Standard Life

Response to the European Commission's Green Paper

Long-Term Financing of the European Economy

June 2013

Introduction

Standard Life welcomes the opportunity to respond to the Green Paper and to contribute to the important debate about how to facilitate greater long-term investment to help promote sustainable economic growth across the EU.

As a major provider of long-term savings and investments with total assets under management of £233.1bn (c. €270bn) as at 31 March 2013, Standard Life is well placed to comment on many of the issues covered in the Green Paper. The Standard Life group includes savings and investments businesses, which operate across its UK, Canadian and European markets; corporate pensions and benefits businesses in the UK and Canada; Standard Life Investments, a global investment manager, which manages assets of over £179.1bn (c. €210bn) globally; and our Chinese and Indian Joint Venture businesses.

We are encouraged that the Green Paper recognises the important role that institutional investors such as insurance companies and pension funds can play in allocating resources efficiently and effectively within the economy and society more broadly, and that it correctly highlights their importance in supporting long-term growth. In addition, we welcome the efforts of the European Commission to seek to implement the structures necessary to ensure that longer term investment opportunities are correctly aligned to the individual objectives of investors.

Standard Life has engaged with a range of EU policy makers to date, and we look forward to continuing this dialogue on issues of fundamental importance to our business, our customers and to wider society.

Our responses to the individual questions posed in the Green Paper are provided below, along with a summary of our key points. The Green Paper is necessarily broad in scope and, as such, we have focused on those questions where we are best able to contribute our expertise. Specific recommendations are highlighted in bold text.

Overview of key messages

- It is important to acknowledge that many investment decisions must be taken at a national, or even a local level, and that many institutional investors will already be engaging with national policymakers about the promotion of longer term investment. As such, **it is vital that efforts to boost growth at the EU level are closely coordinated with those of individual Member States** and that any public policy initiatives are, as far as possible, mutually reinforcing. The Europe 2020 strategy is an example of recommendations at an EU level being specifically tailored to the characteristics of national markets. As such, we believe that the European Commission can deliver the most value in this area by setting an overarching framework that encourages long-term investment decisions.

- It is also important to recognise that ‘institutional investors’ are not a homogenous group of investors, and that each segment has disparate investment objectives. For example, insurance companies and pension funds invest to support their liabilities, some of which are long-term and also illiquid in nature. These investments are actively managed in the best interests of customers and also governed by strict prudential rules, largely set by governments and/or regulators which define the value they can apportion to the different types of assets they hold and which set their regulatory capital requirements.

- **In order to attract more investment from insurance companies, the impact of Solvency 2 needs to be clarified.** The very useful work that the European Insurance and Occupational Pensions Authority (EIOPA) has done to ‘test the Long Term Guarantees package, which fundamentally affects long-term investment, has helped considerably in this respect and the Solvency 2 project itself must now progress at pace to full implementation. We also welcome the recent statement by Commissioner Barnier that the prudential solvency framework that was set to be included in the Revision of the Institutions for Occupational Retirement Provision directive will be addressed at a later date. We believe that further consideration is needed before introducing measures that could impact the ability of pension funds to provide investment.

- Increasing the existing exposure of pension funds and similar investment vehicles to long-term investments could be difficult, as they are driven by current client mandates and are often measured against specified benchmarks. In addition, they are frequently required to be priced on a daily basis with daily liquidity. **Protections against the various risks borne by investors need to be addressed if policy makers are to enable pension funds to invest in more infrastructure projects**.

- Further to this point, it is crucial to recognise the need for our customers to have a return on their investment and for this to be safe. **This fiduciary responsibility is a fundamental obligation and should be foremost when considering the policy options available**.

- To meet the diverse objectives of institutional investors, **it is our view that the Commission and policy makers more broadly will need to seek to support new mechanisms to allow an increased allocation of existing money and funds into infrastructure and SMEs.** These could potentially be made attractive to large and mid-range institutional investors and increase investment into, for example, infrastructure projects.

- While infrastructure is clearly a critical element of long-term investment – and therefore a major focus of our response – it is important to stress that the broader spectrum of asset classes is also crucial to the provision of long-term financing and can play a major role in facilitating long-term growth in the EU.

- We are increasingly concerned by the International Accounting Standards Board’s (“IASB”) reluctance to refer explicitly to "stewardship" in its over-arching

Conceptual Framework. We believe such explicit reference will help to address in a principled way how fair value accounting is promulgated and applied. **We would like the Commission to take account of the need to address this in assessing its approach to supporting the IASB and endorsing its standards. We believe that embedding explicitly stewardship in the IASB's Conceptual Framework is fully consistent with the Commission's objectives relating to the provision of long-term finance in Europe**.

Summary of key actions/factors to help improve long-term investment in Europe

A number of factors and/or related actions could help support long-term investment in the EU. These include:

- **A well-defined and stable public policy environment** as far as possible, with a clear focus on long-term investment horizons (across all countries).

- Solvency 2 rules need to allow for insurers to invest in infrastructure over the long-term without impacting adversely on capital. It is essential that Solvency 2 allows for a Classic Matching Adjustment and an appropriately calibrated Volatility Balancer that are applicable to the unique characteristics of insurers' liabilities. In particular, **the Classic Matching Adjustment and Volatility Balancer should apply to fully, and partially, illiquid insurer liabilities, respectively, and also include a wide range of high quality long-term financing assets within their scope of eligibility.** The results of the EIOPA impact assessment into the long term guarantee package demonstrate why this is of crucial importance to the success of this project.

- **The infrastructure project pipeline should be clearly defined by the relevant bodies at a national and/or EU level so that industry/investors know what to expect and when** (and also efficiently managed to best avoid spikes or troughs of supply).

- **Best practice (transparent, easily accessible and regularly published) project information** should be made available both during and post construction, to give investors comfort in the credit quality of the project they are being asked to fund.

- **No overly engineered financial solutions** – the final structure must be straightforward and free from political 'interference' (explicit language within bond/project documentation to reflect this will be particularly helpful).

- **A new infrastructure sector index/benchmark would be helpful in more clearly demonstrating to clients where money is invested, and also make it easier to identify the size of the sector compared with others and assist relative value discussion/measurement.**

- **Volume and liquidity in secondary markets are important**, as investors need to be able to trade bonds freely rather than be locked into a buy and hold position to maturity (note: that this is different from *insurance investors,* who do not require liquid assets per se due to the illiquid nature of certain of their liabilities – see paragraph 7.3 for further details*).*

- UK Private Finance Initiative (PFI) infrastructure deals were structured to achieve a 90:10 debt:equity ratio (or worse) and to scrape barely into an underlying credit rating of BBB- due to the accompanying monoline insurer guarantee. **To encourage and positively enhance long-term investment in the sector, projects should be structured in a less levered way to achieve A or high BBB ratings**.

- **A specific idea which warrants further examination is infrastructure bonds**. There are considerable difficulties for retail or institutional investors in funding long-term projects directly, say a pension scheme owning and managing a toll road. However, the non-government bond market is expanding rapidly in size. **In an environment where investors are seeking income, a degree of security (e.g. via the credit rating) and the ability to compare terms and conditions on a uniform basis, an expansion of infrastructure bonds could be attractive.** The aim, for example, could be to duplicate the municipal bond market as developed in the USA. We note the establishment of the pilot project bond initiative between the EU and European Investment Bank that was signed in October 2012 and we look forward to seeing the results of this initiative.

- **It is also worth exploring the potential for tax neutral pooled investment vehicles through which long-term investment could be channelled.** By tax neutral we mean that there is no tax within the vehicle; it is tax transparent and there is no tax on distributions from the vehicle. That way, investors are subject to tax as if they were the direct providers of long-term finance. Such pooled investment vehicles could be established anywhere within the EU, for example under the existing Societas Europaea model.

Response to Specific Questions

Supply of long-term financing and characteristics of long-term investment

Q1) Do you agree with the analysis set out above regarding the supply and characteristics of long-term financing?

1.1 While we agree that it is right and proper for the EU as a whole to consider the most economically and socially efficient measures to channel savings from households, corporates and governments into the most productive areas and types of investment in the private and public/private partnership sectors, we would also stress that national characteristics are extremely important. Many such investment decisions must necessarily be taken at a national, or perhaps even a local level. This reflects, inter alia, the tax code, planning controls, labour market regulation, level of pension provision, savings incentives, infrastructure programmes etc, which each country implements.

1.2 We consider that the Green Paper focuses a little too much on banking and the problems that have afflicted that sector, and consequently too little on the role of the equity and bond channels, or indeed the possibility of opening up other markets/conduits. For example, the Paper posits that: “The financial crisis has affected the ability of the financial sector in Europe to channel savings to long-term investment needs”, and later states that “The diminished role of banks in long-term lending opens up new needs and opportunities for other financial institutions and market-based intermediation to channel financing to long-term investments.” In our view, investment should be as broadly based as possible and not focused too heavily on the banks.

1.3 The evidence that the financial sector as a whole has less ability to channel savings into investment requires further elaboration. While some of the European banks have obvious problems, the equity and corporate bond markets have been open for investors since the crisis of 2008-09, whether in terms of volumes of trades, market liquidity or new issuance. For example, there were 430 European IPOs in 2011 with a total offering value of €26.5bn, compared to 134 IPOs in the US raising a combined €25.5bn. Corporate bond issuance post 2008 has also been stronger with €436bn debt issuance in 1,240 deals during 2012, approximately double the 2006 figures on both metrics.

1.4 It is therefore important to recognise that a large body of non-bank, long-term investors does exist – e.g. investment trusts, life assurance, pension funds and family offices, choosing between a range of equity and bond instruments.

1.5 The relative importance of bank and non-bank sources of investing will also vary from country to country. While in Germany there is a long history of banks providing financing for private business, in other countries such as the UK the stock market is a more important channel. This can be seen in terms of the number of quoted companies in each country, with 2,747 corporations listed in the UK, compared to 738 in Germany. As such, any action at the EU level should take into account the national specificities of each market.

1.6 The Green Paper states that ‘Europe faces large-scale long-term investment needs’. While we would not disagree with this general sentiment, it is worth considering the view of many commentators that publically quoted firms already have considerable access to long-term investing through several sources, including banks, the stock market, and the corporate bond market. A major problem is that small and mid-sized companies in Europe rely primarily on banks for capital and in particular that they currently have difficulties gaining access to short-term, not long-term, finance (and there is also a wider point about the diminished return opportunities that stem from the depressed economic environment). This can be seen from the pressures on the ECB to ensure better monetary transmission mechanisms for short term finance for the SME sector.

Q2) *Do you have a view on the most appropriate definition of long-term financing?*

2.1 We are concerned about the definition used in the Green Paper, as it seems to aggregate rather different areas. The Paper states that: "The focus is put on long-lived capital goods (such as economic and social infrastructure, buildings <u>and</u> R&D, education and innovation)".

2.2 We would make two specific points in respect of this. First, funding for R&D, education and innovation need not necessarily be long-term in nature; many such projects could be short-term, and indeed in fast moving sectors such as technology they may need to be. Second, the Paper at various points emphasises the importance of physical capital formation i.e. infrastructure. However, there are many sectors of the economy, such as services in general or insurance in particular, which require long-term capital, but in financial rather than in physical forms.

<u>Capacity of financial institutions to channel long-term finance – commercial banks</u>

Q3) Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?

3.1 Our sense is that the banks have dramatically stepped back from providing long-term funding (and, indeed, other forms of funding) and that while there remains a minimal level of appetite from some banks, this is insufficient to be deemed 'material'.

3.2 Investment banks will continue to be interested in earning fees for bringing deals to the capital markets, for those investments that are large enough to qualify for benchmark inclusion, or perhaps for smaller deals structured as private placements.

3.3 Overall, we consider that the banks are unlikely to be a key driver of growth, or a major provider of finance to invest in long-term projects, for the foreseeable future. This is because other vehicles, for example equity capital or the bond markets, are ultimately more effective channels.

<u>National and multilateral development banks and financial incentives</u>

Q4) How could the role of national and multilateral development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?

4.1 Although pension funds and insurance companies could be sources of long term finance and investment, their role in this space is often curtailed by the size of projects seeking investment, the structure of the investment opportunity and the restrictions within investment mandates set by those charged with the oversight of investment strategies. Typically, until now, projects that are able to issue sizeable bonds of investment grade that are included on bond benchmarks can attract investment from pension funds, insurance companies and mutual funds.

4.2 Unfortunately, much of the demand for financing at this time as defined in the Green Paper tends to be smaller in size, larger in number and heterogeneous in nature. Historically these would seek financing from either government or from banks that have the appropriate skills and capacity to assess high volumes of small size projects and companies.

4.3 As indicated in our previous answers, banks are currently unable to provide the required levels of financing due to their de-leveraging/higher capital requirements, while governments are similarly restricted by austerity measures. **National and multilateral development banks could potentially fill this gap by, in effect, pooling the high volumes of smaller project demand. The development banks could issue bonds that are used to provide financing to smaller projects and SMEs.** These bonds would in effect securitise the lending made, but would be of a sufficient size, risk and rating to attract investment from insurance companies, pension funds and mutual funds.

4.4 There is already activity in this area with the European Project Bond initiative of the European Investment Bank (EIB). **Additional coordination between development banks could broaden the types of such bonds and the scope of projects and entities eligible for financing.** It would also be useful for governments to provide some support to such bonds so that the risk/reward assessment allows insurance companies and pension funds to invest. Unless the risk/reward is appropriate, those responsible for the investment strategy of insurance companies and pension funds will not be willing to allocate investment in this manner, given their responsibility to ensure the best outcomes for policyholders. **Governments could support such bonds through either the risk or reward part of the balance by, for instance, providing either credit support to reduce risk or tax benefits to increase reward.**

4.5 Investment by large asset pools into bonds already occurs and therefore the creation of bonds that are appropriate in size, risk and rating would make use of the existing market structures for investing in fixed income assets.

Q5) Are there other public policy tools and frameworks that can support the financing of long-term investment?

5.1 At a theoretical level, the area of 'nudge economics' has been developed to consider ways in which small changes, for example in documentation, can have a large impact on the final outcome.

5.2 Indeed, Standard Life published some research in 2011, *Keep on Nudging*, which provided concrete examples of how behavioural techniques could be used to 'nudge' people towards saving more for their retirement. The report can be accessed via the following link: http://www.standardlife.com/static/docs/2011/reports/keep_on_nudging.pdf

5.3 This report was designed to complement the launch of automatic enrolment into workplace pension schemes in the UK, which itself utilises ‘nudge’ principles by requiring people to actively opt out of the scheme. Automatic enrolment started amongst large employers in October 2012 and the early signs have been encouraging – Standard Life oversees two pension schemes which have seen their participation levels increase from c.89% to c. 96%, while initial opt-out rates across the industry as a whole are around 10%, much lower than originally envisaged.

5.4 At a more fundamental level, the framework surrounding infrastructure investment merits serious consideration. Some commentators argue that the lack of, say, pension fund investment in infrastructure is a sign of market failure. However, the major reason why such schemes choose not to invest is the level of economic, regulatory and political risk and uncertainty that makes it difficult to commit clients’ funds in this manner. In addition, faced with ageing populations, pension funds have moved increasing amounts of their liabilities to the ‘pay out’ phase and so their asset allocation needs to move into short term, less risky assets.

5.5 The overarching concern for these funds is the need for its customers to have a return on their investment and for this to be safe enough for each scheme. **This fiduciary responsibility is a fundamental obligation and should be foremost when considering the policy options available**.

5.6 Pricing for any investment needs to reflect the risks, which on infrastructure can be significant. Key factors include where investors’ money stands in the capital structure – the associated ‘haircuts’ where things go wrong/change can be severe.

5.7 **In summary, protections against the various risks borne by investors need to be addressed if policy makers are to enable pension funds to invest in more infrastructure projects.** Standard Life has produced a more detailed briefing note on this subject which we have shared with both EU and UK policy makers and a copy is provided as an appendix.

Institutional Investors

Q6) To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

6.1 As described above, there is already significant investment in fixed income assets by institutional investors. If more bond issuance that is used to provide long term financing requirements could be designed to meet the risk and return parameters of these existing investors, then institutional investors would allocate investment to such vehicles using the existing market infrastructure.

6.2 In addition to making use of the existing markets and investment structures, both institutional investors and those that manage their assets are seeking alternative ways in which investments could be made. Pension funds are looking at opportunities to make broader infrastructure investment as they are felt to be good matches for their long term liabilities, through the payment of regular coupons and the return of capital, as well as offering the opportunity to make investments that benefit society over the longer term. Asset managers are working to develop mechanisms by which investments can be made into infrastructure projects. These developments seek to allow investment across the capital structure, rather than through debt alone, and across the life of an infrastructure project from development to operation. As this type of investing is in the early stages of development, it is difficult to assess the potential size of the market.

Q7) How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?

7.1 The two aspects that we feel it is essential are appropriately balanced in the design of Solvency 2 are:

(i) The Solvency 2 liability valuation discount rate, and;
(ii) Solvency 2 capital requirements.

(i) <u>The Solvency 2 liability valuation discount rate</u>

Illiquid liabilities and assets

7.2 The liabilities of insurers are long-term and, at least in part, often illiquid. For example, once an annuity has been sold to a customer, the annuity liability will remain in place for the lifetime of the customer until they pass away. Annuity products have no surrender options that would increase the liquidity of the liability.

7.3 This means that, in practice, insurers can invest in long-term and illiquid assets, safe in the knowledge that they will not be forced to sell these assets, even in periods of financial stress. Insurers are therefore able to invest in illiquid assets on a 'buy-to-hold' basis.

7.4 It is worth noting that many categories of long-term financing, being relatively illiquid, are ideal candidates for insurers to invest in and insurers, because of the long-term illiquid nature of their liabilities, are uniquely placed to invest in long-term finance, provided there is certainty about cash flows.

How Solvency 2 can support long-term financing

7.5 It is also well established that illiquid assets generate returns in excess of the risk-free rate of return and, because insurers can invest and hold such assets to maturity, they are able to capture and genuinely earn this excess return.

7.6 If Solvency 2 is not to discourage insurers from continuing to invest in illiquid assets, and so in the provision of finance to invest in long-term projects, **it is essential that Solvency 2 permits insurers to recognise this additional return in the Solvency 2 balance sheet.** This would allow insurers to discount their liabilities at a more appropriate rate of interest that better reflects the volatility of the underlying cash flows, relative to assets. Otherwise, insurers' liabilities will be over-stated and they will have little incentive except to invest in assets like government bonds and so potentially deprive long-term finance of an important source of funding.

The Long Term Guarantees package

7.7 In order for Solvency 2 not to discourage insurers from investing in long-term finance, **it is essential that Solvency 2 allows for a Classic Matching Adjustment and an appropriately calibrated Volatility Balancer.**

7.8 In particular, **the Classic Matching Adjustment and Volatility Balancer should apply to insurers' full, and partially, illiquid liabilities, respectively, and also include a wide range of high quality long-term financing assets within their scope of eligibility.**

7.9 We support the Classic Matching Adjustment and an appropriately calibrated Volatility Balancer, as proposed in EIOPA's Long Term Guarantees impact assessment report, and we would be very happy to provide further details if required.

(ii) Solvency 2 Capital Requirements

Capital Requirements Calibration

7.10 In order for Solvency 2 not to discourage investment in long-term financing assets, **it is essential that Solvency 2 is appropriately calibrated to ensure that the amount of capital that insurers hold in respect of these assets is fair and consistent.**

7.11 We welcome EIOPA's study to determine whether the current calibration of Solvency 2 is appropriate and to provide assurance that it does not inappropriately penalise investment in long-term financing assets. We look forward to EIOPA's conclusions being published in July 2013.

Asset-Liability Cash Flow Matching

7.12 A further important point is that insurers typically 'cash flow match' their illiquid and partially illiquid liabilities and assets. This ensures that the income generated by the asset very closely matches the liability payments and, in practice, this means that short term fluctuations in the market value of the assets are compensated for by broadly equal and opposite movements in the value of liabilities. In short, cash flow matching stabilises the balance sheet and reduces its sensitivity to short term fluctuations in interest rate spreads.

7.13 We believe that Solvency 2 should acknowledge this behaviour. In other words, **when insurers' cash flow match illiquid and partially illiquid liabilities with illiquid assets, such as long term-financing investments, Solvency 2 capital requirements should appropriately reflect the reduced sensitivity of the Solvency 2 balance sheet to interest rate spread movements and so result in reduced capital requirements.**

Q8) What are the barriers to creating pooled investment vehicles? Could platforms be developed at the EU level?

8.1 Pooled investment vehicles can be created in a number of different structures. The structure used for a particular vehicle is generally driven by the type of investor in the fund. 'Pure' institutional investor funds are normally created in a manner that allows broad investment freedom and it is envisaged that, going forward, these will normally be provided under the AIFM Directive. For funds where the end investors are retail customers, a more regulated structure such as the UCITS regime is used.

8.2 When designing funds asset managers place a great deal of importance on the types of end investor and the suitability of the product to the investors that will be targeted to make investments. In our experience retail customers and institutional clients (i.e. those that can take a truly long term view) react very differently when making investment/saving decisions.

8.3 Retail customers do not tend to have long-term views of investments and so react by withdrawing their investments in situations where they have become uncertain about the outcome. On the other hand, institutional investors are happy to continue with investment through uncertain times as they have genuine long-term liabilities. Therefore, when designing funds for use by different investor types, asset managers may consider whether a fund that is closed end is more appropriate for long-term investing than an open end fund which can have volatile cash flows due to the behaviour of retail investors.

8.4 When deciding whether to launch a product, Standard Life's senior directors assess the possible impact on the firm's reputational risk and if it would involve too much risk to the customer and to the business, the product will not be launched. Before launching a pooled vehicle available to retail investors that will invest in low liquidity long-term assets such as infrastructure, asset managers will be concerned to ensure any reputational risk is minimised.

8.5 It is possible that some asset managers will not be willing or able to take the risks inherent with selling infrastructure funds to retail investors, thus restricting the amount made available for investment in such funds. The current fund types (i.e. AIFM and UCITS) allow the development of new infrastructure vehicles and a possible increase in the allocation to infrastructure investment. Such an increase would require an improvement in the pipeline of appropriate investments suitable for the current mandates. We also recognise the wish to create a further long-term investment fund vehicle, but we remain unconvinced that such funds are necessary or appropriate.

8.6 We are aware that the Commission's forthcoming proposal on a long-term investment fund tailored towards retail investors will seek to address some of the issues outlined above.

Q9) What other options and instruments could be considered to enhance the capacity of banks and institutional investors to channel long-term finance?

9.1 As mentioned above, it may be beneficial to develop an instrument that would allow the pooling of investment opportunities. The example given is the creation of bonds issued by an entity that provides the financing to a number of entities seeking finance. Historically, closed end funds have been used to collect speculative investment into infrastructure. Creating a corporate structure that raises capital for investment in selected infrastructure or SMEs would create the opportunity for end investors to trade shares of the closed end vehicle in the market, thus giving exposure to a basket of infrastructure projects and SMEs selected within the closed end fund. It should be noted that shares in a closed end fund trade at a market price rather than the net asset value (NAV) of the underlying assets.

9.2 As banks are working to de-leverage they are finding it difficult to provide the level of financing required by SMEs and smaller infrastructure products. Previously when banks have been unable to put further lending on their balance sheets they have used securitisation vehicles to pass on the debt assets to other investors seeking exposure. It would be important to ensure that the securitisation vehicles were well designed with all risks clearly defined and understood.

The combined effects of regulatory reform on financial institutions

Q10) Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be best addressed?

10.1 Our key observation is that fundamental prudential regulatory change is occurring across the whole spectrum of both the European and global financial services sectors and there is a real risk that this change may not be fully aligned and consistent. The core objective of regulatory reform to date has been prudential stability but, as has been well documented, there is a risk that this has been at the expense of investment and lending by financial institutions.

10.2 Major prudential changes are occurring for global and domestic systemically important banks, insurers and asset managers - Basel 3 in global banking, Solvency 2 for European insurers, MiFID, IORPS, the IAIS Comframe proposals for global insurers and the designation of global systemically important insurers and banks.

10.3 We are also witnessing material prudential supervisory change and uncertainty. For example, in the UK the Financial Services Authority (FSA) has recently been replaced by the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA), while a single Eurozone banking supervisor is being created in Europe.

Consequences

10.4 As the amount and pace of change is unprecedented in response to the banking and sovereign debt crises, and because the developers of Solvency 2 might not be fully aware of Basel 3 and its consequences, there is a real danger that the combined effects of Solvency 2 and Basel 3 could inadvertently stifle the availability of funding for long-term finance investments.

10.5 For example, if a good outcome is not achieved on Solvency 2’s Matching Adjustment, as described in our response to Question 7, not only will this discourage insurers from providing finance to invest in long-term projects, it could also deprive banks of a valuable source of funding that could be further utilised to fund long-term investments.

10.6 Cumulative unintended consequences like this example could, we believe, be potentially very damaging and also difficult to identify in advance. **We would therefore welcome a greater emphasis in the Commission's impact assessment on the impact of new regulatory initiatives on lending and growth.**

How to address this

10.8 In order to address these impacts, it is essential that the supervisors and developers of the new prudential regulatory regimes, both within Europe and globally, work closely together to ensure that the new regimes are consistent and complimentary and do not generate cumulative unintended consequences.

<u>The efficiency and effectiveness of financial markets to offer long-term financing instruments</u>

Q11) How could capital market financing of long-term investment be improved in Europe?

11.1 **There are a number of factors that would help to improve long-term investment in Europe. In summary, these are:**

11.2 **A well-defined and stable public policy environment** as far as possible, with a clear focus on long-term investment horizons (across all countries).

11.3 **The infrastructure project pipeline should be clearly defined by the relevant bodies at a national and/or EU level** (and also efficiently managed to best avoid spikes or troughs of supply).

11.4 **Best practice (transparent, easily accessible and regularly published) project information** should be made available both during and post construction, to give investors comfort in the credit quality of the project they are being asked to fund.

11.5 **No overly engineered financial solutions** – the final structure must be straightforward and free from political 'interference' (explicit language within bond/project documentation to reflect this will be particularly helpful).

11.6 It may be useful to focus on the 'value for money' argument by looking at the end cost to the consumer and how (if) that impacts their cost of living. Consumers may be more inclined to view infrastructure expenditure more positively by their respective governments if they can see how it might (positively) impact their lives.

11.7 From the bond investor's perspective, clients are less inclined to specify infrastructure as part of their portfolio/mandate due to the lack of a valid benchmark (index/indices) for the sector. It is unclear where many infrastructure deals are currently categorised within bond markets, sometimes being included in the Industrials sector, Services, Transportation, or under

Asset Backed Securities - which many clients negatively associate with the worst aspects of the financial crisis. **A new infrastructure sector index/benchmark would be helpful in more clearly demonstrating to clients where money is invested, and also make it easier to identify the size of the sector compared with others and assist relative value discussion/measurement.**

11.8 **Volume and liquidity in secondary markets are important**, as investors need to be able to trade bonds freely rather than be locked into a buy and hold position to maturity (note: that this is different from *insurance investors,* who do not require liquid assets per se due to the illiquid nature of certain of their liabilities – see paragraphs 7.2 to 7.4 for further details*).*

11.9 UK Private Finance Initiative (PFI) infrastructure deals were structured to achieve a 90:10 debt:equity ratio (or worse) and to scrape barely into an underlying credit rating of BBB- due to the accompanying monoline insurer guarantee. **To encourage and positively enhance long-term investment in the sector, projects should be structured in a less levered way to achieve A or high BBB ratings**.

11.10 As noted in our response to Q7, Solvency 2 rules needs to allow for insurers to invest in infrastructure over the long-term without increasing barriers to investment.

Q12) How can capital markets help fill the equity gap in Europe? What should change in the way market-based intermediation operates to ensure that the financing can better flow to long-term investments, better support the financing of long-term investment in economically- socially- and environmentally-sustainable growth and ensuring adequate protection for investors and consumers?

No comments.

Q13) What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose this framework?

13.1 Covered bonds can help overcome many of the criticisms of the securitisation market, principally because the issuer retains full exposure to the performance of the underlying assets. The market is further strengthened by national laws across Europe e.g. 'Pfandbriefe' (Germany) and 'cédulas' (Spain), which govern standards limiting excessive risk-taking and help avoid weaker underwriting standards while maintaining regular reporting and monitoring requirements.

13.2 Establishing a framework across Europe as a whole rather than just at a national level will prove more challenging, not least because of different legal and tax systems. However, in moving towards a harmonised framework, liquidity in the asset class should be improved and the current variation in covered bond spreads should reduce, making it less costly for certain issuers. Another issue relates to the different collateral and loan-to-value rules backing a covered bond. While harmonisation of rules could resolve the collateral issues, it may be not be welcomed in those countries which allow a wider spectrum of collateral included in the cover pools or in countries where collateral rules are tighter; it could, over time, reduce the quality of collateral backing the covered bonds.

Q14) How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?

14.1 There are a number of changes to the securitisation market which could allow this market to improve maturity transformation in the financial system, while at the same time maintaining financial stability.

14.2 **First, the product class needs to see better disclosure and increased transparency**. For example, improving disclosure about the underlying assets will allow participants in the product class to exercise appropriate due diligence. In addition, more regular and standardised reporting of the performance of the underlying assets would improve transparency to the investor base.

14.3 **Second, there should be greater standardisation of products** which should enhance investors' understanding of the risks, improve the ability to value products and aid the development of more liquid secondary markets.

14.4 **Finally, regulatory initiatives aimed at reforming the importance and influence of rating agencies in the securitisation market and improving the capital framework for banks** to better reflect the risks of this market could help avoid the regulatory arbitrage in securitisation products available under Basel II.

Cross-cutting factors enabling long-term saving and financing – EU savings accounts

Q15) What are the merits of the various models for a specific savings account available within the EU level? Could an EU model be designed?

15.1 In principle, this idea appears attractive, and would allow for more seamless cross-border savings activity. In practice, such concepts have been tested with pensions and, thus far, remain inherently problematic. We are aware of EIOPA's work to assess the feasibility of establishing a single market in personal pensions and we will monitor this process carefully.

15.2 Setting up a transferrable product is relatively straightforward, but when it is subsequently used in a different member state, the application of local social and labour laws creates significant complications. Any attempt to introduce such a product would need to address these issues in order to ensure it is workable in practice.

Taxation

Q16) What type of CIT reforms could improve investment conditions by removing distortions between debt and equity?

16.1 The question pre-supposes that the differing tax treatment (in many countries) between debt and equity is both distortive and a barrier to investment. We do not believe, however, that the Green Paper provides sufficient evidence to support this view.

16.2 There is no doubt that hybrid financing instruments have been developed over the years that economically and commercially have many of the characteristics of equity, but which from a tax perspective are treated as debt. These instruments have tended to be raised by banks, insurance companies and securitisation vehicles either to provide regulatory capital or as a conduit for financing underlying “bundled” financial instruments. Whilst the tax treatment has influenced their form and structure, the underlying driver has been the ability to access sources of finance out with traditional equity markets.

16.3 In the absence of a common corporate tax regime in the EU, **one way of improving investment conditions and encouraging long-term financing of infrastructure investment would be to create tax neutral pooled investment vehicles through which such investment could be channelled** (see also the responses to questions 8 and 9)**.** By tax neutral we mean that there is no tax within the vehicle; it is tax transparent and there is no tax on distributions from the vehicle. That way, investors are subject to tax as if they were the direct providers of long-term finance. Such pooled investment vehicles could be established anywhere within the EU, for example under the existing Societas Europaea model.

16.4 This would be an attractive proposition to tax exempt investors such as pension funds and other tax wrapped savings vehicles and it would provide a tax neutral way of channelling long-term savings into long-term investments.

Q17) What considerations should be taken into account for setting the right incentives at national level for long-term saving? In particular, how should tax incentives be used to encourage long-term saving in a balanced way?

17.1 Standard Life has considerable experience of long-term savings in several EU states, most notably Ireland, Germany and the UK. Our experience is particularly strong in the UK, where we are one of the largest providers of workplace pensions, operating more than 35,000 schemes with over 1 million members.

17.2 The UK has a well-established system of tax relief to incentivise long-term saving, most notably into private pension arrangements. This is vital to ensure that individuals are properly encouraged to forego part of their income now in order to put money aside for their retirement.

17.3 The principle of tax relief is particularly important as the UK embarks on automatic enrolment into workplace pension schemes (described in our response to Q5 above), which we strongly believe will deliver a significant increase in long-term savings. Indeed, our research suggests that automatic enrolment could create an additional six million savers, adding around £12.5bn annually to retirement savings by 2017.

17.4 It is important that we now have a period of stability in the tax system while automatic enrolment ‘beds in’ so as to give this vital reform the best possible chance of success.

Q18) Which types of corporate tax incentives are beneficial? What measures could be used to deal with the risks of arbitrage when exemptions / incentives are granted from specific activities?

18.1 For institutional investors such as pension funds and insurance / pension companies, the key criteria for investment are return, asset-liability matching and regulatory treatment. In most jurisdictions the investment return earned by pension funds is exempt from corporate tax and so corporate tax incentives will not act as an incentive to invest in specific activities. Such incentives would also not be relevant to other tax wrapped savings vehicles – e.g. Individual Savings Accounts (ISAs) in the UK or gross roll-up life bonds.

18.2 Indeed, there are good reasons as to why we believe that a common corporate tax regime is not appropriate – please see response to Q19 below. For this reason we suggest that the focus should be on creating tax neutral vehicles through which long-term investment can be channelled, as per our response to Q16 above.

18.3 What may be realistically achievable at the EU level is to apply tax incentives at the consumption level, e.g. reduced VAT applying to goods and services consumed by infrastructure and other long-term investment projects. That way the overall return to investors is enhanced. Other options could include providing some form of centrally provided “above the line” EU grant for investors in qualifying activities such as the recently introduced “above the line” tax credit in the UK.

Q19) Would deeper tax coordination in the EU support the financing of long-term investment?

19.1 We do not believe that a common EU tax system is a pre-requisite of an EU wide tax system that supports long-term investment. As set out in our answer to Q16 above, there are alternative options which can still provide for an EU wide approach.

19.2 Given that many of the options for sourcing long-term investment capital are not subject to corporate tax (e.g. pension funds and other tax wrapped vehicles), deeper integration in terms of a common corporate tax system (such as the Common Corporate Tax Base) would not necessarily incentivise particular behaviours.

19.3 The corporate tax regimes that operate in the EU have emerged over time and reflect the legal, regulatory and commercial law regimes that are in operation in individual member states. Unlike transaction taxes, to operate effectively a common corporate tax regime would require disparities in these issues to be addressed. The corporate tax regimes in member states also reflect the relative tax take as a proportion of the total tax take and this varies between member states. Whilst tax rates are undoubtedly a driver of these differences in tax take, the tax regime itself is also a significant contributor.

Accounting principles

Q20) To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?

20.1 Fair value accounting causes apparent volatility in the financial position of companies and can therefore cause decisions that use fair value as a driver to be more short-term in nature. These decisions could be those made by asset owners (when reviewing assets and liabilities), asset managers (when assessing companies), companies (when allocating resources) and regulators (when assessing those they regulate). It is therefore not just investor behaviour that is impacted by fair value accounting.

20.2 **In order to compensate for such effects, the introduction of some form of smoothing of the values used in accounting could help.** This would recognise that there can be volatility within the value of an asset, but that this volatility does not necessarily have a significant impact on firms' ability to generate long-term value on a sustainable basis. It is a difficult balance to assess value, as it is important that any real loss of value is not disguised as volatility. Further, long-term investors must be able to discount their liabilities at a more appropriate rate of interest that better reflects the volatility of the underlying cash flows, relative to assets.

20.3 More fundamentally, although we are supportive of the International Accounting Standards Board ("IASB"), we are increasingly concerned by its reluctance to refer explicitly to "stewardship" in its over-arching Conceptual Framework. We believe such explicit reference will help to address in a principled way how fair value accounting is promulgated and applied. **We would like the Commission to take account of the need to address this in assessing its approach to supporting the IASB and endorsing its standards. We believe that embedding explicitly stewardship in the IASB's Conceptual Framework is fully consistent with the Commission's objectives relating to the provision of long-term finance in Europe**.

Corporate governance arrangements

Q21) What kind of incentives could help promote better long-term shareholder engagement?

21.1 The interaction between asset owners and asset managers is key to the promotion of long-term shareholder engagement. The behaviour of asset managers is driven to a significant extent by the demands of their clients and their advisers. There are a number of practices that are currently common in the asset owner/manager interaction that reinforce a focus on the short-term. These practices include the use of benchmarks to measure performance, the review of performance on a quarterly basis and the reporting of performance drivers on a quarterly basis.

21.2 This, almost continuous, focus on short-term movements by asset owners and their advisers leads asset managers to hold companies to account over more short-term measures which are reinforced by the requirement for companies to issue quarterly interim management statements (IMS). As such, **we welcome the Commission's proposed revisions to the Transparency Directive, which would abolish the requirement to publish IMS.**

21.3 Rather than introducing incentives to encourage long-term engagement our preference would be to reduce or remove the current incentives for short-term focus. There have been a number of reports and papers issued that provide suggested remedies to short-termism; a particular example is the Kay Review which is being used in the UK and more widely as a blueprint for improvements. **We would advocate that legislators and regulators continue to develop such proposed actions in partnership with the industry in order to promote longer term shareholder engagement.**

Q22) How can the mandates and incentives given to asset managers be developed to support long-term investment strategies and relationships?

22.1 A number of bodies have issued suggested standard templates for mandates. These are often designed to ensure that there are incentives for asset managers to develop long-term strategies and relationships. Examples of this work are the International Corporate Governance Network (ICGN) Model Mandate Initiative and the work being undertaken by Tomorrow's Company to develop guidelines on the relationship between asset owners and asset managers. Encouraging the use of the standards proposed by the ICGN and those that will be issued by Tomorrow's Company would be beneficial in improving the support for long-term strategies through mandates and incentives.

Q23) Is there a need to revisit the definition of fiduciary duty in the context of long-term financing?

23.1 The duties that a fiduciary is bound to deliver does not alter because of the length of the investment outcome being sought, or the length of the relationship that is to be in place. It is therefore not clear why the definition of fiduciary duty should be revisited in the context of long-term financing.

23.2 In the chain of relationships between saver and investee company, there are several relationships that require the delivery of a fiduciary duty, but this duty will not be driven by the length of the relationship. There is currently a lot of discussion about the nature of a fiduciary relationship and which parts of the saver to investee chain include a fiduciary duty. We believe that it is important to get clarity around which of the relationships are fiduciary in nature and therefore which entities should be held to the highest standards of care and trust in delivering for their counterpart or client, but the discussion on long-term financing does not seem the appropriate driver for providing this clarity.

Information and reporting

Q24) To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?

24.1 Current corporate reporting is predominantly focused on economic decision-making and short-term value drivers but does not recognise the increasing importance of stewardship and sustainability. To be more useful, **corporate reports should balance information needed for economic decision making and stewardship.** Companies too will find it useful to be able to demonstrate more clearly their stewardship and the creation of social, as well as economic, value.

24.2 We are supportive of the work being done by the International Integrated Reporting Council (IIRC) in developing standards of reporting that balance financial and non-financial information. We believe that the inclusion in reporting of key stewardship factors such as corporate culture and purpose, long-term business sustainability, risk appetite, the allocation of resources (of all types), environmental management and relationships with society will contribute to better investment decision making. This is because it is these factors which allow for an assessment of the way a company utilises and develops its resources to generate long-term value on a sustainable basis.

24.3 On a more general note, investors welcome increased provision and clarity of information from companies, which has improved since the onset of the financial crisis. However this must be further supported by investor access to management teams on a regular basis; the combination of factors helps investors to make more informed investment decisions. Sustainable investing and ethical considerations are also more in focus with clients and therefore any information companies do provide that gives a clearer view of such strategies will be very helpful to potential investors.

Q25) Is there a need to develop specific long-term benchmarks?

25.1 Even if benchmarks are not used for the assessment of performance of a particular fund or mandate, they do provide a method of defining a sub-set of investments which an asset manager may use to deliver a client's desired outcome. It is for this reason that large infrastructure bonds which are included in relevant benchmarks already form part of existing fixed income portfolios. If such bonds are not included in the benchmarks, they do not generally receive investment from current portfolios.

25.2 Consistent with our response to question 11, **it would therefore be useful to develop benchmarks for long-term financing vehicles so that asset owners and asset managers could use them, primarily as a mechanism for defining the investment set to be used for a particular portfolio or mandate.**

The ease of SMEs' access to bank and non-bank financing

Please note that the following comments attempt to provide a collective response to questions 26 to 29 on SME financing:

26.1 European banks have made progress in de-leveraging their balance sheets. Aided by policy measures introduced by the ECB, this has allowed the process to be managed in an orderly manner, avoiding a very sharp contraction in economic growth.

26.2 However, further de-leveraging is required, especially in southern Europe, given banks' weak balance sheets. This will make it harder for companies to access funding through bank channels which have traditionally provided the majority of finance to these economies. While the very largest firms can access the corporate bond markets, small and medium enterprises (SMEs) face different pressures.

26.3 The following remarks examine the key alternatives to the banking funding channels and consider their capacity to provide the capital necessary to sustain a revival in credit lending in the EU.

Covered bonds

26.4 The ECB has launched two covered bond purchase programmes aimed at easing funding conditions for credit institutions, improving market liquidity and ensuring business lending is maintained. In addition, the regulator has been active in ensuring that haircut margins have been noticeably lower for covered bonds versus comparably rated securitisations. Covered bond markets have also proven beneficiaries of the new capital regimes, as defined by Solvency 2 and Basel 3 regulations.

26.5 By protecting the structures of outstanding issues, the ECB may have helped to reinforce conventions and dampened innovation. This has raised the hurdle to the further development of this market as a source of capital for the real economy. It has also heightened investor anxiety about recent attempts to broaden the pool of assets used to collateralise debt instruments, particularly for SMEs.

26.6 One attempt to push the envelope of the covered bond market was Commerzbank's €500m issue in February. This hybrid offering was backed by loans to SMEs and structured in a way that was reminiscent of securitisation offerings of the past - complete with a special purpose vehicle (SPV) to carry the collateral. However, unlike earlier securitisation deals the underlying assets are not sold but transferred to the SPV. This means there is no segregation between the originator and the assets, so they remain on the bank's balance sheet.

26.7 Such new structures remain unproven and have raised questions about whether the investor base for the covered bond market, where rates and sovereign bonds investors account for a significant portion, would be willing to digest such structures on a large scale.

26.8 Much will depend on whether investors feel they have been adequately rewarded for the associated risks. If a two-speed covered bond market emerges, with these 'non-pfandbriefe' retaining a premium over the more conventional issues, and a steady pipeline of deals appears, it may help attract new credit investors into the market. However, it remains uncertain whether investors would choose to gain access to European corporates through the covered bond market rather than more direct corporate debt exposure. In addition, there are considerable doubts whether the evolution of the covered bond market can happen at a pace, and on a sufficient scale, to have a material impact on the real economy.

Securitisation

26.9 Securitised issuance reached €525 billion prior to the financial crisis, but recently has been largely dormant. This is partly explained by a loss of confidence in the credit origination conventions, particularly as applied to the US sub-prime market, but has been compounded by regulatory concerns (e.g. Basel 3 and Solvency 2).

26.10 Despite this, there have been some indications that policymakers may be prepared to help resuscitate these securitised markets. At a national level, Spain has already pledged €3 billion for 2013 to its FTPYME programme to support SME securitisation funds.

26.11 Perhaps more importantly, we note that there has been speculation of a more 'region-wide' focused initiative. In particular, the ECB is looking at restrictions in the use of securitised debt as collateral for refinancing from the central bank. An exception for SME-backed securitised debt is a possibility, as the Bank looks to support the asset-backed markets. It is of considerable debate whether this will have as big of an impact on lending at the local level as recent surveys suggest is required.

High Yield Debt

26.12 Many banks can also offer corporates another route to funding by supporting their access to debt and equity capital markets. Driven by tougher regulations and deleveraging pressures, banks are increasingly steering European corporates towards the public markets.

26.13 Although banks would lose out in one way - that is, the loss on interest income on the traditional loan - they may be compensated by fees from capital market activity. It is also more efficient from a balance sheet perspective, as credit risk is passed from the bank's balance sheet to the investor, while the bank does not reduce its funding needs nor does it need to hold capital to back the loan. There are advantages too for the corporate borrower such as broadening access to a range of lenders or investors, and possibly reducing funding costs as well.

26.14 While access to traditional corporate bond markets is well established in Europe, especially for companies with an investment grade rating, a larger, deeper high yield corporate bond market offers the greatest alternative to companies as a major source of financing. Issuance in the European high yield market has grown substantially over the last 10 years and has remained relatively consistent between €40-50 billion in the last three years.

26.15 A combination of persistently low interest rates, investors seeking income in a world of low yields, and a decline in risk aversion have all resulted in significant new issuance in 2013. We anticipate a record year of high yield bond issuance in the region of €65 billion. Additionally, the number and range of companies accessing the high yield market has grown, including some first time issuers based in the peripheral eurozone. While the European high yield market is only a quarter of the size of that in the US, we believe it can provide a platform for companies to broaden their access to funding sources, thereby reducing reliance on bank loans while at the same time allowing the banks to de-leverage.

Q30) In addition to the analysis and potential measures set out in this Green Paper, what else could contribute to the long-term financing of the European economy?

30.1 **A specific idea which warrants further examination is infrastructure bonds**. There are considerable difficulties for retail or institutional investors to fund long-term projects directly, say a pension scheme owning and managing a toll road. However, the non-government bond market is expanding rapidly in size. **In an environment where investors are seeking income, a degree of security (e.g. via the credit rating) and an ability to compare terms and conditions on a uniform basis, an expansion of infrastructure bonds could be attractive.** The aim, for example, could be to duplicate the municipal bond market as developed in the USA. As noted earlier in our response, we are closely following the pilot programme between the European Commission and the European Investment Bank.

Appendix: Standard Life briefing note: Infrastructure Investment

1. Current 'barriers' to investment

1.1 It is important to start with the need for our customers to have a return on their investment (and for this to be safe). This fiduciary responsibility is fundamental and needs to be at front of mind for policy makers.

1.2 Pricing for any investment needs to reflect the risks, which can be significant. Key factors include where investors' money ranks in the capital structure, as the associated 'haircuts' where things go wrong/change can be severe.

1.3 Uncertainty over the durability of political non-interference/the prospects of unwelcome change is a key concern (especially when investors are being asked to commit over several decades). Stronger and more enduring protections need to be provided (an example to illustrate this point is the Railtrack experience, where the use of 'force majeure' clauses resulted in heavy losses for investors).

2. Actions required to support / encourage investment

2.1 Protections against these risks need to be addressed if policy makers are to enable pension funds to invest in more UK infrastructure projects.

2.2 As part of this, it is important to stress that there are no short-term fixes or solutions – the industry needs to be confident that it will be able to deliver returns to savers over a long period of time.

2.3 Specific actions by policy makers that would help facilitate stronger investment flows include:

- Simplification: guide structurers/sponsors need to simplify new funding vehicles and avoid 'complicated' financial solutions. This may mean the government retains more risk.

- Multi-strand solution – the best outcome would be more than one structure or funding vehicle in order to get the infrastructure pipeline funded – e.g. single large infrastructure projects would be able to issue own name liquid, benchmark size bonds, while other smaller sub-benchmark projects may be pooled and issued by an aggregating entity, similar to The Housing Finance Corporation in the social housing sector, or funded through private placement, etc.

- Transparency of information – government should do more to encourage sponsors to improve project information availability to investors, both on existing projects where they are involved and for any new projects. This will help to increase confidence in the sector, and avoid a two-tier market of 'old', mainly opaque, PFI and new more bondholder friendly PFI structures.

- Focus on creating a 'A'/high BBB rated asset – achieved either through government taking on more risk (than before) or via a larger first loss piece.

- Investors value a regulatory framework (utilities, social housing), but can also get comfortable with a contractual framework (like PFI) as long as there is confidence in the strength of the documentation (clear language is needed).

- Need to ensure there is a controlling creditor role within the new structure, who must have ‘skin in the game’ and be prepared to be involved to maturity, but who is expected to be more bondholder friendly and transparent than previous monoline insurer behaviour.

- It would be helpful to understand the government’s view on the mechanism for decision making under new PFI arrangements. This could be a single controlling creditor entity (as in the previous point) or a split role, part controlling creditor – to turn to when things go wrong, combined with an independent arbiter who might be responsible for more of the day-to-day decisions.

- Potential changes to the way that RPI is calculated could negatively impact the treatment of PFI deals with RPI-linked revenue streams and be very difficult to manage if investors need to be cognisant of ‘old’ RPI calculations, as well as numerous ‘new’ RPI calculations/versions for different issuers, perhaps using a variety of different experts. This kind of change does not support the ‘keep it simple’ requirement from investors.

- How bonds are classified on bond indices can be important for client mandates. As such, a new bond index for infrastructure could be useful. Currently PFI is classed as asset-backed securities (ABS), which has suffered in recent years from collateralised debt obligations (CDO) connotations/associations and some clients exclude ABS from fund mandates as a result.

- Government should be mindful of investor appetite and manage dealflow/pipeline accordingly, timing large bond issuance without flooding the market too quickly and allowing for sensible absorption.

2.4 A further suggestion is that the ABI Insurers’ Infrastructure Investment Forum could be instructed to work through one of the pipeline projects to show how a new deal might be structured. This could be used as a ‘compare and contrast’ exercise, taking the best bits of old projects and producing an improved new structure/sector.

Appendix: Factors impacting on investment decisions

1.1 There are four key areas that can impact materially on a project’s credit quality and any related investment decision:

(i) The underlying project credit risk

1.2 Each project relies on a payment stream from a government department to cover its debt-servicing. We don't view all UK public sector entities as straight AAA (UK sovereign rating) risk - this is a key point when looking at any infrastructure project.

1.3 We view the underlying credit quality of the project itself as key to any investment decision - if our analysis/judgement is that the project/asset cannot survive over the term of the bond to maturity then we won't invest.

1.4 For example, if it is a new hospital seeking funding but there are other new hospitals in the local vicinity, there may be a question mark over one of these hospitals' financial future at some point (government budget cuts, change in priorities etc) before the bond matures.

1.5 In contrast, we would view an existing PFI asset like GCHQ as absolutely core to the government's strategy and there should not be any question over its necessity in future years or its funding.

<u>(ii) Construction risk</u>

1.6 Construction phase is the biggest single risk to any project, and can cover from three to five years (or more) of a typical 30 to 35 year maturity. Revenues only kick in once a project reaches completion and delays to completion can result in financial loss or deferred revenues, while in addition cost overruns can be a significant risk on a complex, large project.

1.7 There are four key risks that bondholders are exposed to:

- Complexity of the construction project;
- Approach taken by the construction contractor;
- Experience, capabilities and financial resources of the contractor; and
- Degree of contractual and third party support.

1.8 Traditionally, bonds have been issued when a project is either through construction phase (funded by banks initially) or materially through construction. This happened when banks had the appetite to fund and also the monolines existed (as controlling creditor) to take care of day-to-day issues (project budget variations, etc), so bondholders were only consulted on major changes that might, for example, require additional funding.

1.9 Once through construction, a project should be of better credit quality and therefore the rating can be notched up to reflect that decrease in risk. In the 'new' world of PFI it is not clear who will fund projects through construction now that the banks are no longer in the market.

<u>(iii) Revenue structure and operational risk</u>

1.10 Once construction has been completed, the supporting government department will pay the project company for providing services under a typical 25yr to 35yr contract. Key factors in assessing the risks in this revenue structure are:

- How certain or controllable is the revenue stream?
- To what extent do any conditions imposed by the contractual arrangements represent a threat to the revenue stream?
- What degree of complexity or difficulty is involved in meeting the contractual or performance obligations that underpin the revenue stream?

(iv) Financial and legal structure

1.11 A project's robustness to stress-testing cash flows in adverse scenarios can impact on its level of leverage, with more robust structures typically having required a lower level of equity support on Day 1 (more leveraged) relative to other weaker projects.

1.12 In assessing the level of strength in a project's cash flows, we would consider:

- the debt service profile;
- how the debt service reserve builds up over time;
- robustness to cash flow stress-testing;
- debt service cover levels and cash-trapping mechanism[1]; and
- level of first loss piece, as protection for bondholders but also as incentive for sponsors to remain committed to the project if problems do occur.

[1] Cash-trap mechanism – if the project performance drops below pre-determined trigger levels, cash flow is ‘trapped’ within the structure and not permitted to be distributed to sponsors, etc. Projects have both trigger ratios (for cash-trapping) and default ratios, documented in PFI contracts and measured either annually or semi-annually.