The Financial Inclusion and Markets Centre

Promoting finance that works for the economy, environment, and society

Call for evidence – Government's use of private finance for infrastructure Inquiry by the Public Accounts Committee

Submission by The Financial Inclusion and Markets Centre

INTRODUCTION

The Financial Inclusion and Markets Centre is a new unit of the Financial Inclusion Centre created to focus on: financial services policy and regulation; financial market reform; evaluating the economic, environmental, and social utility of finance; and understanding the implications of the intersection between finance and technology including developments in AI, big data, and other technologies. [The Financial Inclusion and Markets Centre | The Financial Inclusion Centre]

For further information, please contact Mick McAteer, Co-Director, The Financial Inclusion and Markets Centre (FIMC), mick.mcateer@inclusioncentre.org.uk

Summary

1. We are pleased to have the opportunity to make a submission to this important Inquiry. We are unable to comment on the preparations for the number of PFI contracts about to expire over the coming decade. We focus on the potential risks and harms for consumers and citizens of using various forms of private finance to fund core physical, green, and social infrastructure. We also focus on the funding of core infrastructure, not the delivery or building of infrastructure.

2. It is welcome that the Committee is considering the various forms of private finance currently being deployed to fund core infrastructure. The most well recognised form is the traditional private finance initiative (PFI) model which has a well-deserved poor reputation. But, in our view any analysis of private finance should also include funding of core infrastructure by pension funds, insurers, asset managers, banks, private equity, and so called blended, catalytic, and social impact finance designed to 'crowd in' private finance. While the corporate and legal form may be different these are all forms of private finance. The role of state institutions such as the National Wealth Fund (NWF) and GB Energy should also be considered.

3. Private finance is being deployed towards a range of public policy goals including: greening the economy; transforming the energy sector; building public infrastructure and services; building affordable housing; tackling homelessness; providing social care; levelling up and regeneration; and tackling poverty, financial and social exclusion. A whole new category of monetizable *social sector assets* has emerged because of the growing interest in ESG related concepts, and the financialisation of the economy and society. The state (central and local) is limiting its role in funding affordable housing, health, social care, specialist education, and other public services. Private finance seeks to fill that gap.[1]

4. To be clear, we are not saying the state should fund all critical infrastructure or that private finance should not have a role. However, we have concerns about the: costs of private finance borne by consumers and citizens (we call this the private finance penalty)

[1] Social Impact Finance | The Financial Inclusion Centre

and how the consequences of using private finance are not being explained to the public; the financial deregulation deployed to encourage private finance; the lack of meaningful transparency, governance, and accountability mechanisms to ensure consumers and citizens get a fair deal in commercial arrangements; the risks of ceding control over the funding of core infrastructure to largely unaccountable, powerful financial institutions; the wider financialisation of the economy and society and, more generally, the apparent absence of a strategic framework for determining how, where, and when to deploy state funding and private finance. We are at risk of repeating the mistakes of previous versions of PFI.

What is driving the growth in the use of private finance?

5. We do not yet know how much private finance in total will be deployed towards funding core physical, green, and social infrastructure. But, it is likely to be substantial. In opposition, the Government's green investment plan committed £28 billion ***a year*** in public investment over the term of this Parliament. This has been scaled back to £4.7 billion a year.[2] In other words, rather than £140 billion over the lifetime of a five year Parliament, this will be reduced to just under £24 billion. Government will instead rely even more on private finance to fund the green transition. GB Energy will not compete with the privatised utilities to provide electricity directly to consumers. It is a state owned investment vehicle intended to be capitalised with £8 billion of investment over the lifetime of this Parliament[3] to help finance and build renewable energy infrastructure. We have yet to see any real detail on how this would work with the private sector. From what we can see, it looks like its main role will be to de-risk projects for private finance. The National Wealth Fund is being capitalised with £7.3 billion over the course of this Parliament. The remit is to support the Government's growth and clean energy missions, and make 'transformative' investments across every part of the country. The NWF would set out to attract £3 of private finance for every £1 of public investment. We have yet to see the detail on how the NWF would attract that private finance. But, reading the initial report on the NWF, again the basic approach seems to be that public funds will be used to de-risk investments to 'crowd in' private finance sector.

6. The trend for using private finance is driven by the: i. view that the state cannot afford to spend more on infrastructure and there is no option but to turn to private finance to meet infrastructure funding needs; and ii. very effective private finance lobbying that portrays private finance as 'productive finance' which keeps funding costs off the state 'balance sheet' thereby saving society money.

7. The private finance sector has achieved a triple benefit. It has convinced politicians, regulators, and parts of civil society to support the:

- Creation of opportunities to generate high returns from *social sector assets.*[4]

[2] Keir Starmer slashes £28bn green spending pledge to £4.7bn in major U-turn

[3] Great British Energy Founding Statement

[4] Social housing, poverty initiatives, care provision and so on. See, for example: AlphaReal and Just Group invest in over 100 health and childcare facilities assisting approximately 1,800 people - AlphaReal Some civil society organisations are actively promoting the use of 'blended' or 'catalytic' finance to address social issues.

- Creation of favourable conditions to crowd in private finance and enhance the commercial attractiveness of funding core infrastructure. It has been effective at persuading the state and other actors to socialise the risks and privatise the rewards associated with infrastructure finance through the provision of corporate welfare in the form of de-risking and incentives; and successful at persuading policymakers and regulators to create favourable regulatory conditions.[5]
- Rebranding of return-seeking activities as positive sounding ‘social purpose’, 'social impact', ‘productive finance’, or part of 'blended', or 'catalytic' finance models so providing a reputational boost. The standards applied to determine whether different financing options are indeed genuine social impact finance rather than just conventional return-seeking finance repackaged as social impact are not particularly robust.[6]

The costs of private finance

8. Decisions on public spending and investment are, of course, a matter for government. But we are very concerned that the consequences of relying more on private finance have not been fully explored or explained to the public. Private finance by definition is more costly than state financing. Governments can use taxation, borrow, or indeed use innovative central bank funding models to generate the necessary financial resources at a lower cost than private finance.

9. Private finance expects to generate a return premium above the risk free rate before providing capital. The risk free rate is generally taken to be the yield on government bonds (Gilts). The fact that private finance expects a premium above the risk free rate means private finance will be more costly than state financing even if the cost of government borrowing rises.

10. The NAO reported that in previous PFI models the premium was between 2%-4% above government borrowing costs, in some cases 5%. In the course of our research for a report analysing the social impact finance sector, we found asset managers claiming to generate annual returns of between 8%-13% *net* investing in social housing.[7] Private finance deals can involve a number of parties. On top of the returns generated each of the parties will expect to generate fees. This pushes up the gross return extracted from a particular financing deal.[8]

11. The cost of financing matters. As the NAO points out, even small changes to the cost of capital can have a significant impact on costs. Paying off a debt of £100 million over 30 years with interest of 2% costs £34 million in interest; at 4% this more than doubles to

[5] Of course, this isn’t described as corporate welfare or deregulation. It is described in positive terms as ‘a partnership’ between the state and private finance, and ‘enabling’ regulation. A narrative is promoted that regulation stifles economic growth.

[6] Social Impact Finance | The Financial Inclusion Centre

[7] Social Housing | Sourcing & Development | Axxco The fact that these are net returns suggests that the gross return before charges and fees would be even higher meaning that private finance penalty compared to state funding mechanisms would be even greater.

[8] For example, in this case, Macquarie Asset Management (one of the biggest global infrastructure investors and criticised for its role in the difficulty Thames Water has found itself in Australia’s Macquarie among lenders to Thames Water’s parent company | Thames Water | The Guardian), acted on behalf of Phoenix Group (one of the UK life insurers which has been most active in lobbying for further weakening of the Solvency UK regime) to provide financing to Westminster City Council to purchase temporary accommodation from a housing association. We don’t know on what terms this financing has been provided or what fees Macquarie and Phoenix are extracting on top of the returns. Agan, this is part of wider issue of the lack of transparency and accountability relating to private finance. Macquarie Asset Management and Phoenix Group finances more than 350 temporary accommodation properties in central London | Macquarie Group

£73 million.[9] Scaling these numbers up to account for the amount of private finance being, or expected to be, deployed means that the additional costs of using different forms of private finance to fund infrastructure will be significant. Indeed, the private finance penalty will be even greater if compared to the cost of state funding generated by taxation or use of central bank funding mechanisms rather than compared to government borrowing costs.

12. The size of the private finance penalty will depend on a number of factors such as whether it is debt or equity financing (or blended structures) and the negotiating power of the respective parties in a transaction. Someone has to pay for these higher return expectations. Ceteris paribus,[10] using more costly forms of finance pushes up the costs of funding core services, building infrastructure, or tackling social problems. Infrastructure service users will pay more in higher costs and fees to meet those return expectations.

13. Some will argue that using private finance provided by insurance companies, pension funds, and asset managers is a 'win-win' – infrastructure, deprived regions, and the social sector gets the capital and savers/investors get better financial returns. Financial institutions will indeed provide capital if the price is right. But, if one group of citizens receives a high return, this is paid for by other citizens who pay higher costs and charges to generate those returns.

14. To be precise, it is not actually a zero sum game where savers/investors gain and other households pay. Using private finance creates a less-than-zero sum game. The returns *generated* are not the same as the returns *received* by ordinary investors because of the high fees extracted by financial institutions such as insurance companies and investment managers especially if alternative assets such as private equity is involved. Moreover, the private finance institutions that supply high cost finance and expect high returns are often based overseas so value is extracted from the UK economic system.

15. Moreover, it is not just the direct costs that should be considered. Private finance allocates capital to where it can generate the best returns and fees, not to where resources are most needed. This is not a criticism, it is just how the market works. So, as mentioned, to direct private finance towards public policy goals, governments and other agencies have been willing to provide corporate welfare in the form of deregulation, derisking or underwriting of risks, and incentives to make that finance commercially attractive.

16. A prime example of this is the deal the National Wealth Fund (NWF) has struck with two of the largest UK banks, Lloyds and Barclays. The NWF is providing up to £750 million in financial guarantees to underwrite £1 billion of loans from Barclays and Lloyds to housing associations to retrofit homes.[11] We are not told what rates the banks are charging on these loans only that these are 'competitively priced', an illustration of the lack of transparency on deals involving private finance.

[9] NAO PFI and PF2 January 2018

[10] Some may argue that the higher funding costs of private finance would be offset by efficiencies in constructing, delivering, and operating infrastructure. But, NAO studies do not support the claims that private sector efficiencies offset the private finance penalty.

[11] National Wealth Fund, Barclays UK Corporate Bank and Lloyds Banking Group join forces to unleash £1 billion to retrofit social housing | National Wealth Fund

17. The Government says it wants to attract overseas financial institutions. To do that, it will have to compete with other nations to attract that finance. So, it will have to offer overseas investors the opportunity to generate high returns and/or provide generous corporate welfare. Unless robust frameworks and safeguards are put in place to protect the public interest, the competition for international finance is likely to push up costs of funding priorities such as green and physical infrastructure.

18. We are concerned that the cost implications of turning to private finance is not being explained to the public. The impression is being created that using greater levels of private finance will save society money whereas the return expectations of private finance institutions makes this a more costly form of financing infrastructure. The costs will be passed on to service users.

Concerns about financial regulation

19. The main financial regulators, Financial Conduct Authority (FCA), Prudential Regulation Authority (PRA), and The Pensions Regulator (TPR) are coming under intense pressure from government and the private finance sector to promote the interests of the UK financial sector on the grounds that this will in turn support the growth and competitiveness of the UK economy. The main regulators were given a secondary growth and competitiveness objective to pursue this policy goal. However, we and others in civil society argue that what was meant to be a secondary objective has now become a de facto primary objective.[12]

20. Finance is seen by some as the 'goose that lays the golden egg'. The wisdom of prioritising the growth in the finance sector is questionable – allowing finance to become too dominant can have a destabilising impact on economic stability as well as wider social impacts such as exacerbating inequality. But, we have specific concerns about the current regulation of private equity and alternative assets and deregulatory measures being implemented to encourage the greater use of private finance to fund infrastructure. The main financial regulators are playing a very active role in trying to encourage the financial institutions within their remits to diversify their investments into private finance.

21. Private equity is considered a key vehicle for infrastructure investment. Yet, there are a number of concerns about the conflicts of interest and lack of transparency associated with private equity and other alternative assets.[13]

22. The main regulation that covers insurance companies, Solvency UK[14] already allowed insurers to use a mechanism called the Matching Adjustment to make their balance sheets look stronger than they really are.[15] It has been further weakened due to pressure from the insurance lobby who argued that this was needed for insurers to invest in the green transition, levelling up, affordable housing, and infrastructure. Moreover, the charge cap on

[12] Supporting growth is now one of the FCA's priorities FCA launches 5-year strategy to support growth and improve lives | FCA
[13] UK watchdog probes private asset managers over conflicts of interest An Inconvenient Fact: Private Equity Returns & The Billionaire Factory by Ludovic Phalippou :: SSRN
[14] Solvency II in the EU
[15] Submission to HM Treasury Review of Solvency II consultation | The Financial Inclusion Centre Regulation is masking the true condition of insurers

workplace pensions that protected workers from high fees has been weakened to encourage investment in infrastructure. There are concerns that further deregulation is on the cards.[16] Both the FCA and TPR are actively moving the focus away from costs towards a wider concept of value for money (VFM) with an emphasis on investment performance to try to encourage greater investment in private assets.[17]

23. The FCA has developed a new sustainable investment label for investment funds. The regulator has produced guidance on what could be considered eligible assets for firms intending to use the regulator's new labels. It includes an example of a hypothetical investment fund called the 'ABC Social Impact Real Estate Fund'. This fund would invest in and make profits from properties used by local authorities to house homeless people. These assets would count towards eligible assets for using the Sustainability Impact™ label. This opens the door for investment funds to claim that making profits from other social assets such as children's residential care should also be classified as 'Impact'. It surely wrong that investments which generate market level returns from hard pressed local authorities trying to tackle homelessness or caring for vulnerable children could be classified as 'social impact'. It cannot have been the intention of the FCA to legitimise what amounts to financial extraction dressed up as social impact finance.

Transparency and governance

24. We have concerns about the lack of transparency and governance relating to the role of private finance in funding core green, physical, and social infrastructure. We are not able to see on what terms partnership deals with private are struck due to the general protection given to commercial interests.

25. Moreover, the various task forces that have been involved in developing a large role for private finance have or are dominated by commercial interests, with little civil society representation to speak of.

26. The Productive Finance Working Group which recommended weakening the charge cap on workplace pensions is almost entirely dominated by private finance interests.[18] Likewise, the National Wealth Fund task force was dominated by private finance interests.[19] Of the financial experts now on the board of the National Wealth Fund, almost all have or did have a private finance background.[20] The British Infrastructure Task Force is almost entirely dominated by senior representatives of financial institutions which stand to gain from the greater use of private finance to fund infrastructure.[21]

Conclusion

27. As outlined above, we have significant concerns about the use of private finance to fund critical green, physical, and social infrastructure. We are very pleased that the PAC is scrutinising the role private finance as the deployment of this costly, largely unaccountable,

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[16] Rachel Reeves reveals plan to rip up banking regulations brought in after 2008 financial crash | The Independent Top British bank chiefs urge finance minister to scrap ring-fencing in letter | Reuters

[17] FCA consultation on a pensions Value for Money Framework | The Financial Inclusion Centre

[18] Productive Finance Working Group - current members list

[19] Green Finance Institute

[20] The Board of Directors | National Wealth Fund

[21] Government launches British Infrastructure Taskforce - GOV.UK

and poorly regulated form of finance is being expanded without any significant challenge up to now.

28. To reiterate, we are not saying that private finance should not have a role in funding infrastructure. However, we have concerns about the: costs of private finance borne by consumers and citizens (the private finance penalty) and how the consequences of using private finance are not being explained to the public; the financial deregulation deployed to encourage private finance; the lack of meaningful transparency, governance, and accountability mechanisms to ensure consumers and citizens/taxpayers get a fair deal in commercial arrangements; the risks of ceding control over the funding of core infrastructure to largely unaccountable, powerful financial institutions; the wider financialisation of the economy and society and, more generally, the apparent absence of a strategic framework for determining how, where, and when to deploy state funding and private finance.

29. We hope the PAC's inquiry will lead to greater scrutiny of the role of private finance in funding critical infrastructure. We urge the Government to ensure there meaningful governance, accountability, and transparency in the operations of agencies such as the new National Wealth Fund and GB Energy. Critically, to avoid a repeat of the PFI regime, we urge the Government to develop a strategic framework to ensure that private finance is deployed in an economically and socially useful way and that risk and reward is shared fairly so that we do not end up socialising the risk and privatising the reward.

This marks the end of FIMC's submission.
April 2025