

Investment Strategies and Opportunities in Africa

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New actors and instruments for long-term financing

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The focus on long-term financing is considerably growing, both at the European and at the global level:

- in the EU with the publication by the Commission of the “Green Paper on Long-term Financing of the European Economy” (March 25th 2013)
- at the global level with the Russian Presidency of the G-20 giving to the long-term financing a priority status in the 2013 Agenda of the Summit.

These are, of course, very good news for the Long-Term Investors Club.

In the last four years, in fact, the Club has been campaigning, alongside other economic and financial associations, to raise the attention of the EU and of the global community on the key role of long-term investment (LTI) for a balanced and sustainable growth.

Therefore at the EU level we welcome and support the publication of the Green Paper on long-term investment by the Commission. It is an important step in the reorientation of the model of growth in the European Union. The Commission Green Paper identifies rules, conditions, instruments and incentives that could foster the flow of private capital into LTIs, following the guide lines identified, years ago, with the Jacques de Larosière and the Mario Monti Reports.

At the global level, the Russian Presidency of the G20 is going to propose to the give a priority status on the Agenda for 2013 to the issue of LTI financing. This could mark a turning point. At the first G20 summit (Washington D.C., 2008), during the discussion on the guidelines for reforming the financial system, the issue of LTI was not even considered. It is true that the conclusions of the G20 summit in Pittsburgh made the objective of growth (a strong, balanced and sustainable growth) a central priority. But in reality, this did not

alter the bank-oriented, short-termist, pro-cyclical approach that dominated and still dominates the international regulatory culture. Rules and measures aimed solely at ensuring financial stability have helped turn the financial crisis into a double-dip economic recession, thereby thwarting, at least in a good portion of Europe, efforts to restore financial health and achieve fiscal consolidation.

The persistence of the crisis obliges all of us to acknowledge that, in a modern market economy, financial stability, growth and social cohesion are inextricably intertwined, and that investment is a key factor not just for growth and competitiveness, but also for the stability of financial institutions and for rebalancing the public finances. It would have been better to understand this earlier. But, as always, better late than never.

A large part of long term financing includes financing infrastructure. The demand for infrastructure financing is going to be huge in the next decades. Although there is a variety of different modes to finance infrastructure in advanced and in emerging economies, there is generally a strong tendency – at least in the high public debt countries - towards using project financing and PPP structures to attract private savings, increase the speed and the quality of the construction of public works, and save national budget resources.

Let me then briefly focus on project financing for infrastructure and its perspectives.

There are many constraints in developing a global market for project financing.

The first constraint is the fact that the European banks, which have been prominent in project finance globally as well as in the emerging economies, are deleveraging. This may continue for some time. Compounding that is the fact that in global banking generally there is now an increased aversion towards large projects and long term tenures. Basel III and the risk weights it implies make it more costly for banks than before. There is then reduced bank appetite for long-term finance.

While we wait for the European banking system to recover, a growing role could be played by other long-term investors (such as pension fund, life insurance, SWFs and national or multinational development banks), if they will decide to raise the quota of their total investment allocated to infrastructure as an asset class. The global industry of institutional investors is estimate by the OECD in almost 90 trillion US dollars. Today they invest around 3% of their asset under management in infrastructure (mostly in the form of unlisted equity) equivalent to about 2.3 trillion US dollars globally. Potentially, long-term institutional investors' asset allocation in infrastructure can grow up to about 4.5 trillion US dollars (5% of total Asset Under Management, according to a recent research by HSBC). The goal is reasonable and the increase of resources for infrastructure quite outstanding in size.

The second constraint is that financial markets worldwide are still relatively undeveloped when it comes to long-term finance. Banks in emerging countries are building up their capabilities for project finance. The emerging economies capital markets too are not as developed as they are in the US. The market for project bonds and hedging instruments such as long-dated currency swaps is not deep and the instruments not as actively traded. So we are still at the stage of development in most of these markets. It should not be a long-term obstacle, but for now it constrains the availability of capital to meet the demand for infrastructure.

Moreover, there is the necessity to develop stronger pools of institutional investors in emerging markets. Now only less than 20% of total institutional asset at the global level are coming from the emerging economies. With such high rates of growth, however, middle classes in the developing world are poised to expand substantially in terms of both absolute numbers and the percentage of the population that can claim middle-class status during the next 15-20 years. Even the more conservative models see a rise in the global total of those living in the middle class from the current 1 billion or so to over 2 billion people (*National Intelligence Council, 2012*). Others see even more substantial rises with, for example, the global middle class reaching 3 billion people by 2030 (*Goldman Sachs, 2008*). This could rapidly increase the quota of emerging economies savings going into long-term institutional investors.

The third constraint is that emerging countries governments are themselves developing their capabilities to structure private-public partnerships and tenders in a bankable and sustainable fashion. This too should not be a limiting factor; but it will take some time before it is developed.

Nevertheless, many countries in advanced as well as in emerging economies are well placed to catalyze the development of infrastructure finance. This will probably produce a large capital intermediation between advanced and emerging economies.

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Let me add a few other crucial points for the future of global infrastructure finance.

The debt/equity leverage is going to be much lower than in the past. This will decrease equity returns and make less attractive equity for infrastructure for those investors that claim high returns. This is the logic which guided us in creating some new Long-Term Equity Funds such as Marguerite and InfraMed, which provide the market with equity shares in the initiatives with non-speculative IRR and longer durations, in order to catalyze private equity

and institutional investors participation. These funds are now seeing as models in many other non EU countries.

New instruments and new agencies (NDB and MDV) are 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 pension funds and insurance the senior part of debt and by attracting co-investments in the equity side of the projects. The Project Bond Initiative launched by the EU goes in this direction. Other common initiatives are under study.

Among the new instruments which may need to be reinforced are credit enhancement mechanism, such as monoline mitigation mechanisms, which may include credit and risk guarantees, first-loss provisions, and bridge financing via direct loans.

Regulatory and policy risk must be very seriously controlled and reduced. It can be a detrimental element in discouraging inflow of investment into the financing of projects. Political and legislative stability, fast and streamlined administrative procedures, low regulatory and bureaucratic burdens, a swift and reliable judicial system, and an efficient and technically capable public administration are recognized as key factors in investment decisions, which today consider the entire globe.

Moreover: to lower the long-term debt/equity risk a few other actions should be taken.

First, reconsider the securitization of lending. The recovery rates of infrastructure lending have been recently found to be statistically higher than the recovery rates of corporate bonds (*Standard & Poor's*, 2012). So infrastructure bonds (via securitization of lending to PFI initiatives) could become quite attractive to institutional investors.

Second, today, the regulatory framework is skewed in favor of short-term lending, including speculative loans, while penalizing long-term investment, thereby discouraging those investors (particularly pension funds and insurance companies) that, in view of their usual business model, could hold long-term assets. This does not mean diminishing the effectiveness of measures meant to prevent new crises and preserve financial stability, but to fine tune them in order to reduce their recessive effects and adapting the rules to the specific business models of financial institutions other than commercial banks.

We find the concept contained in the Commission's Green Paper for a "an integrated re-calibration of the regulatory framework" the right approach for revisiting accounting regulation to achieve stability and stronger incentives to invest long term .

Third, we should consider risk-segregation in the different phases of projects, i.e. construction, development and managing. Each phase may need special financing actors, rules and instruments, with banks (both private and public) taking care if the first

(construction) and the second (development) phase and the capital market, i.e. institutional investors taking over the longer term and lower risk management phase.

Fourth, governance risk management by long term institutional investors has to be reinforced to include also infrastructure financing. Building internal capacity is expensive and needs a large dose of innovation in investments' allocation strategies. As institutional investors expand and move into new geographies and sectors – particularly if they are trying to execute multiple transactions or overly complex transactions at the same time – a key challenge is ensuring that they have built up the right team. Both resourcing and filtering the deal flow are challenges. Institutional investors are facing a cultural change in developing a direct investment program to invest in infrastructure projects. There are well known best practices in countries such as Canada and Australia where pension funds and insurance companies invest up to 15% of their asset in infrastructure projects. Their model, or at least similar ones, should be replicated elsewhere.

Conclusions

To conclude, Long-term investment plays a fundamental role in sustaining growth, fostering competitiveness and ensuring the conditions necessary for financial stability and the consolidation of the public finances. In the current economic environment, at least in the high public debt countries, resources for funding LTI can no longer come primarily from government budgets (which are squeezed by fiscal imbalances) or from banks (which are restructuring and under pressure from Basel III). We need to create the conditions for promoting the entry of private capital. More specifically, institutional investors can play an increasingly important role. However, substantial changes in public and regulatory policies and new financial instruments are needed, both at the European and at a global level, to encourage, or at least not penalize, LTI.

We must prepare for a massive structural flow and increasing competition in long-term financing on global markets. A great long-term challenge for policy makers, regulators and market players. The Club of Long Term Investors has been so far at the forefront of this process. I believe we should keep playing such strong driving role also in the future.