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Found Money: Matching Canadians' Saving with their Infrastructure Needs

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March 8, 2007

Crumbling bridges and leaking pipes need fixing; new roads and power lines need building as cities cope with growth — Canada needs infrastructure investment. Last fall's *Advantage Canada* document from federal finance minister Jim Flaherty made infrastructure a priority. Yet governments face huge bills for health, education and income support. Infrastructure, once a big-ticket item, earns fewer votes nowadays.

Meanwhile, Canada is awash in saving. Canadians are aging and seeking to secure their retirements. Cash is flowing into corporate pension plans. Millions of individuals contribute to RRSPs. Huge assets are building in the Canada and Quebec Pension Plans and government-worker funds. This burgeoning saving is a major driver behind Canada's net flow of funds abroad — more than $30 billion annually since 2004.

Impressive as it is alongside Canada's needs, this dollar amount is only one facet of the opportunity that exists to better match Canadians' infrastructure demands with their saving. The Canada Pension Plan Investment Board made headlines in the UK in late 2006 when it partnered in a £2.2 billion takeover bid for one of the country's largest water companies. Private-sector and government-worker plans are scouting the world for investments in power and gas transmission, water, roads, bridges and tunnels, airports and ports. The reason: these assets are long-lived, with returns that are relatively stable and well correlated with real income growth and inflation — just what a population saving for retirement needs. More Canadian savers, large and small, would do well to get a piece of this action. So what's wrong? Why do we not fund more domestic infrastructure with domestic saving?

One major obstacle is political. Private participation in infrastructure is rare partly because Canadian governments tend to own these things themselves. Even though Canadian organizations such as the Ontario Teachers Pension Plan, Borealis, the Caisse, BC Investment Management Corporation and Alberta

* I thank Robin Banerjee, James Cowan, Paul Haggis, Nick Le Pan, Claude Lamoureux, Patrick Meneley, Finn Poschmann, Aaron Regent and several anonymous reviewers for comments, and absolve them from blame for conclusions and any remaining errors.

Investment Management have successful project track records that make them sought-after partners around the world, private participation is contentious at home. Government unions see private participation as a threat to their work practices. Opponents make spurious arguments about private profits, "tax leakage" and governments' lower borrowing costs — as though nationalizing Loblaws and Canadian Tire would make groceries and hardware cheaper! Charging users raises the stakes. When prices rise — think of Ontario's Highway 407 — a toxic mix of ideological and interest-based opposition can prompt regulatory changes and lawsuits.

A second obstacle is that these investments are large and illiquid. A revenue stream from a unique facility exposes investors to price or volume shocks that are hard to diversify against. Small investors have few options for buying into such projects, especially if they don't want too many nest-eggs in one risk-return basket. Large pension funds are better placed. But the lack of liquid markets in these claims is a problem for them too. Large stakes in real assets such as bridges and airports are hard to trade. And for investors large and small, changes in prices and yields are critical market information. Plan sponsors, participants and regulators increasingly want pension funds to mark their investments to market. Without regular quotations, all actual and potential parties to these transactions lack up-to-date assessments of the prospects and performance of projects.

The Highway 407 saga illustrates the resulting vicious circle. Controversy over fees and private participation led a new provincial government to try reneging on the contract. Although the consortium won in court, the episode cast a pall over public-private partnerships in Ontario. A market for claims on such investments would give price signals to the province and investors alike of the risk-premium appropriate for the province — akin to the premium countries with poorer records of servicing their debts pay on their debts. Absent such price signals, no deals are getting done.

Meanwhile, Canadian pension funds are looking abroad. The UK and Australia, eager for the dynamism and efficiencies private partnerships bring, give Canadian investors familiar legal, regulatory and business environments — and good treatment to boot. US states are getting into the act. One need not be an economic nationalist to wonder about the merits of policy-driven, cross-border investment, however. Investors large and small tend to prefer investing at home, where people, laws and business conditions are familiar. Local knowledge is likely at least as great an advantage in infrastructure. So what could Canadians do to mitigate some of the risks that hinder investment in infrastructure in their own cities, provinces and country?

One promising avenue is securitization. Over the years, financiers have designed various financial claims — from government bonds and company shares to futures, options and myriad instruments — that pool risk in a portfolio of underlying assets and then re-package and sell it to whoever is readiest to take it on. Lately, we have seen an explosion of securities backed by real property that is hard to buy and sell on its own, such as real-estate investment trusts, leasing obligations, and packages of residential mortgages.

Infrastructure securities would be a logical next step. Bonds and shares issued by companies running single large projects are familiar, and packaging different risk and return profiles to suit investors occupies many of Canada's brightest minds. Securities backed by infrastructure portfolios, with adjustments to ensure a good mix of credit quality among the available units, would create a potentially huge new class of assets for Canadian savers. Regulatory changes that allowed Canada's large pension plans to take large stakes and manage assets for third parties would let them originate and manage infrastructure assets in partnership with retail investors. And critically, securitized infrastructure could alleviate the problems that impede investments in Canadian infrastructure by Canadians.

Better market access for individual investors is the immediate, obvious benefit. A range of liquid infrastructure-backed securities would give individual savers and smaller pension funds access to a valuable asset class. Over time, intermediaries will create their own portfolios and sell units in them, as has happened with securitized investments in commercial real estate and mortgages — and as is happening in Australia, where Macquarie Bank and others are supplying retail demand. Pooling of underlying assets, as occurs in many securitized investments, could give small investors diversification, valuation and risk tranching benefits that they cannot easily achieve on their own. Trading in those units, moreover, would lessen pensioners' exposure to assets that lack regular price quotations. Perhaps counter-intuitively, falling prices for US mortgage-backed securities in late 2006 illustrate this merit — a high-frequency reminder of the state of the US housing market gave investors both incentive and ability to gauge their willingness to finance residential mortgages.

Intriguingly, securitized infrastructure might also improve the political climate. A single, large faceless capitalist — even a government-worker pension plan — is easy to attack, and gets little sympathy when legislation or litigation goes against it. Millions of small investors with pieces of a project in their RRSPs would be different. Neither big nor faceless, they would be ordinary people — users of infrastructure, taxpayers and voters — setting something aside for their old age.

The time is ripe, then, for another financial innovation in Canada. Individual savers need a piece of the infrastructure action. Governments can get attractive terms: the yield on federal real-return bonds is less than 1.8 percent, and deals such as the recent purchase of TSI Terminals at the port of Vancouver are commanding attractive multiples. Sophisticated international and domestic pension funds are ready to partner, offering the small investor large and experienced friends.

While political and project risks are inevitable, diversification and participation by myriad smaller investors can mitigate their effects. Securitized infrastructure could help close the gap between Canadian retirement savers looking for good opportunities, and the infrastructure repairs and expansions that need their support.

This *e-brief* is a publication of the C.D. Howe Institute. For more information contact:
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