Funding the country's infrastructure needs

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Few people doubt the benefits to society of moving towards a more environmentally-friendly and sustainable economy. Indeed, there are many who think that we don't really have a future unless we make this shift. But where will the required capital come from, given the weakened state of government finances? Commentators have woken up to this disconnect and are eagerly eyeing the asset pools that pension schemes and insurance companies have to deploy. The hope is that they will ride to the rescue, helping us dig ourselves out of our current economic mess, like they did in the 1970s. There is talk in the air of a national Infrastructure Bank, to help channel such investments to where they are deemed to be most needed.

Unfortunately, pension schemes and life insurers are likely to be less well placed to bail us out this time round, at least in the 'corporatist' manner many hope will be the case. Insurers and pension funds control large amounts of capital, but their room for manoeuvre is much less than was the case in the 1970s.

The most obvious change is the increasing maturity of defined benefit pension schemes, as the shift to defined contribution gathers momentum. DB schemes are less well funded now than they were then because of benefit improvements, improvements in pensioner longevity, lacklustre longer-term equity returns and declines in long term interest rates. The investment strategies they are following increasingly focus on the precise cash flow characteristics of their liabilities, witness the growth in liability driven investment. Likewise, declines in with-profits business have reduced the sizes of asset pools invested primarily with future bonus distributions in mind and over which insurers might have had very broad investment flexibility.

Another important change is an increasing focus on liquidity risk. Some might say that this focus is overdue. Although the recent financial crisis is most commonly referred to as a credit crisis, it could perhaps be better described as a liquidity crisis. The banks that failed were disproportionately ones that relied on the wholesale markets for their funding. It was when these funding sources dried up that they ran into problems.

Other regulators are understandably jittery about possible carry-overs of these problems into their own industries. Under new Solvency II rules coming into force in a couple of years' time, EU insurers are likely to find it more expensive to carry liquidity risk. Some insurers have been adjusting downwards the values placed on some of their illiquid liabilities (e.g. ones in their annuity books), thus improving their stated solvency position, on the grounds that yield premiums seem to be accessible by investing in illiquid assets. EU insurance regulators do not appear likely to outlaw such behaviour, but do seem likely to limit its extent. In time, as pensions and insurance practices converge, pension regulators may do likewise.

In such a brave new world, how might DB pension schemes and with-profit insurers view infrastructure investment? Traditionally, proponents have argued that the long-term inflation-linked income streams available from infrastructure investment are inherently suitable for such investors. However, infrastructure investment is also often rather illiquid, particularly if it is packaged within

bespoke financing vehicles. So, in a world in which liquidity risk is likely to be priced more expensively, we may expect investors willing to invest in such assets to demand a higher return to compensate for the (liquidity) risks incurred when doing so.

Last time round, the infrastructure investment society needed was supplied arguably relatively cheaply, because the liquidity risks involved were inadequately appreciated. We were lucky. The risks didn't come home to roost. This time round, the investors of last resort have less headroom and flexibility available to support such strategies, and at the same time are being forced to become savvier about the liquidity risks such investments entail. The required investment may still be forthcoming, but it will almost certainly cost more to access.

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