jim Winpenny
Ceema Namazie
Heidi Mayhew
Koko Warner
Johan Kuylenstierna

1. Generally: How can the identified barriers to increased investments in the water sector be mitigated?

Group 1

- Through good examples or practices in case studies. More investments (i.e. water funds)
- Increased expertise is needed. There is a lack of knowledge and capacities/ partnership and cooperation, which would potential reduce transaction costs
- Long payback periods- Change compromises "sustainability"
- Long-term shareholder value arguments i.e. current UNEP FI's line of work on the PRI.
- Identifying different sub-sectors in water where the private sector can participate though their investments.
- Value vs. risks/ blending different financial products/ ECA water sector soft loans. Structured loan approach could be used to mitigate potential risks that generally create aversion from investors.

- Use of case studies exemplifying potential opportunities/ bankable projects/ partnership with their own expertise for specific projects
- Local entrepreneurship with knowledge could be used as potential partners with market knowledge.
- Opportunities of scaling up. Qualities issues/ blending products and financial mechanisms.
- Look into existing mitigating strategies.
- Look into guarantee instruments.
- Combining expertise by merging of management (NGO's, water experts, credit analysts, investors, rating agencies)

2. More specifically: How can local and national policy be adjusted and appropriate policies enforced to create a more "enabling" environment for encouraging investments into water?

Group 1

- A proper legal framework is needed.
- Tariff selling policies.
- There is a lack of financial resources and human resources at local level. Capacity building strategies for regulators are necessary.
- Performance base contracts.
- More disclosure is needed on regarding policies and contract arrangements.
- Compelling case on the risks and opportunities by policy makers at national and local levels. Presenting a business case for policy action could steer more investment possibilities.
- Tangible value for investors, in line with proper legal framework with sustainability criteria.

Group 2

- More support needed for small entrepreneurs, i.e. micro-finance, cooperatives, and community projects.
- A good solid local banking system needed.
- Corporate law needs developing to reduce risks of potential loss of assets.
- Policies are often counteractive, thus should be in-line with necessity/demand driven with long term perspectives.

3. How can financial institutions within their business associates play a more pro-active role in overcoming the identified barriers and contribute to the necessary policy changes?

Group 1

- Depends on market domination.
- Through knowledge sharing between partners and identifying proper financing mechanisms.
- Through business associations that give more leverage i.e. banking associations.

Group 2

- By establishing partnerships with local actors i.e. NGOs, MFIs and commercial banks.
- Through a stable regulatory structure. A certain level of control of central banks over local banks is necessary, but at the same time, this should not be too restrictive.
- Banks can be more proactive in assessing local conditions and contracts before granting credit to projects.
- Legal frameworks and institutional framework considerations need to be incorporated in to their credit rating processes to reduce risk.
- Financial institutions could push for the business/ projects they back to adhere to the international standards. i.e. ISO standardization system, GEMI.

Closing Remarks:

General comments:

- Look at terminology and communication. Where are the language barriers between policy makers and financial institutions?
- There is often a lack of reliable or up to data on local conditions, demography, increasing urbanisation, etc. which can make it difficult for developing a business plan, or financial model for investments. Investors may need to make some assumptions based on available data, and for transparency purposes it may be necessary to share these assumptions or obtain an agreement from the national government, local institutions, or municipality regarding the data that is used. Since if a business plan is not built on mutually agreed credible data, this can lead to problems later. Also, when considering the issue of mechanisms for tapping data we need to consider what are the requirements for credible data?
- Can you quantify water related risk? The WHO report on water attempts to answer this questions.
- Project finance in water can be high due to legal cost, etc. how can we keep this standardised?
- Focus on local capital markets for sustainable long-term access to finance, and identifying where the opportunities lie.
- How can water funds be pro-actively engaged?
- Who is the target audience? It was agreed that we should target both investors and commercial banks as they have the key skills to generate new ideas. At the same time we should not exclude other actors from the process who have expertise and ideas to feed in to the process, i.e. IFIs, ECAs, MFIs.
- It was recommended that the guidelines should include a matrix showing the sector specific risk factors according to the type of financial institution.
- It was considered useful to map the value chain within each sub-sector of water.

Points raised regarding the tentative expert workshop in June:

- How can we actively engage more financial institutions in the process of developing these guidelines?
- Recommendations were made that the guidelines should be promoted as a way of opening doors to the water sector, by identifying barriers. This would also be a way in which FIs involved could strengthen their CSR activities.
- Would institutional investors be a target group to look at?

- Gauge interest and exposure by inviting a journalist to be a commentator.

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Next steps:

- 2nd Expert workshop on water-related risk management guidelines for financial institutions in Geneva, Switzerland. (Date tbc.)
- Launch of the guidelines at the World Water Week in Stockholm, 20 - 26 August 2006
- Launch of the guidelines at the International Disaster Reduction Conference in Davos, 27 August - 1 September 2006.

Examples of guidelines	
Guidelines	***Web link***
ISO- International Organization for Standardization	www.iso.org
GEMI - Global Environmental Management Initiative's guidelines, water and sustainability tool	www.gemi.org/water
International Finance Corporation's Equator Principles	www.equator-principles.com
UNEP Finance Initiatives' Principles for Responsible Investment	http://www.unpri.org
Swiss Agency for Development and Cooperation (SDC) Swiss State Secretariat for Economic Affairs (SECO) and Swiss Re's Public-Private Partnerships for Water Supply and Sanitation, Policy Principles and Implementation Guidelines for Sustainable Services	www.partnershipsforwater.net /en/instruments/downloads.html

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