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