Publication Number P-0808.CYE

WHITE PAPER

Original Publication Date: 09 November 2018

UFT
COMMERCIAL FINANCE, LLC

Converting Claims Risk into Yield Enhancement;

A New Role for Insurers in Infrastructure

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A New Role for Insurers in Infrastructure

"With little interest from the private sector, the only meaningful option for these projects is for them to win a share of whatever public sector debt capacity may be available from the government sponsor… So, these projects wait. Mother Nature strikes, rivers rise, storm surges hit, and property losses soar."

Look around -- there has never been a greater need for public projects aimed at delivering critical infrastructure necessary for public safety and natural disaster aversion. These "resiliency" projects not only preserve existing asset and property values, but make what would have otherwise been uninsurable assets insurable. Most prominent in this category is the backlog of projects sprinkled around the globe dealing with flood resistance and prevention initiatives. Organizations such as the Rockefeller 100 Resilient Cities initiative have identified countless projects in dire need of execution by working closely with their member cities in developing resiliency plans. Major projects like dikes, seawalls and flood barriers, reservoirs, and enhanced storm water management systems are just a few types of infrastructure that need a way forward.

In the era of public-private partnerships as they have been organized in years past, these types of projects – although critical to averting tens of billions of dollars of property losses annually – are often times the last to be executed. Not because these projects aren't vital, but, the fact is, rarely do these type of infrastructure projects produce a direct income stream or support a definable revenue generation model that can be directly applied to incentivize private lenders to allocate capital toward them. Private infrastructure funds, investment managers, pensions, and other investors cannot readily identify a profit motive for pushing capital in this direction. They certainly recognize the need and they probably don't expect a default by the government sponsor. Fundamentally, however, they have a fiduciary responsibility to optimize the use of funds they hold in their care and balance risks linked to their deployment for the benefit of the parties' whose interests they represent. Using strictly an economic measure, these types of projects don't compete very well with many other investment options available to investors in the broader marketplace, both when it comes to return calculations as well as overall investment liquidity.

With little interest from the private sector, the only realistic option for these projects is to win a share of whatever public sector debt capacity may be available from the government sponsor. Meaning, if they get addressed at all, almost universally, the way to pay for these projects has been through direct debt issued by the government sponsor through traditional municipal bond issuances or some similar vehicles. The problem is that many public sector sponsors today lack either credit rating, access to affordable credit enhancement, uncommitted tax revenue to cover debt service, or debt capacity on their balance sheets to consider taking on yet another bond obligation. So, these projects wait. Mother Nature strikes, rivers rise, storm surges hit, and property losses soar. Sadly, all this is usually accompanied by a loss of life – the most costly preventable loss of all had the target project been executed.

"This is an important first step in converting inherently long-term, portfolio-constraining investment projects into agile high-quality shorter-term fixed income investments that benefit directly from a quasi-sovereign risk profile."

All-Inclusive Bids™; a True Public-Private Partnership

Looking beyond designer financing proposals like "catastrophe bonds" or "resilience bonds" that in one way or another attempt to incentivize private investors to take on what is often unquantifiable insurance risk blended with investment risk, the advent of the All-Inclusive Bid[1] represents a welcome structural alternative. The All-Inclusive Bid provides a means of delivering infrastructure funding almost entirely from private sector resources. When paired with the Infrastructure CPC™ or Infrastructure Enhancement CPC™, government sponsors have a new way to initiate these important projects and private investors have a way to better define their credit and investment risk. This structure provides greater flexibility in how an investor positions "infrastructure" in its investment portfolio while improving expected long-term liquidity by coordinating:

(i) private sector infrastructure contractors to take on a more significant role in delivering the project;

(ii) the government sponsor's commitment of the asset being improved (land or existing asset) with an agreement on periodic contract payments; and

(iii) the application of dynamic analytics to quantify asset performance, define value, and measure risk.

Historically, regardless of a desire to acquire these "high-impact" investments that have a social or other non-economic investment rationale driving their selection, many investors are unable to participate. They are limited by investment guidelines that prevent them from allocating to a large selection of investments that either fail to hit a minimum performance benchmark or for which there is no foreseeable secondary market within a reasonable (say, 24 to 36 month) forward-looking period. Today, however, by investing through the CPC™ Platform[2] — with its highly standardized credit structure and legal framework coupled with the corresponding likelihood of a near-term OTC market to be followed by exchange-based trading — investors can look a little more optimistically at what would now be considered long-dated, illiquid infrastructure projects.

Utilizing the CPC to convert inherently long-term, portfolio-constraining investment projects into agile high-quality shorter-term fixed income investments is an important first step in enabling infrastructure investment. Expectations are that the CPC market will start seeing significant liquidity once market volumes of select CPC product types reach a minimum volume of US$10 billion (or the equivalent). This is expected within an anticipated twelve to eighteen months of the date of publication. With that new-found liquidity, investors in CPC products will be able to overcome what has historically been a major impediment to infrastructure investment.

While CPC market volume is in the process of building and corresponding market liquidity increasing, what is needed is an interim liquidity management tool. Investors need an option that enables them to engage in infrastructure investment without impairing the management of their core portfolio assets that are relied on to satisfy liquidity requirements. The Infrastructure Enhancement CPC™ could provide that option.

1 *See,* UFT Commercial Finance White Paper entitled, *"All-Inclusive Bid™ and the CPC™; Infrastructure with a Lighter Public Balance Sheet Load"*, published 25 October 2018.

2 *See,* UFT Commercial Finance White Paper entitled, *"Master Credit Participations; the Un-Securitization"*, published 15 December 2008, and updated 01 April, 2010.

Infrastructure Enhancement CPCs™

Like all Enhancement CPCs™, an Infrastructure Enhancement CPC is acquired by an investor "cashlessly™". Meaning that, since Enhancement CPCs are fractional ownership interests in credit enhancement facilities that are aimed at supporting a particular project, commercial business, or investment, they do not represent a cash-based grant of credit, such as one might expect with a conventional loan or line of credit. When an investor acquires an Enhancement CPC™, it delivers an acceptable form of credit support for the benefit of the target project or investment as its purchase consideration, rather than presenting cash. In short, the investor will cause the issuance of a specially formatted letter of credit that serves as both the support for the target project as well as the purchase consideration for the Enhancement CPC. That letter of credit will be deposited into a transaction-specific trust where it will then reside for the balance of the investment's lifetime. Setting aside the letter of credit issuance fees paid, the investor may likely never fund any amount of cash to a well-performing project, although it has gained tangible investment exposure to that project in the form of the Enhancement CPC. At first blush, this may not appear to be a catalyst that could change investor behavior. However, in actual practice, the impact is potentially truly far-reaching.

The Enhancement CPC reveals a whole new dimension of investment capacity that was previously inaccessible to an investor using conventional tools. The "ether" that is indigenous to almost every investment portfolio and has gone largely unnoticed and unexploited by the market can be opened up and put to use once asset managers get acclimated to the Enhancement CPC.

Metaphorically speaking, an investment portfolio is like a house with many rooms in which every square foot of floorspace represents available cash for investment. As the investor surveys the indoor landscape and arranges the furniture it has purchased, it not only consumes available investable cash with each new table or chair, but it consumes available floorspace. Eventually, when all the furniture is moved into place, conventional wisdom labels the house "complete". All available cash has been invested, and the core investment portfolio has been built.

The introduction of the Enhancement CPC is the equivalent of pointing out to the decorator that, although they've done a beautiful job with placement of the furniture, they forgot to think about window coverings, artwork and shelving to fill the ample vertical space on the four walls *above* the floor. This theatre of vertical space, although part of the same house with a shared foundation, means that there is room for even more furnishings that otherwise wouldn't comfortably fit or make sense if placed on the "floor" of the home. Plus, the selections for this new vertical canvas allow the decorator to develop a complementary or contrasting theme from that reflected in the underlying furniture floorplan.

Carrying this metaphor across to an investment portfolio, the recognition of the added investment dimension introduced by the Enhancement CPC helps an investor to optimize the efficiency of the original investment floorplan. It fills up the "empty space" floating *above* the core portfolio to pack more investments into the same "square footage" of cash assets under management without introducing conventional leverage and without necessarily correlating risks. In simplest terms, by using the Enhancement CPC to build an Enhancement Portfolio™ atop a core cash-based investment portfolio, an investor has the opportunity to:

(i) increase investment capacity;

(ii) yield enhance portfolio performance;

(iii) keep direct leveraged debt off of its books;

"The "ether" that is indigenous to almost every investment portfolio and has gone largely unnoticed and unexploited by the market can be opened up and put to use when an investment manager gets acclimated to the characteristics of the Enhancement CPC."

(iv) decrease reinvestment risk;

(v) diversify portfolio composition;

(vi) introduce long-dated or less liquid investments without opportunity cost; and

(vii) justify a "Cashless Investment™" in opportunities that may have otherwise been passed over.

The introduction of a well-thought-out Enhancement CPC investment strategy as part of a broader portfolio strategy draws more investment capacity from the same block of core assets under management to produce an independently risk modeled Enhancement Portfolio™. There, desirable and impactful investments can reside with virtually no opportunity cost and without disrupting the core portfolio strategy. The key is to identify those private investors that not only have an ***economic benefit in their investment portfolios*** when applying the Infrastructure Enhancement CPC™, but that also see a ***beneficial impact on their commercial operations*** when these "resiliency-minded" projects are enacted in reliance on their new-found investment capacity.

Getting the *Right* Investors' Attention

Investors today are on a quest for yield. The Enhancement CPC™ is becoming a useful option by driving performance and enhancing yield, diversifying investment exposure, reducing traditional leverage, managing investor balance sheet, increasing investment capacity or "dry powder", improving cross-border investment agility, better managing reinvestment risk, and significantly reducing opportunity costs associated with making long-dated or "total return" investments.

Recognizing the value of the investment attributes espoused above, one would think that the "discovery" of additional investment capacity and the potential for a new source of yield would be enough to inspire any investor to take a second look at engaging in impactful infrastructure projects of the ilk discussed earlier. Afterall, the Infrastructure Enhancement CPC™ doesn't consume available cash-based investment capacity. It doesn't cause a reallocation of capital away from an existing portfolio strategy or cause an investor to make significant structural adaptations to its core portfolio to access this new layer of investment capacity or apply this new class of credit asset. Unfortunately, sometimes an investor needs more than the promise of additional investment returns to inspire action. In this case, a broader understanding of the commercial value of the underlying infrastructure project to the investor is a key part of the equation.

"The most comprehensive and consistently capable investor class for infrastructure projects that mitigate property losses, avert the likelihood of business interruptions, and protect the highest volume of insurable assets has to include insurance and reinsurance carriers...."

Once investment friction has been reduced and more investment capacity availed by the introduction of the Infrastructure Enhancement CPC, the focus turns to an assessment of the additional value to be derived from the "business case" for investment in a particular project. In this regard, the most likely investor audience for any resiliency-linked Infrastructure Enhancement CPCs would be those specific entities that have something to potentially lose or something definitively at risk if the disaster-prevention project contemplated fails to get completed. The most comprehensive and consistently capable investor class for infrastructure projects that mitigate property losses and avert the likelihood of business interruptions has to include insurance and reinsurance carriers at the top of the list.

These entities are the ones whose very business proposition is built around managing and mitigating risks. More importantly, these organizations understand the commercial value to their bottom line of so doing. Following a logical path forward, the world's insurance and reinsurance carriers stand the most to gain in averting disasters that would result in an array of claims and losses. The most readily addressable of these disasters as mentioned earlier stems from prudent water and flood management,

"… historical attempts to convince insurance companies and large corporates to invest in the type of flood resistant infrastructure projects of which we speak using "designer bonds" that embed insurance risk with investment risk have been met with a lukewarm reception."

inclusive of the embedding of infrastructure assets necessary to reducing, if not eliminating, the type of devastating losses arising from notable storms, such as Hurricane Katrina in 2005 or Hurricane Harvey in 2017. In both cases, losses in excess of $100 billion were paid out; the vast majority of which could have been avoided had infrastructure projects of the type now being discussed been given the means for execution.

It makes sense that insurance companies would be capable of balancing the interests of their commercial operations (avoiding 12-digit losses from potentially preventable claims) against the interests of their investment operations (the optimization of yield on available cash under management) to conclude that it is prudent to accept less yield on their investments *if* that results in the prevention of losses incurred in insurance operations. The pragmatism of Ben Franklin, however – "a penny saved is a penny earned" -- sometimes has little to do with business decisions and the balancing of intra-company interests.

The practical ramifications of siloed internal operating environments as exist in most large corporate bodies essentially incentivizes one division or business group to compete for resources with another. That competition manifests with the application of key performance indicators that quantify "performance" in terms and measures applicable to the particular functions of that operating group. Senior management then uses that data to make decisions as to strategic direction, budget, corporate focus, and – cutting to the human element – compensation of the key personnel in each of those groups. Human nature and self-interest being what it is, what makes sense on a corporate level for the good of the holistic company, does not necessarily make sense when viewed through the lens of the interests of the individuals that drive the operations within that same company.

As you might expect, investment performance is almost the sole basis for quantifying the effectiveness of the investment group of any company. As a result, historical attempts to convince insurance companies and large corporates to invest in the type of flood resistant infrastructure projects of which we speak using "designer bonds" that embed insurance risk with investment risk have been met with a lukewarm reception. These structures make risk factors potentially hard to define and the proposed returns are often incongruent with what would be demanded by the marketplace for those largely indefinable risks.

"There is no bonus being paid to an investment manager for saving the company billions on claims losses that have not yet occurred."

When you get down to the essence of the matter, the skill and efficacy of every investment manager in an investment division is judged by the performance of the portfolio of assets that he/she has assembled. There is almost no motivation on the part of an investment manager to knowingly reduce the level of performance in his/her portion of the larger portfolio by buying into projects that benefit the broader interests of an insurance company by mitigating loss risk. That may be healthy for the company, but does little for the investment portfolio's net performance numbers. There is no bonus being paid to an investment manager for saving the company billions on claims losses that have not yet occurred.

Moreover, even if such an investment was undertaken, the infrastructure asset was built, and the company avoided billions in losses by a disaster

averted, the factor of *what wasn't lost* will likely never be quantified. In other words, the ultimate question to be asked is as simple as: why would an investment manager charged with extracting highest yields and best performance on assets in their care forego allocations to higher performing assets in order to allocate that same capital to lower performing and generally illiquid infrastructure assets with – in the case of catastrophe and resilience bonds – difficult to measure risks? The answer — the manager wouldn't.

Aligning Intra-Company Interests

The investment management side of insurance carriers is charged with achieving best performance on the company's assets under management. The insurance operations side is charged with accurately assessing insurance risk and then pricing and selling the insurance that addresses that risk. The investment side should be exhilarated by the prospect of finding new ways to drive up yield on a finite amount of capital under management without introducing additional traditional leverage risk to the portfolio. The insurance side should be exhilarated by finding ways to reduce losses, expand their market for insurance, and generate higher premiums (as the company's primary source of operating income) without incurring greater risks. Given these disparate motivations and regardless of common company identity, there has been very little economic incentive at the operational level to develop collaborative programs between the investment management and insurance sides of this "business coin". There needs to be a way to inspire cooperation between these groups that helps each to excel in their separate objectives while better achieving the broader goals of the company of greater overall profitability and market-reach.

The Infrastructure Enhancement CPC™ is a vehicle for coordinating these groups in support of project investments that drive each group's agenda without impairing existing operations. This product straddles the fence to simultaneously access a definitive, reliable new source of portfolio yield enhancement for the investment group and, when engaging in strategically relevant resiliency projects, mitigate identifiable insurance risks and open up a new base of insurance customers whose assets or businesses would have previously been deemed uninsurable had it not been for the completion of the target project. This internal leveraging of intra-company motivations in any corporate setting is prized, and its implementation is generally a precursor to increased profitability and growth.

"Given these disparate motivations and regardless of common company identity, there has been very little economic incentive at the operational level to develop collaborative programs between the investment management and insurance sides of this "business coin"…. The Infrastructure Enhancement CPC™ is a vehicle for coordinating these groups…"

By bringing this synergy into practice in an insurance company, the operations side of an insurance carrier can readily become a source of viable and attractive investment referrals, opportunity flow, and project prequalification with regard to strategically important infrastructure projects that drive down insurance risk upon completion. Specifically, it has the ability to improve the direction and overall performance of the insurance company as a whole by:

- taking stock of the scope and nature of high-flood risk markets to which the insurer has exposure;
- assessing specific infrastructure projects being scheduled by a government sponsor in those markets using an All-Inclusive Bid™;
- determining how each such project would directly result in a reduction in potential claims risk to the insurance carrier; and

- targeting projects that utilize the Infrastructure Enhancement CPC™ to enable a cashless investment by the insurer's investment group to enhance portfolio yield *without* disrupting existing portfolio strategies.

This synchronized approach to introducing critical, high-impact infrastructure projects to the insurer's investment portfolio through the Infrastructure Enhancement CPC™ can offer further portfolio diversification, greater liquidity and tradability, and a previously unavailable source of yield enhancement to the investment group that together will help the meet or exceed benchmarked performance and risk metrics applicable to the investment group. Similarly, holistic insurance company performance will be further improved when operational flood-related losses are markedly decreased in the period following completion of the various projects targeted and new customers can be acquired in markets that were previously uninsurable.

Conclusion

There is a potential multi-tiered impact across an array of broader market participants when we make it possible for impact infrastructure to proceed. Insurance company investment managers improve their performance by introducing the Infrastructure Enhancement CPC™ to a newly minted Enhancement Portfolio™. Government sponsors find a way forward for infrastructure projects that are critical to public welfare and safety. Insurance contractors get the funding they need to win contracts using an All-Inclusive Bid™ structure that reduces balance sheet drag on the government sponsor, improves contractor accountability, and keeps pricing efficient. Local businesses and citizenry are safer and their property is better protected than before.

With all of that said, the most direct impact, however, is on the insurance industry. It can be expected to broadly enjoy marked reductions of insurance claims in high-risk areas and an increase in the amount of insurance that can now be written in those same markets when once uninsurable risks and assets are deemed insurable. The execution of key strategic infrastructure projects with investment support from the insurance industry, but without taxing available investable capital of those market participants, represents a pivotal step in improving the efficacy of ***true*** public-private partnerships. Not only will this pioneering approach provide the government sponsor with the strength to help the public, but this new-world of enhancement-based investment could be the insurance industry's best way to help itself by assuring the completion of projects that reduce long-term catastrophic risk in markets that are currently most at-risk.

For more information about the CPC:

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