Infrastructure – a sensible investment?

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What is infrastructure?

- Fixed assets which can be used to create economic or social benefit
- Such fields as transport, energy, communications, water, waste disposal, housing
- Commercial property is already a familiar infrastructure investment

World needs more infrastructure

- Need to spend about 3% of world GDP each year up to 2030 – especially in developing nations and emerging mega-cities but also in developed countries
- Existing mechanisms may not suffice to reach this target
- Can institutions be tempted to put more investment into this field?

Attractions for institutions

- Stable and predictable cash flows over 30 yrs enable liability matching
- Low correlations with other investments create greater stability in overall portfolio
- Often good credit ratings
- May have some inflation protection
- Desire to enhance reputation

Hurdles for institutions

- Regulatory requirements
- Illiquidity
- Lack of understanding of risks
- Lack of transparency
- Need for long and costly due diligence
- Poor statistics
- Fee levels for intermediaries
- Difficulty of getting the best projects

Risk-reward balance

- Will the returns suffice to counteract the risks and lack of liquidity?

- Which routes in to infrastructure will offer the best risk-reward balance? – bonds, direct ownership, participation in equity structure, infrastructure funds, listed equities?

The risks

- Construction
- Forecasting
- Operating and revenue
- Guarantor credit
- Financing
- Bias in assessments
- Hostile acts
- Climate changes

Bonds

- Perhaps the easiest way in
- But returns are very low at present – high demand and not enough projects
- Bonds are not free of risk

Direct ownership

- Freehold or long leasehold
- Willing to bear construction risks?
- If not, be willing to give prior commitment to buy out when constructed and in operation?
- Or invest in commercial property *associated* with new infrastructure?
- Energy schemes?
- Residential?
- Continuing revenue and maintenance risks

Listed equities

- Shares in utility companies – transport, energy, telecoms
- Lower volatility than other shares?
- Not enough diversification from other types of equities?

Unlisted infrastructure funds

- Short terms, usually 10 years
- Illiquid
- High returns projected but gearing risks
- Uncertainty over realisation prices for assets
- Lack of transparency
- Do they meet institutions' needs?

Acceptable returns

- Bonds – small margin over gilts, depending on credit rating?
- Direct ownership – perhaps 6% p.a. for 30 year lease (by analogy with commercial property)?

Regulation(1)

- EIOPA advice 29 Sept 2015 (insurance companies)
- New asset class for high-quality infrastructure, with reduced risk calibration (Solvency II)
- Strong requirements for “high quality”:
  - Stress testing in various scenarios
  - Predictability of cash flows
  - Protective contractual framework
  - Debt must have credit assessment CQS 3 or more

Regulation (2)

- Equity investments and unrated debt must have risks managed:
  - Political risk
  - Structural requirements
  - Construction risk
  - Operating risk
  - Design and technology risk

Regulation (3)

- Risk management requirements:
  - Understand risks
  - Assess impact of investment on whole risk profile
  - Assess consistency with interests of policyholders
  - Validate cash flow models
  - Have written ongoing monitoring procedures
  - Carry out regular stress tests

Conclusion

- Working party paper - an introduction
- What more is needed to stimulate institutional investment?
- Should the working party continue?
- Today's discussion