

Infrastructure as Long-Term Investment Tool for Sustainable and Comprehensive Growth¹

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ABSTRACT

The infrastructure sector faces major challenges. These include insufficient investment, partly due to fiscal consolidation, as well as shortcomings caused by poor project selection and planning, inefficient delivery and persistent emphasis on building new capacity rather than using existing assets optimally. Among the market inefficiencies are lack of suitable project pipelines, inadequate risk-adjusted returns, prudential and regulatory constraints and high development and transaction costs.

To increase long-term investors' asset allocation to infrastructure, this field needs to be transformed from the realm of an 'alternative' investment category into a real asset class that will attract new streams of investment from around the world. Pension funds, insurance companies, asset managers, foundations, endowment funds and sovereign funds are eager to invest more in infrastructure. Today they invest on average in this area less than 1% of total assets. In Canada and Australia, by contrast, pension funds and insurance companies invest over 15% of their assets under management in infrastructure

So there is a lot of work to do for governments and public administrations, international regulators and the financial industry. Development institutions from the G20 countries (the so-called D20) will play a growing role in facilitating the process at the national, regional and global level.

Schemes financed by public private partnerships and other private finance initiatives may be part of the solution. Today, globally, these account for only about 10% of total infrastructure financing – while 54% is financed by taxpayers' money and 36% by corporates. One way to attract global long term investors into infrastructure financing is to work on the quality, innovation and standardisation of projects and financial products alike.

I hope that governments accelerate what is needed to be done. Those facing fiscal pressures can build on various forms of taxes, user fees and divestures. They may capture property values of land and other real estate to raise funds for new investments or to reduce the price of the infrastructure by providing the land. Privatisation of brownfield asset and utilities to finance new infrastructure developments should be intensified. Governments need to increase private and institutional investors' participation in PPP-like

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structures by establishing comprehensive policies in this sphere, with an appropriate legal and institutional framework. They should increase transparency and provide visibility in project pipelines, establish efficient bidding and procurement processes, and improve risk distribution by providing credit enhancement and/or co-investment mechanisms and instruments.

The global financial industry can increase availability of long-term financing for investment through standardised financial documents, agreements and contracts. Also necessary are methods to facilitate re-financing or resale of mature investments on the book of institutional investors and development banks.

Regulators should help the banking sector improve infrastructure financing by removing regulatory disincentives to long-term investments, especially in the construction phase. The cost of valuing projects for investors can be mitigated in various ways, through constructing less risky and more standardised financial instruments. Investors looking for assets to match their risk appetite and future liability need reliable cash flows for long-term projects.

Establishing infrastructure as a fully-fledged asset class will open up this category to a broader range of investors and pave the way towards innovative financial instruments, capable of bundling and securitising equity and debt of investment vehicles with well-defined risk-adjusted returns and customer-focused investment periods.

The industry needs to develop local and regional capital markets and giving a boost to capital market financial instruments (such as Project Bonds and ABS on project financing loans). This requires a new complementary relationship between banks, capital markets and institutional investors. The Juncker plan for greater investment in Europe promoted by the European Commission and the European Investment Bank has an important role to play here.

Financing infrastructure especially in the social field is a vital issue for strong, sustainable and inclusive global growth. In North America, the Far East, Australia and New Zealand, such investments are seen as more than mere catalysts for new business opportunities. Social infrastructure brings other benefits essential for economic performance and human development. Harnessing the capacity in this area of governments, regulators and the financial markets is an essential task for us all.

Ladies and Gentlemen,

First of all, I wish to thank the Turkish Presidency of the G20 for endorsing the third edition of the meeting of the D20, TSKB who organized this event and all professional staff who have worked to make this Conference possible.

In 2013, in Moscow, under Russian Presidency, for the very first time, a large group of G20 official financial institutions named D20 (which included national development and promotional banks, public financial institutions and the European Investment Bank, EIB) gathered during the international Conference on “Sustainable Growth through Long Term Investment”. At the end of the Conference they issue a Common Statement to be delivered to the G20 Heads of States. One of the point which characterized the Statement is the common view that *“they believe that active support from G20 official financial institutions is crucially important for those programs and projects, which require long term financing, in sectors such as national and trans-border infrastructure, green, innovative and inclusive growth*

projects, and projects on mitigation of climate change and its aftereffects, as well as systemic support to SMEs and entrepreneurship.”

The second meeting of the D20, under the auspices of the Australian Presidency of the G20, took place in Rome in the month of July 2014 during the international Conference "Improving the Financing of Sustainable Growth: The Role of D20 Institutions". The aim of the Conference was to continue to discuss their role in helping address the global challenge of achieving strong, balanced and sustainable growth. They particularly decided to focus on the importance of attracting private long-term finance to infrastructure and SMEs, using the scarce public resources in the most effective way and of enhancing the D20 catalytic role. They also emphasized the synergies that could result from closer cooperation between the D20 and the MDBs in a common efforts to support growth and employment.

With the Turkish Presidency of the G20, infrastructure financing has gained the very center of the G20 agenda.

The average G20 country spends annually 3.8% of GDP on economic infrastructure (transport, power & water, and telecom), 1,9% of GDP in social infrastructure, 1% of GDP in oil, gas and mining and 6% of GDP in real estate (B20, 2015). This amounts worldwide to around 9 trillion US\$ annually and around 12-13% of global GDP. Of course there are significant differences globally, as well as across G20 countries. These are anyway very large numbers and they will probably grow in the future.

In the next decades, in fact, we expect a huge increase of demand for capital investment. In mature countries, there is a pressing need to finance infrastructure, innovation, environmental programs, as well as to prepare for the consequences of an ageing population; in developing countries, the income per capita catching up process is requiring vast investments in infrastructure (transportation, TLC, energy, urbanization and environment). Mature economies will also need to increase their share of long-term investment to exit the crisis, to reinforce their growth rates and competitiveness on global markets and to ensure public debt sustainability (successful fiscal long-term consolidation requires both stricter fiscal policy and more economic growth).

According to the B20 Task Force on Infrastructure three are the major challenges which the infrastructure sector must face:

1. Fiscal consolidation has led a significant decrease of capital investment in infrastructure by Government of countries facing years of fiscal consolidation and public and private deleveraging;

2. Private capital that could potentially be deployed is constrained by market inefficiencies;
3. Investments that are made are – in many cases – not spent effectively or efficiently – due to poor project selection and planning, inefficient delivery, persistent emphasis on building new capacity rather than optimal use of existing assets.

Current barriers mentioned by the B20 Task Force on Infrastructure are:

- a. Lack of suitable project pipeline;
- b. Inadequate risk-adjusted return;
- c. Prudential and regulatory constraints;
- d. High development and transaction costs.

So there is a lot of work to do to face the global infrastructure challenge of the XXI Century. Governments and public administrations; international regulators; and financial industry are the main players. D20 institutions have had in the past and will have even more in the future a growing role in facilitating the process of infrastructure financing at national, regional and global level.

PPP and PFI may be part of the solution. Today, at a global level, these type of schemes finance only about 10% of total infrastructure financing – while 54% is still financed by taxpayers' money and 36% by corporate. One way to attract global long term investors into infrastructure financing is to work on the quality, innovation and standardization of the projects and on the quality, innovation and standardization of the financial products. Pension funds, insurance companies, asset managers, foundations, endowment funds and SWFs are eager to invest more in infrastructure. Today they invest on average less than 1% of total asset under management. But in Canada and Australia, as you know, pension funds and insurance companies invest in infrastructure over 15% of their asset under management.

In order to increase long term investors asset allocation to infrastructure, however, the financial industry demands that infrastructure financing be transformed from an “alternative class” into a real new “asset class”. When the financial industry moves or demands all other stakeholders usually respond. So we are in the ideal conditions to face the challenge. The challenge, however, is a tough one. It is especially tough because much of the work to get high quality PPP and PFI depends on the capacity of Governments to reform key parts of the legal and economic environment. The process of reform is frequently slower than needed. My hope is that Governments will feel the pressure and accelerate what is needed to be done.

Let me briefly go through some of the major challenges that each of the main players will need to face.

Governments. For those with tough fiscal concerns they can lever on various forms of taxes, user fees and divestures. They may capture property value of land and other real estate to raise funds for new investments or to reduce the price of the infrastructure by providing the land. Privatization of brownfield asset and utilities to finance new infrastructure developments should be an important part of their agenda.

To increase private and institutional investors' participation to PPP and PFI for infrastructure national Governments should: establish a comprehensive policy, legal and institutional framework for PPP; increase transparency and provide visibility in project pipelines; provide lean administrative procedures and cut red tape and regulatory and bureaucratic burdens; establish efficient bidding and procurement processes; work on the distribution of risk by providing credit enhancement and/or co-investment mechanisms and instruments; provide technical assistance to achieve streamline project delivery by shortening time and risks and defining pathways with clear criteria and time limits; establish leading practices to protect investors' rights and their enforceability; reduce forecasting risk; provide clauses to mitigate sovereign risk; mitigate political and regulatory risk. Finally, to increase efficiency it is crucial to optimize life-cycle cost, meet budgets and enforce competition between bidders to drive price down.

Financial industry and regulators. The global financial system needs in general to increase availability of long term financing for investment. We have been lobbying for this since 2009 and finally it seems that the issue of importance of long term investment has been universally accepted. To make long term investment attractive the financial industry should promote standardized financial documents, agreements and contracts; render easier and more rapid the re-financing or selling off of mature investments on the book of institutional investors and development banks. Regulators should facilitate the financing of infrastructure by the banking sector removing regulatory disincentives to long term investments, especially in the construction phase (i.e. capital and liquidity ratios); the cost of valuating projects for investors must be mitigated – in various ways – but mostly by setting up less risky and more standardized financial instruments; investors that look for assets to match their risk appetite and future liability need reliable cash flows and long term nature infrastructure projects; establishing infrastructure as an “asset class” in order to enable broader range of investors means to pave the way to innovative financial instruments, capable of bundling and securitizing equity and debt of investment vehicles with well-defined risk-adjusted returns and customer-focused investment time frames, and, finally, it means to lower transaction cost, which are - especially for small and medium institutional investors - still too expensive, by standardizing and categorizing risks and their allocations, especially in order to bundle small and medium PPP projects and project financing loans.

Bank lending still covers around 65% of global project financing – so the supply of loans by banks will remain high in the future, that is also why we need to recalibrate

regulatory frameworks to make them more long term investment friendly; banks, moreover, can provide a catalyzer role also in bringing non-bank long term private investors into the projects. Reducing leverage rate may also increase institutional investors' infrastructure allocations. Finally, to un-lock additional institutional investors' funds regulators need to lower current barriers such as: investments limits on infrastructure and capital adequacy and reserve requirements. Regulation should recognize that infrastructure debt has statistically default and recovery rates lower than corporate bonds, which determine much lower capital absorption. The aim should be to create a new asset class which could be placed in institutional investors books between sovereign bonds and corporate bonds. There is, by now, wide consensus that with no recalibration there will be no new "asset class" for infrastructure financing.

D20 Institutions. Global financial markets are undergoing a great transformation. In that process, they are not fulfilling, as they should, their necessary role in financing the real economy (primarily in terms of long term, patient, capital investment). Development or promotional banks are in a position to partially fill in that gap; by further using their risk absorption capacity and by acting as a broker of developmental/transformational financing. There is a great opportunity for development banks to re-invent themselves. They have the credibility to act as intermediaries of financial flows for a number of reasons: long history (track record); predictable (non-volatile) behavior; known as carefully structuring transactions; in-depth local knowledge; benefit from preferred creditor status not tainted by financial crisis abuses. Moreover, a large majority of them have political weight and have delivered returns consistent with risk (and market).

Moreover, development banks fill market failures and may have a role in balancing economic cycles . They may also have a subsidiary role to support commercial banking, which may receive cost-covering margin for on-lending promotional loans on nondiscriminatory basis. In doing this they become, in specific circumstances, complementary to the market, on the principle that privileges of development/promotional bank (tax exemption, public guarantee) do not distort competition. The costs of promoting are low (as the promotional bank does not need local branches and they often enjoy State-guarantees on the funding and/or the lending) and only economically sound projects (examined by the on-lending banks) are promoted

Among the new instruments which may need to be reinforced by Governments' agencies, Multilateral Development Banks (MDBs) and National Development Banks (NDBs), there are credit enhancement mechanism, such as monoline mitigation mechanisms, which may include credit and risk guarantees, first-loss provisions, and

the provision of bridge financing via direct loans. Moreover, they may give special liquidity provision if needed.

The key point is that development banks are different from commercial, poly functional, universal and investment banks (viz. other categories of banking) in that they have the aim of *providing medium and long-term capital for productive investment, often accompanied by technical assistance*. Also, the *productive investments* should be identified, appraised and selected with a two-fold set of criteria: in the short term, they should help make full utilization of production factors (and thus increase employment) and in the medium and long term, they will provide physical, financial and technical capital (and thus, increase productivity of the production factors). In short, they should be both Keynesian and neo-classical. This, we may consider as one the key discriminating feature between development banks and other categories of investment banks.

In any case, development needs development finance which is a special blend of finance - not just equity or lending (even concessionary lending). Development finance does not mean merely long-term finance, but long term finance coupled with the capacity to provide technical assistance to the borrower and to evaluate financial and social returns as well as to assess the opportunities and the risks inherent in development projects and programs and to formulate supporting policy measures. Only institutions with this capacity can, for example, evaluate a program of investments and associated changes in the tariff regime, fiscal transfers, and regulations. Or appraise a major infrastructure program and address its environmental dimensions. Specialized knowledge must be integrated with finance.

New instruments and new agencies (MDBs and NDBs) are therefore going to be needed to mitigate risk and face credit crunch. They should work as catalyzer of institutional investors participation to infrastructure financing by playing credit enhancement and leave to institutional investors the senior part of debt and by attracting co-investments in the equity side of the projects.

In Europe, in particular, while waiting for a return of stability in the banking system, the role of large national and multilateral development banks (EIB, KfW, CDC, CDP, ICO) has become increasingly important. New financial instruments have been designed; additional resources have been mobilized to support the economy during the crisis, most importantly by financing infrastructure and SMEs, either directly or through the banking system; and new European and domestic long-term equity funds have been launched to invest in infrastructure projects and strengthen company capitalization. Cooperation between these institutions could lead to further new initiatives and new instruments.

Now with the Juncker Plan the role of the EIB and of National Promotional Banks and Institutions (NPBIs) has been growing in the attempt to build, together with the

commercial banks and the capital market, a Single European Market for Infrastructure, SMEs and Corporate Financing.

The idea behind the Plan is that with an aging population, a public debt overhang, and the tough competitive economic global challenges, the EU should rely on a system for financing infrastructure and SMEs which weighs as little as possible on public finance. The new model should be technically very advanced, as well as financially reliable, and standardized in order to attract long term investors and private capital around the globe, where liquidity is great but is directed where risk is lower and yield is higher, and where the demand (and the competition) for capital investment will increase, at exceptionally high rates, throughout the XXI Century.

From this point of view we hope that the UE new Plan may be a success and a model also for other G20 countries or regional union of countries.

Ladies and Gentlemen,

Let me conclude with a few remarks on the two main topics of today's Conference.

Non-banking financing on infrastructure is probably the most important topic for the creation of a global "asset class" for infrastructure financing. So the issue – as I already tried to discuss - is the real game changer. It means developing local and regional capital markets and giving a boost to capital market financial instruments (such as Project Bonds and ABS on project financing loans). It means finding a new complementary relationship between banks and capital markets – and banks and institutional investors.

Financing social infrastructure is also crucial issue for a strong, sustainable and inclusive growth for the world economy. Globally, there is, in fact, renewed interest in and understanding of the value of social infrastructure in our economies. In North America, the Far East, Australia and New Zealand, for example, these investments are also seen as more than catalysts for new business opportunities that enhance economies and internal markets. Social infrastructure brings other benefits that are essential for economic performance and human development: attractiveness of place, employment, improvements in social and human capital, a better quality of life and critically, services for currently unmet social needs.

Despite this change in public outlay, there is a need for new models that engage private sector investors, that can help them deal with the current low interest rate environment and provide a predictable (inflation adjusted) cash flow with a low correlation to existing investment returns.

The rationale is that financial markets, the real economy and society form a holistic entity. Each depends on the other two. None of the three are inherently stable. In the interplay of economy, society and financial markets, social infrastructure provides a

key catalyst for employment, money and interest. This is why I believe that social infrastructure is a desirable option for long-term investors and an under-utilized resource for public service and social sector providers.

There is one more topic that had raised unanimous consensus at the first and second D 20 meeting and which I would like to stress once again with some special emphasis the need to have a prudential and accounting framework at national, regional and global level more friendly for long term investment.

On the need of a regulatory recalibration we reached not only an agreement among our institutions but a very broad consensus in all sectors including industry, policy makers and academics. However, so far, no concrete results have been foreseen. On the contrary, the Basel Committee is debating a new set of rules (Basel IV) which would make even harder (in terms of capital absorption and liquidity ratios) to finance investment in infrastructures and in the real economy. The risk – at the end – is that financial institutions with a development or public mandate may be left alone in a market where other potential investors will have no convenience to participate, even if they wished to do so, due to the effects of rules drafted with no clear understanding that economic growth (that is, long term investment) are a binding condition for both financial stability and long-term sustainable fiscal consolidation.

We should not forget that one of the fields on which global competition is playing its game is the setting of prudential regulations and accounting standards. The tough prudential and accounting regulation which penalizes the financing of real economy and infrastructures has become a major weapon in the global economic and financial war, which characterizes the XXI Century.

The tough prudential and accounting regulation which penalize the financing of real economy and infrastructures need a “levelling playing field” to avoid “regulatory arbitrage” and support homogenous treatment of long term investment. Financial systems, which are more bank-oriented, may pay a greater price due to prudential regulations and accounting standards than market-based financial systems. We believe that international, regional and national regulators should work together to avoid regulatory and asymmetric global environments.

Thank you.