Reflection Paper: Pension funds, insurance and infrastructure, a complex debate

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In a deleveraging world where banks are facing stricter capital requirements, there is a clear need to find new sources to finance long term projects. Infrastructure and long term investing are placed very high on the international political agenda. Today many policy makers want pension funds and not for profit insurance to support the economy and there is a widespread consensus that these actors should and could do more. AEIP reminds that pension funds and not for profit insurance are indeed long-term investors, but they should first abide by their fiduciary duty towards their members and cannot solve the infrastructure problem alone.

The G20 that took place in Moscow in September 2013 foresaw dedicated sessions to infrastructure in collaboration with OECD. The European Union is endorsing infrastructure investments as it is in dire need of replacing the existing and needs several billions to finance new projects.

In Europe, where credit is largely distributed by banks (according to several sources the share of credits intermediated by European financial institutions amounts to 75 % of the total whereas in the USA it represents only 30%) the situation is very pressing.

In March 2014, one year after the Green Paper on Long Term Financing of the European Economy[1], the European Commission issued a Communication supporting infrastructure as a tool to foster European growth, to make the Union more competitive and as a result to reduce the very high level of unemployment.

In this framework some measures have been taken to review the IORP directive[2], which regulates occupational pension funds, and within Solvency II[3] with the purpose to limit the hurdles that pension funds and insurance institutions face to invest in long term assets. Alongside this measure, the European Commission has proposed a review of the Shareholders rights' Directive[4] and will take action to allow third pillar pension funds to extend the field of investment opportunities. The main point that remains to be addressed is the extent of the interest for pension funds and not for profit insurance managing occupational retirement schemes to invest in infrastructure. Most experts would insist on the long term liabilities of pension schemes and not for profit insurance that are in line with the long term nature of infrastructure projects; others will remind the cash flow-generating nature of i.e. toll roads or parking lots. Many are attracted by infrastructure, as very often the

[1] COM(2013) 150 final
[2] COM(2014) 167 final
[3] In September 2012, the Commission wrote to EIOPA asking them to examine the Solvency II calibration and design of capital requirements for investments in certain assets relevant to "long-term finance" in the EU
[4] COM(2014) 213 final

financial instruments linked to real assets are not listed on the stock exchange and are thus less volatile. Other observers highlight the fact that infrastructure markets are highly regulated and are protected by barriers to entry.

In order to approach infrastructure in a disciplined way, one should make a first distinction between economic and social infrastructure. The first being linked to the business development of a country and the second meant to serve welfare, health and education purposes. Speaking about economic infrastructure, people refer to the energy and utility sectors, to transports and to communication. Social infrastructure refers to hospital, schools, social housing and waste managements.

The second important distinction is between listed and non-listed infrastructure. Listed infrastructure investments are those linked to listed companies whose business encompasses the construction of ports, airports, roads, housing. Listed infrastructure does not mean only equity investments, but also debt and in that space one can find several bonds issued to finance hospitals, railroads and windmills.

Some projects are identified as greenfield and others as brownfield. Greenfield projects include the planning and construction and therefore bear a higher risk. Brownfield investments exploit existing infrastructure, less risky and less yielding by definition. The choice between the two is dependent on the risk-return profile of each project, as well as the risk-profile of the pension fund.

In the current economic cycle, infrastructure investors expect double digit internal rate of returns from investments in ports, airports and telecommunication (between 13% and 15%); expectations for utilities projects are a bit more conservative around 10%.

Some empirical evidence from Australia and Canada (markets that have a long term experience in this asset class) show that long term returns average 10% gross returns.

Long-term investors, such as pension funds and not for profit insurance, can use infrastructure investments to serve essentially four purposes:

1. To achieve real returns;
2. To diversify their equity risk and achieve a return between equity and bonds;
3. To match their liabilities;
4. To search a return higher than the equity one.

As the reader can immediately understand, the risk associated with these targets becomes higher moving from the first to the last option.

As of today, the picture of pension funds investing in infrastructure is quite scattered. The largest players in the world are the Canadians and the Australians. Both countries enjoy a legislation that fosters infrastructure investing. The size of their pension funds also makes it easier to venture into less traditional investment decisions. Northern European countries have made some very important steps in this asset class. The Dutch in particular with their large funds have been able to attract very

skilled financial professionals and implementing business units dedicated to the analysis and follow-up of specific projects. Nordic pension funds have operated joining forces as very recently UK funds did. The situation in Continental Europe is very heterogeneous as some funds even in smaller countries as Belgium and Cyprus were ahead of the curve and other larger funds in larger countries did not venture in this kind of investments.

The reality is that infrastructure represents a valuable asset class and for sure a viable option for long-term investors, but these latter face several hurdles to access it. Just to name the major issues investors encounter, one should remember that there isn't enough comparable and long-term data relating to performances. In addition, given the absence of infrastructure benchmarks, pension trustees find it hard to compare between asset classes. Furthermore, infrastructure investments are complex to assess and difficult to access, also due to regulatory uncertainty.

The switch taking place from defined benefit to defined contribution schemes does not really favor illiquid assets as pension fund members can often redeem their assets earlier than the day they retire. Direct investments, those that yield the most interesting returns, are the most difficult to pursue as their governance and monitoring require skilled individuals and a strict discipline regulating possible conflicts of interests. More in detail, European pension funds are mainly limited in size and resources to deploy an asset allocation including infrastructure. National regulation does not always simplify direct investments and pension regulators in some cases limit the use of the asset class in a direct or indirect way. Governments have indeed a role to play in the intermediation process: often the lack of infrastructure investments is not due to a lack of projects, but not finding the right match with investors. Some form of standardization might be investigated.

Today many policy makers want pension funds and not for profit insurance to support the economy and there is a widespread consensus that these actors should and could do more. AEIP reminds that pension funds and not for profit insurance are indeed long-term investors, but they should first abide by their fiduciary duty towards their members and cannot solve the infrastructure problem alone.

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