GOVERNANCE
BASEL INSTITUTE ON GOVERNANCE

12th IACC Guatemala
Workshop 5.2.: Infrastructure project finance
Thursday 16 November 2006 (11:30-14:00)

Workshop report

Speakers/Panellists:

Neill Stansbury, TI UK, TI Project Director Construction and Engineering
Kevin Ford, Associate General Counsel and Chief Global Anti-Money Laundering Officer
Steve Zimmerman, Chief of Office of Institutional Integrity, Inter-American Development Bank

Moderator and Rapporteur:

Gretta Fenner, Director, Basel Institute on Governance

Background and Objectives

Infrastructure sectors such as construction, transportation, electricity and others, offer particularly wide avenues for corruption and are repeatedly named among the most, if not as being *the* most corrupt sectors around the world. In most major infrastructure projects, the state is heavily involved, e.g. as owner of utilities, as implementing agency and through regulation, as is on the other side of the equation the private sector that designs, implements and often operates the projects.[1] Furthermore, monopoly situations in the relevant sectors are not uncommon, which further diminishes the level of transparency. Finally, the sums involved in infrastructure projects are usually incommensurably large, and therefore the profits that derive from corruption are exceptionally high (as are the losses that corruption in this sector consequently generates to the state and its citizens).

Corruption in project finance often results in increased project costs, low quality of final product, possibly resulting in dangerous or environmentally destructive projects, and the direct misappropriation of funds. Combating corruption in public works should accordingly be a high priority on every anti-corruption agenda, be it of states, of the private sector, of international organizations or of citizens and non-government organizations.

As indicated above, the roles of the state and of companies (that often detain a quasi-monopoly position in the concerned market) is key in any public works project. Their roles in preventing and detecting corruption in infrastructure projects have been widely discussed

[1] O'LEARY, Donal, *The Role of Transparency International in Fighting Corruption in Infrastructure*, Transparency International, prepared for Annual Bank Conference on Development Economics, Tokyo, 29-30 May 2006.

Basel Institute on Governance
Peter Merian-Weg 8, P.O. Box
4002 Basel, Switzerland
Phone +41 (0)61 267 05 00
Fax +41 (0)61 267 24 81
E-mail info@baselgovernance.org

in current literature.[2] The role of those that provide financing to such major projects has however been less in the focus of attention despite the fact that the relevant projects invariably require the involvement of funders, be they private financial institutions or multilateral development banks. It is this particular issue that the workshop on infrastructure project finance sought to address by identifying the nature of involvement of funders in public works, the techniques of project finance, and the corruption risks inherent in this business and potential remedies thereto.

Corruption risks in infrastructure project finance

The complex technical requirements of infrastructure projects and consequently the large number of contractors, providers of goods and services, professionals, beneficiaries and other stakeholders involved in the execution of a project result in complex contractual and project implementation structures which open doors to misuse. In addition to “traditional” bribery, fraud is a common form of crime occurring in infrastructure projects. Some participants even went as far as saying that the problem of fraud is far greater than the problem of bribery. In any event both forms of crime go hand in hand.

Corruption in major infrastructure projects not only occurs during contract award, as often thought, but can occur throughout the management/provision of funding and during the entire execution, i.e. in planning, design, tendering, project implementation, etc. Actually, given that a growing number of countries have more or less transparent procurement processes in place which would detect corruption if paid at the moment of the bid, the new way of bribery in infrastructure projects is to defer it to a later stage (e.g. by modifying project specifications, equipment prices, quality of equipment or services, etc.).

In general, corruption in large infrastructure projects is difficult to detect because projects cannot be compared well. Different locations, different technical requirements, sizes etc. render a definite comparison of prices particularly difficult.

In terms of the role that funders play, it is clear that project finance entails both *risks* and *obligations* for funders to take adequate measures to ensure integrity and transparency in funding activities. One form of risk for funders is of *contractual* nature and relates to the fact that, if a contract is found to have been obtained through corruption, it can legally be cancelled. The invested funds are likely to be lost without chances for recuperating, which results in a major *financial risk* for the funder. Further risks are of *criminal liability* and of *reputational* nature.

Recommended action for preventing corruption in infrastructure project finance

While it was agreed that financial institutions do not bear the main responsibility for corruption in general, and for corruption in project finance in specific, they do bear a level of responsibility in preventing and detecting corruption. It was agreed that funders do not (yet)

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[2] Reference is given to a pertinent case study in lieu of many: ENGERMAN, Stanley, and Kenneth L. SOKOLOFF, *Digging the Dirt at Public Expense: Governance in the Building of the Erie Canal and Other Public Works*, NBER Working Paper No. 10965 (December 2004);

apply the same level of attention and care to corruption as they do to other problem zones such as safety and quality in project finance. Major efforts therefore still remain to be taken by funders, and their responsibility in preventing and detecting corruption must be more recognized. A somewhat “standard” set of anti-corruption measures can carry a funder a long way towards dealing adequately with the highlighted risks:

Obviously *adequate due diligence* in all operations is key, encompassing the screening of the key project partners as well as of third parties (agents, intermediaries, sub-contractors). Financial transactions need to be analysed carefully for risks of money laundering or fraud, and projects need to be screened for their potential exposure to individuals that may entail a certain risk, i.e. so called “politically exposed persons”, or through the involvement with which the funder may provoke a conflict of interest situation. In this regard, it has to be well understood that *no party involved in project finance can rely on the other involved parties to do adequate due diligence*. All stakeholders involved in project finance, be they governments, multilateral development banks, or private financial institutions, are therefore responsible for engaging their own due diligence procedures. Relying on another funder’s due diligence is not likely to be considered a sufficient safeguard against liability in the event that corruption or fraud occurs. All speakers agreed that this point was not yet sufficiently understood by most funders.

Any contract entered into in the context of the funding of an infrastructure project should contain commitments to stringent anti-corruption standards. These provisions however remain paper tigers if not accompanied by proper monitoring. Therefore, the development of an *appropriate internal compliance system*, with a set of policies, corporate guidelines and codes as well as an adequate structure of approval procedures, documentation, internal control and reporting systems, supported by a sufficient number of specialised staff, is highly recommended to any company, and even more so to companies and funders involved in major infrastructure projects.

It goes without saying that maintaining the highest level possible of *transparency* about all facts related to the project can contribute greatly to rendering the concealment of corruption more difficult. Providing appropriate access to information on bidding processes and project implementation to the public, and monitoring professional conduct are key to ensuring transparency and integrity in project finance.

In order to deal with the enhanced complexity of large infrastructure projects highlighted further above, it was agreed that such controls can only be ensured if *independent and skilled professionals* are appointed to each project to carry out thorough monitoring of the project from the first stages until completion of a project.

Finally, the workshop speakers and participants agreed that *blacklisting* is an effective tool for preventing and deterring corruption, but that it only covers one part of the equation and therefore needs to be met by adequate measures on the side of contractors as well as the project “owners”, i.e. (mostly) states.

Gretta Fenner, 11 December 2006, Switzerland