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A Blueprint for an Infrastructure Bank

“Launch Version¹”

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Prepared for the Growth Commission

¹¹ **PRELIMINARY VERSION**—Not to be quoted or cited. This paper was produced by the Growth Commission’s Secretariat to inform the thinking of the Commissioners. The analysis does not necessarily reflect the views of the Commissioners. In contrast, the proposals are those of the Growth Commission report.

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An Infrastructure Bank (IB) could provide stable, predictable and appropriately scaled long-term support for infrastructure on the basis of robust banking principles and additionality. The IB would be different from existing financial institutions in a number of key ways. First, it would act as a vehicle to reduce policy risk. Indeed, the IB could serve as a vehicle to generate credible commitment to maintaining consistent policy frameworks across parliaments. Moreover, Governments would be less likely to chop and change with policies if a public long-term investment bank were involved. Second, it would have special convening powers and strong networks to put together different coalitions and sources of finance. And lastly, the Infrastructure Bank would develop banking and sectoral skills in new and important areas. (Stern, 2011).

Mandate and operating principles

The core of the Infrastructure Bank's mandate would be to promote medium and long-term growth through facilitating investment in infrastructure projects of national strategic importance. The Infrastructure Bank (IB) would aim to provide additionality by crowding-in the right type of capital that would enable other types of finance to flow.

Under the mandate of facilitating medium and long-term growth, the IB would act in accordance with pre-defined operating principles and objectives against which its executive board could be judged. Crucially, it would need a wide measure of independence from government to fulfil its mandate. In particular, there should be a clear distinction between oversight of mission and purpose, and day-to-day operational control².

The IB would most likely assume the role of senior partner lender/investor in a given project alongside the private sector and other institutional investors. Using a partnership model would enable the IB to tap into the expertise of its partners, including external fund managers who would be expected to assume responsibility for performing due diligence on individual projects and overseeing day to day project activities.

The bank would be expected to act as a fully commercial entity, but would not be required to pay a dividend to its shareholders (that is, taxpayers). Among overseas national banks, only the Nordic Investment Bank pays a dividend, perhaps as a means of assuring taxpayers in the separate countries that it covers that they are getting a return for the capital they invest in the bank.

²In almost all the countries reviewed, similar institutions have been established by or exist and operate by virtue of an act of parliament or equivalent, including KfW in Germany, CDC in France, CDP in Italy, the SBA in the US and the Business Development Bank of Canada.

The role of the bank could possibly be limited in time. However, this requires the establishment of a credible exit strategy. In addition, even if there is an exit strategy in place, there is a danger that it is not implemented due to pressure by groups with vested interests.

Governance

The government would be the IB's shareholder and would set its strategic objectives, it would have no influence over individual investment decisions or how the IB manages its funds³. The strategic policy orientations defined by the Independent Strategy Board (*as per the governance model proposed in the Growth Commission Report*) would be reflected in the operating principles and objectives of the bank.

The IB could have an eclectic board of governors, composed of representatives from government, commercial banks, regulators, business, academia and trade unions. This board would set strategic priorities and assess the performance of the bank against its objectives. It would also be responsible for ensuring that the bank IB remained compliant with EU state aid rules⁴. For frequent advice on technical matters, there should be a number of technical advisory groups whose memberships would be drawn from a wide range of sources, including academia and social partners.

Apart from a board of governors, the IB would have an executive board which would comprise the senior management of the bank. The chief executive would be appointed by a supervisory board and would be expected to regularly report to it. The board of governors, the supervisory board and the advisory council would not be expected to interfere in any way in the day-to-day operations of the bank. These bodies would be responsible for setting the strategic direction of the bank. All banking decisions would, be the responsibility of bankers.

To further reassure the work of the IB is strategically aligned with government policymaking, an advisory council could be established on which ministers, MPs and senior civil servants would sit. It would assess the existing strategic objectives of the IB and make recommendations to the board of governors about changes to them. The KfW's

³For example, the UK Department of Business, Innovation, and Skills is the GIB's sole shareholder and in consultation with the GIB Policy Group, approve the founding articles of the GIB, the GIB charter and the strategic priorities.

⁴This body's composition is similar to the Board of Supervisory directors of the KfW and the Board of Directors of the BNDES Ltd. Within the GIB, this body is split in two components: the GIB Policy Group (comprised of representatives from relevant government departments) and the GIB Corporate Board (which includes experts from business and academy). The Nordic and European Investment Banks, whose shareholders are different countries, have a Board of Governors (made up of the finance ministers of the member states) and a Board of Directors (comprised of members states representatives selected by respective governments).

Mittelstandsrat (SME advisory council) assumes a similar role in Germany (Dolphin and Nash, 2012 and Skidelsky et al, 2011).

Instruments

Traditional financial instruments

The IB would select infrastructure's project on the base of robust financial rules and provide financial support primarily by issuing bonds. These bonds would not have an explicit government guarantee but they would be likely to attract a high credit rating because the bank would be in public ownership and the mix of assets that the IB would acquire would be high quality and the danger of default would therefore be extremely low. Bonds issued by the European Investment Bank have no government guarantee and have always had an AAA rating. If IB bonds also acquired an AAA rating, they could be expected to typically yield a little more than UK government bonds and less than corporate bonds.

An increase in the contribution from UK pension funds' total investment or global sovereign wealth fund market would provide a great support in funding infrastructure networks (Glaister, 2012; CBI, 2012). However, the current risk profile of most infrastructure assets is not sufficiently attractive for private investment. Given this stalling situation, government action is needed to increase the attractiveness of infrastructure investment, such as lifting project ratings above investment grade, as well as specific measures to encourage UK pension funds to enter the market.⁵

An AAA rating would make IB bonds attractive to UK pension and insurance funds and to overseas investors in the UK bond market. When defined-benefit pension funds close, and the money flowing into them through contributions dries up, they shift assets to more closely match their liabilities. This means they are increasing their holdings of bonds, particularly index-linked bonds, and particularly long-duration bonds. The extra yield that BIB bonds would offer compared to government bonds – at very little extra risk – would definitely appeal to them.

It would be wrong to give the impression that this is 'free' money, as the government is prone to do when it talks about pension funds investing directly in infrastructure. If pension and insurance funds buy IB bonds, they will have to sell other assets to do so – including UK government bonds and equities. This will push down the prices of these assets and increase their yields. As a result, the cost of funding for the UK government and for UK firms will go up. This is inevitable; the IB would add to the demand for funds and

⁵ Examples of investments from institutional investors include Gatwick Airport and HS1. The CBI recommends increasing the attractiveness of infrastructure investments through providing a package of benefits, such as tax incentives (CBI, 2012).

increased demand means higher prices. This is not, though, an argument against the IB. The rationale for the IB is that there are market failures in the UK in the provision of finance for infrastructure. A corollary of this argument is that more funds are therefore being channelled to other areas, including the equity and bond markets, artificially lowering yields there. The government and firms that raise funds on the equity market have benefited in the past from the market failures in finance for infrastructure; there is no good reason why they should continue to do so (Dolphin and Nash, 2012).

Innovative financial instruments

Some new investment models allow banks to continue to finance the greenfield (construction) phase while at the same time allowing them to exit projects earlier than in the past. Such models could be built using a 'split-finance' model as suggested by Bhattacharya, Romani and Stern (2012) and CBI (2012). Banks, thanks to their market expertise, due diligence and risk-bearing capacities, would be able to finance the more risky construction phase of a project, and leave the investment once the project reaches a stable operation level and can be refinanced in the capital markets. This strategy would benefit both banks and institutional investors: banks would be able to comply with the capital requirements under Basel III and institutional investors would benefit from the long-term stable returns offered by the management phase of the project without directly bearing any of the initial construction risk.

However, institutional investors could face construction risk indirectly. Any delay or over-expenditure in the first phase can lead to over-leveraged assets in the second phase, when institutional investors enter in the project. If institutional investors are involved in the discussions over the construction phase of the project, this risk could be mitigated. This could be done by structuring the financing of the entire project through a 'secondary debt' structure. Through this financial tool, banks and institutional investors commit funds to cover both the greenfield and brownfield (management) phases of a project.

Over the long term, this model should help to attract non-bank institutional investors in the greenfield phase. However, this would happen only once institutional investors are more likely to increase their risk exposure in exchange for higher returns (CBI, 2012).

Non-financial instruments

The BIB could be a key convener and syndicator of programs in a way that involves the private sector as well as other public institutions such as national development banks and sovereign wealth funds (i.e. co-financing arrangements and/or co-ownership with other institutions). This would be reflected in the composition of its institutional bodies which members would have a wide range of experiences and abilities--from building and running

institutions to project finance and market transactions--as well as technical and academic expertise in specific sectors, sustainable and responsible financial services and development banking. Moreover, the bank would favour a continuous communication with the private and public sector through the publication of periodic reports and the organisations of seminars and conferences.

While the Bank would not devise infrastructure strategy, it could play a crucial role as a centre for project coordination, evaluation, and implementation through building the right capacity and specific skills to meet the infrastructure challenge in new and important areas. This advisory function would be core to the Bank's ability to catalyse private co-investment.

Lastly, the infrastructure bank could serve as a coordination centre. Economic infrastructure cuts across several government departments and a potential investor must always check the different department websites to collect information about the investment opportunities and their details. The IB would simplify this process by providing reliable information on the key investment features of the project, such as the planned timing for each phase (construction, post-construction, and operation), forecast demand and risks etc.

Practical considerations

Three practical considerations that impact on the bank's establishment need to be considered: 1) bank funding; 2) bank activity integration into public accounts; and 3) compliance with the EU law.

First, the IB would need an initial one-off injection of capital. This could come from a number of sources including: general government spending, selling the government's stakes in RBS and Lloyds, national savings, a one-off levy on commercial banks, or a targeted round of quantitative easing (Dolphin and Nash, 2012). The volume of bonds issued by the IB will depend on the size of its capital base and its permitted leverage ratio. The Nordic Investment Bank and the European Investment Bank have relatively conservative leverage ceilings of 2.5 times their capital base.

If the IB were to operate with the same ratio and was capitalised with £20 billion over 4 years (i.e. £5 billion per year), it would be able to build an asset sheet with £50 billion. With an estimated UK infrastructure needs of 310bn (HM Treasury, 2012), and more than two thirds (around 206bn) of this financed by private capital, the bank would be able to share 25 per cent of this amount in a relatively short period of time⁶.

⁶ A similar approach was proposed by Dolphin and Nash, 2012.

Second, an IB would be part of the public sector in the UK. This implies that its financial liabilities – the money it raises in capital markets through bond issuance – would be counted towards public sector net debt but the bulk of its assets would not be netted off (only liquid assets are taken into account in the calculation of net debt). The creation of an IB would therefore lead to a substantial increase in public sector net debt as currently measured. Its activities would also increase measured public sector net borrowing. One solution would be to exclude the self-financing activities of the BIB from the calculation of public sector debt and borrowing, on the same grounds that temporary financial interventions (even though they are likely to stretch over many years) are now excluded, as the German KfW and the Green Investment Bank are doing (Dolphin and Nash, 2012 and Helm, Wardlaw, and Caldecott, 2009).

Finally, the UK government would have to gain approval from the European Commission before an IB could be established. The EU has strict state aid rules that prevent national governments from providing various forms of aid to companies. In the case of an IB, the Commission would need to be assured that any lending done by the IB was not simply undercutting commercial banks, and thus effectively subsidising the rates at which companies could borrow. The EU's state aid rules also carry a number of exemptions, generally in areas where it is widely accepted that market failure is prevalent in all advanced economies. These include financing aimed at promoting SMEs, innovation, and environmental protection. Increasingly, investments that can be demonstrated to have local economic benefits are also looked upon favourably, particularly if these benefits will accrue in deprived regions. Higher levels of state investment in business and infrastructure in deprived regions are permitted by the European Commission. The KfW, for example, offers more favourable loan terms for SMEs in regions that qualify for regional aid. If the IB's remit is confined to funding infrastructure spending, this should not be an impossible process to complete, given the UK's longstanding underinvestment in infrastructure in comparison with similar nations. In addition, facilitating infrastructure projects within the broader aim of rebalancing the economy away from London and the South East would also make it easier to sell the idea of a IB to the European Commission, which is concerned with lifting the performance of slow-growing and low-income regions.

Past and present UK institutions

Green Investment Bank

The Green Investment Bank was launched in 2012 as part of the government's commitment to setting the UK on course to deliver long-term sustainable growth in keeping with the UK's climate change objectives (Dolphin and Nash, 2012). Initially, the GIB will only have funding of £3Bn, from the government, but once public debt is on a downward trajectory, it will be able to raise funds in capital markets (subject to limits imposed by the government).

The GIB will invest up to £100Mn in commercial and industrial energy efficiency projects, as well as make major co-investments with private finance in offshore wind projects. Even then, though, the GIB will be some way short of a full-scale national bank. Skidelsky et al (2011) notes it could be the "nucleus of something more ambitious.

The GIB provides lessons for the Infrastructure Bank (Tott 2011). Over £200 billion in green infrastructure investments will be needed over the next decade. However, bank lending constraints and risk aversion by institutional investors is particularly potent green technology, where projects can involve new technologies and business models with insufficient track record. Compounding the investors' reluctance to invest is the fact that the original business innovator may not reap the full benefits of the technological innovation, despite having to incur the upfront costs of innovation and development. Instead, follow-on businesses may capture the benefits without having to incur any of the costs or risks. Through acting as a pioneer financier, the GIB aims to "crowd in" additional investment through creating new financing structures to overcome the high costs of due diligence for new projects and technologies. Moreover, the GIB aims to overcome credit constraints caused by information asymmetries by developing track records for projects and technologies. The GIB investment activity will follow a set of explicit purposes and is likely to have synergies with other types of infrastructure policy. The German KfW is similar in this regard: its activities are separate but complementary to its other activities.

Industrial and Commercial Finance Corporation

After WWII, the Bank of England and the then 'big five' clearing banks created the Industrial and Commercial Finance Corporation (ICFC) to address the structural small business financing gap. Through a regional branch network, the ICFC combined technical specialists with local business expertise to support local investments. In order to gain independence from the clearing banks, the ICFC turned to the market to raise funds. This led to a shift away from projects with moderate, long-term moderate returns to projects that provided high, short-term returns. In addition to highlighting the important role local networks and technical expertise play in government interventions, the ICFC experience demonstrates the ability of private capital to drive investment activity towards investments with short-term, higher returns (Tott, 2011; Skidelsky et al, 2011).

International Example

*The European Bank for Reconstruction and Development (EBRD)*⁷

The European Bank for Reconstruction and Development (EBRD) is an international financial institution (IFI) that mobilises foreign and domestic capital to foster transition towards “open and democratic market economies” (EBRD, 2012f).

The EBRD’s operating region stretches from central Europe to central Asia and has recently expanded to the North Africa and Middle East. The EBRD provides funds for well-structured, financially robust projects through additionality in order to avoid crowding out private capital (EBRD, 2012f). Moreover, it selects the projects to finance following sound banking principles – i.e. by ensuring the project returns are commensurate with the risks. The Bank shares this project risk by acting with private sector entities, multilateral lenders, and national export credit agencies. Unlike a commercial bank, the EBRD does not provide retail banking services. However, EBRD products are priced on a commercial basis.

The EBRD’s shareholder countries and organisations form a solid capital base that allows the Bank to act as an effective “demonstrator” on the frontier of commercial possibilities (EBRD, 2012f). The EBRD is AAA rated due to the security of its capital base and the quality of its loan portfolios. This enables the bank to raise funds cheaply in capital markets and to pass on the benefits of low-cost financing to its borrowers.

In addition to its regional and sectoral strengths, the Bank is unique from other IFIs in its ability to use a broad and flexible range of financing instruments in both the public and private sectors in order to support the different stages of transition.

For each project it finances, the EBRD assigns a team of specialists with specific sectoral, regional, legal, and environmental skills to provide technical assistance to banks, business and municipalities. Due to its deep regional and sectoral knowledge, EBRD plays also a critical role in the policy dialogue with governments and IFIs.

The EU/EBRD Municipal Finance Facility provides an example of EBRD’s engagement with infrastructure investment. The scheme is aimed at encouraging bank lending to small and medium-sized municipalities (SMMs) and their utility companies in EU accession countries (EBRD, 2010c). The EBRD aims to provide up to €75 million in long-term (10-15 years) lines of credit and €25 million for risk sharing on up to 35 per cent of the partner bank’s risk on a loan portfolio to SMMs. Pricing takes into account the credit risk of the partner bank, which makes loans up to €5 million with a maturity of 5 - 15 years available to SMMs.

⁷ For an overview on other international infrastructure banks such as the European Investment Bank (EIB); the Brazilian Development Bank in Brazil; The Nordic Investment Bank in five Nordic countries (Sweden, Norway, Denmark, Iceland and Finland) see Dolphin and Nash (2012) and Skidelsky (2011).

for infrastructure investments. The EBRD acts as a loan guarantor through providing funding in the event of a loan default.

The EBRD Sustainable Energy Initiative (SEI) provides an example of the Bank's ability to attract both foreign and domestic capital in transition countries' infrastructure projects, as well as to finance a small share of the total project cost. The SEI had a financing goal of €4.5 billion to €6.5 billion with a target total project value range of €15 to €25 billion. In 2012, the EBRD financed 21 per cent of projects in this area. Based on country and sectoral data for selected countries in the last 4 years, the EBRD has financed—on average— 34 per cent of the total costs in the transport (avg. 38 per cent), energy and power (avg. 32 per cent), and municipal and environmental (avg. 32 per cent) infrastructure projects (Table 1) (EBRD, 2012e).

Table 1: EBRD financial involvement in Transport, Power and Energy, Municipal and Environmental Infrastructure Projects

Year	Country	Sector	Number of Projects	Total Project Cost (million €)	EBRD Finance (million €)	% EBRD Finance
2009	Albania	Transport	6	327	134.2	41%
2009	Albania	Power and Energy	7	513.1	112.5	22%
2009	Russia Federation	Municipal and Environmental Infrastructure	35	3519	804	23%
2009	Russia Federation	Transport	29	4115	1494	36%
2009	Russia Federation	Power and Energy	15	4651	973	21%
2009	Turkmenistan	Transport (Port Development)	1	32.2	20.5	64%
2009	Turkmenistan	Power and Energy (Oil)	1	355.8	41.1	12%
2010	Latvia	Municipal and Environmental Infrastructure	2	216	44	20%
2010	Latvia	Transport	5	150	45	30%
2010	Latvia	Power and Energy	3	502	133	26%
2010	Moldova	Municipal and Environmental Infrastructure	5	100.9	43.1	43%
2010	Moldova	Transport	6	159.3	73.8	46%
2010	Moldova	Power and Energy	3	68.8	33.4	49%
2010	Slovenia	Municipal and Environmental Infrastructure	na	48	15	31%
2010	Slovenia	Transport	na	218	86	39%
2010	Slovenia	Power and Energy	na	107	65	61%
2012	Armenia	Municipal and Environmental Infrastructure	3	47	19	40%
2012	Armenia	Transport	3	200	62	31%
2012	Armenia	Power and Energy	4	156	92	59%
2012	Lithuania	Municipal and Environmental Infrastructure	10	216	89	41%
2012	Lithuania	Transport	2	218	76	35%
2012	Lithuania	Power and Energy	4	403	106	26%
2012	Slovak Republic	Municipal and Environmental Infrastructure	7	126	43.9	35%
2012	Slovak Republic	Transport	3	1379	234.8	17%
2012	Slovak Republic	Power and Energy	10	1592	313.4	20%
2012	Turkey	Municipal and Environmental Infrastructure	6	902	213	24%
2012	Turkey	Transport	2	83	37	45%
2012	Turkey	Power and Energy	4	804	203	25%

Source: Authors' data collection based on EBRD Strategy Reports for selected countries and years (EBRD, 2009-12).

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