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Long-Term Investment Roundtable

Policies for a new infrastructure investment model

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Public policies to enhance project financing and PPP in Europe

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The future of Europe depends on delivering together three objectives: fiscal consolidation, growth and social inclusiveness. One way to increase potential growth and social inclusion – with lesser budgetary resources - is long term “project investing” in the real economy.

Policies for enhancing investment in infrastructure, energy and TLC, but also in innovation, high education and SMEs, should become one of the central pillar of the new European “Growth Compact”. However, because of the budget constraints of the Fiscal Compact, the involvement of private capital markets and, more generally of global long term savings, is absolutely needed.

Demand for long term investment in project financing will grow globally at very high rates. Volumes in project and infrastructure debt reached around 350 billion US dollars in 2011 and have a grown of 15% annually over the last few years. As the world population continues to grow, emerging markets become industrialized, and developed markets need to replace aging infrastructure, the need for project financing will continue to grow. A huge amount of public works and financing, then, is going to be needed at the global level. It is estimates that over 50 trillion US dollars in capital investment will be required for roads, water, energy, airports, telecommunications, and rail between 2010 and 2030 in

OECD countries alone (source: OECD, *Infrastructure in 2030: Telecom, Land Transport, Water and Electricity*, 2011).

Then, the demand for long term capital investment is going to grow, while the supply of long-term savings may not keep up with the demand. This means higher costs for the projects and more competition on the global financial markets to attract saving to finance investments. There is therefore a general need to increase the worldwide share of financing for long-term investment (LTI) at the expense of the short-term financial and speculative investment. This is the reason why countries all over the world should create the best and most favorable conditions for foster LTIs with strong positives externalities for the economic growth and the human well-being. Among these conditions, as many OECD Reports have shown, I would like to highlight a good and stable political and regulatory framework, with reasonably low regulatory and bureaucratic costs, a reliable judicial system and efficient and technologically skilled public administration and government services.

Of course, much more is needed, at least in Europe, for enhancing project finance and PPP. The difficulties are now huge. Historically 90-95% of all project financing debt globally had been funded by banks. In particular, European banks still have around two thirds of the global market in this sector. But, after the crisis (which has today its main focus in the European banking system), the European banks have significantly scaled back new credit initiations. This is due to the effects of Basel III and EBA rules and to the rising cost of funding. New Basel III stability ratios, in particular, do not favor long term investment, requiring higher spreads. European banks are reducing risk-weighted assets, the denominator in their capital ratios, rather than increasing equity, the numerator. In the next 18-24 months European banks assets reduction is estimated at around 2/3 billion euros. Moreover, the new liquidity ratios, which are very important for project financing, do not help; similarly, long dated floating swaps, which are required to go over the waves, will have higher spreads.

The project finance bank market is still open for new financings, but tenors and amounts have been significantly scaled back. Tenors have largely come in to 7-8 years and maximum capacity for quality EU based projects is up to 2 billion in

the absence of a visible refinancing plan via capital markets. The cost has risen up (to 250-350 bps, with lesser quality projects up to 500 bps). Given liquidity conditions in the loan syndication market, few banks are willing to take material underwriting risks; “club” transactions are currently thus the norm execution. There are also a growing attempts, on the part of certain European banks, to sell their portfolios on the secondary markets.

The two ECB LTRO operations have temporarily eased the liquidity crisis. But they could not do much for medium and long term financing of the economy. Solvency II does not help the holdings of infrastructure assets by traditional long term institutional investors such as life insurance, pension funds and SWFs. The only LT players still active on the field are in Europe the large development banks (EIB, EBRD, KfW, CDC and CDP), but they cannot make it alone.

To support PF and PPP initiatives ECB may take into consideration a 6-9 years LTRO especially dedicated to long term investment with public guarantees (in exchange of long term collateral, including the best guaranteed PFIs). An EIB capital increase is supported by some but not all Member States; we believe is timely due. Finally, on the equity side we suggest to replicate the success story of the Marguerite Infrastructure Fund by creating new funds for innovation and mid-cap high growth SMEs.

The EU and Member States should support PF and PPP with tax incentives, guarantees and other initiatives to reduce regulatory non-financial risk. Tax incentives, to increase the attractiveness of the initiatives, may serve both growth and fiscal consolidation objectives, up to the point at which the incentive does not overpass the new fiscal revenues directly produced by the new investment, net of substitution effects.

Public guarantee schemes and/or tax incentives are necessary even for the success of the Project Bond Initiative (PB). Project bond market date back in the mid-1990’s. Issuance grew significantly via Triple-A wraps from monoline insurers (up to 26 billion globally). The market collapsed in 2008 with the demise of monolines and has since recovered (16 billion in 2011). Many notable transactions were executed in 2010 and 2011 with tenors as long as 25 years and

investment grade project bonds have priced in the 200 to 400 basis points range (comparable to bank debt cost, but with longer investors).

There are, generally, two types of project bonds: Those which are directly issued by the project companies (as it is the case of the EU project bonds); and those which are issued in the US directly by “Municipalities” and by “Public Authorities”, with strong tax rebates. During the 2008-2009 period, under Obama Recovery Plan, 200 billion dollars of Build American Bonds (BABs) have been issued. In the US the project bonds issued directly by project companies, without tax rebates, are fewer, worth less than 3 billion dollars. Then, the success story of the Obama’s BABs is due to the strong tax rebates granted to this kind of project bonds.

A special credit-enhancing guarantee by the EIB is provided in the Project Bonds initiative launched by the EU Commission. The project eligible to be financed by the PB guaranteed by the EIB are now limited to Ten-T, Ten-E and NGN. I suggest to extend guarantees and fiscal incentives also to other European LTIs with strong positive externalities for growth and competitiveness.

Project finance assets typically involve a strategic asset with high barriers to entry, a monopolistic position, and/or the certainty of demand and price that comes with a long-term off-take contract or revenue agreement; these attributes result in a stable and predictable cash flows. The long tenor of contract, such as power purchase agreements in power projects or long term concession agreements in infrastructure projects, give rise to lengthy and stable revenue streams. Finally, according to recent Moody’s report, ultimate recovery rates for project finance loan market are high (averaged 76,4% over the years 1983-2008 and 57% of recovery were fully restructured or repaid), relatively stable across economic cycles and in any case statistically higher than corporate loans. Even through the recent financial crisis, default rates for project finance debt remained at low levels.

Within such context, the EU Project Bond Initiative, together with the EIB, becomes crucial for the financing European recovery and infrastructure investment. Moreover, a new market of EU project bonds and the scaling back of bank lending to this sector translates into an important opportunity for institutional investors involvement, particularly given the long duration nature of

project/infrastructure asset. Today, institutional investors, already finance (directly or indirectly) about 40% of project financing initiatives. Infrastructure bonds represent an “asset class” which matches well long term liabilities held by life insurance, pension funds and SWFs. An involvement which may grow, also in Europe.

Solvency II, however, makes the holding of long-term bonds quite burdensome in terms of capital requirements. Capital charges are, in fact, higher for financial products with same rating but longer durations. Since the default curve and the expected recovery rates are typically much better for infrastructure bonds than for corporate bonds, it is crucial to stimulate a regulatory effort to introduce a more favorable capital requirement for infrastructure bonds. This would help to create an attractive asset class which could be placed between government bonds (zero weighted) and corporate bonds¹.

The involvement of institutional investors in the project bond market, moreover, is still looking for an execution model to invest in infrastructure assets. Material institutional participation in project finance will evolve differently by region/currency, and manner of execution needs to be reconciled with certain key attributes of project financings. There are still limited number of asset managers with skill set and system to manage project bonds.

The long term institutional industry, however, is wary that the challenge is coming ahead and ready to take it. Some countries, such as Canada, are leading the game, with up to 15-20% infrastructure assets in insurance and pension funds overall asset allocations. Even though, at least for the time being, banks will remain central to the sector, Basel III will be an important catalyst to driving significantly more funding into institutional markets.

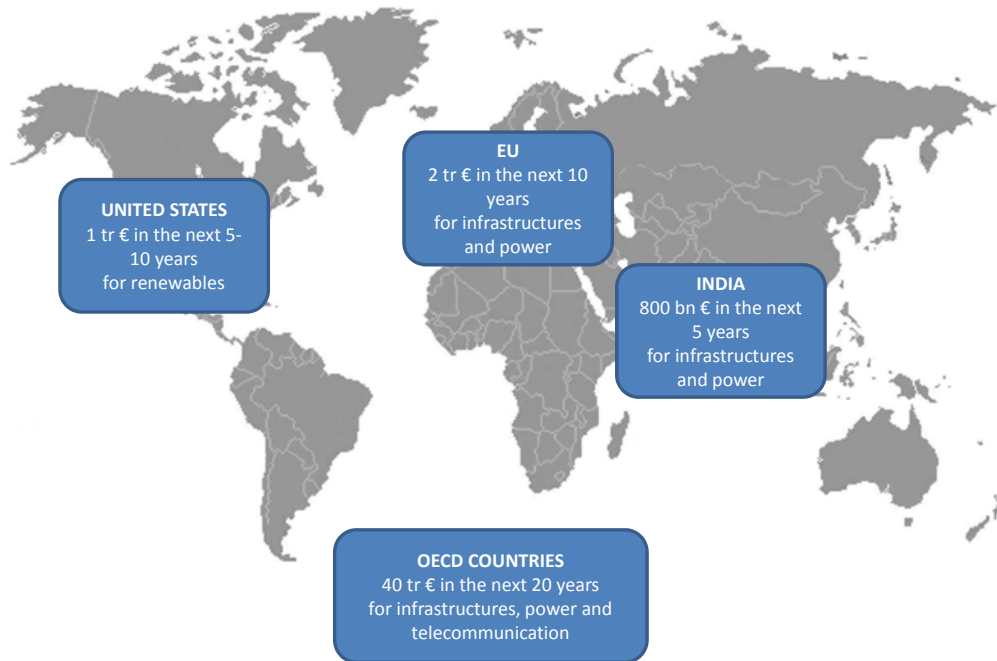
¹ Under Solvency II standard formula, a A-rated bond and a Triple-B rated bond with the same duration of 25 years would attract exactly the same capital charge (of more than 32%), thus basically vanishing any EU-supported credit enhancement’s attempt and altogether the EU resources associated.

To facilitate the transition, however, we have to act both on the equity side (considering the process of private and public deleveraging) and on the debt side, especially in the first years of the PFIs, i.e. during the construction phase. More generally, to give a strong boost to LTIs in Europe we need to rephrase the regulatory framework (Basel III, Solvency II, accounting rules and EBA norms) that - as today - penalize LTIs. It is not a question of easing the financial stability framework, but to find fine-tuning solutions which assure financial stability and at the same time help the financing of economic growth, without which financial stability, as a whole, could tomorrow itself be at risk.

The definition of a new regulatory framework more friendly to LTIs is suggested by the Jacques de Larosière and Mario Monti Reports. It is also suggested in five recent EU Commission's Communications. This general consensus is still waiting to be translated from words into deeds. The time to do so is now.

Figure 1.

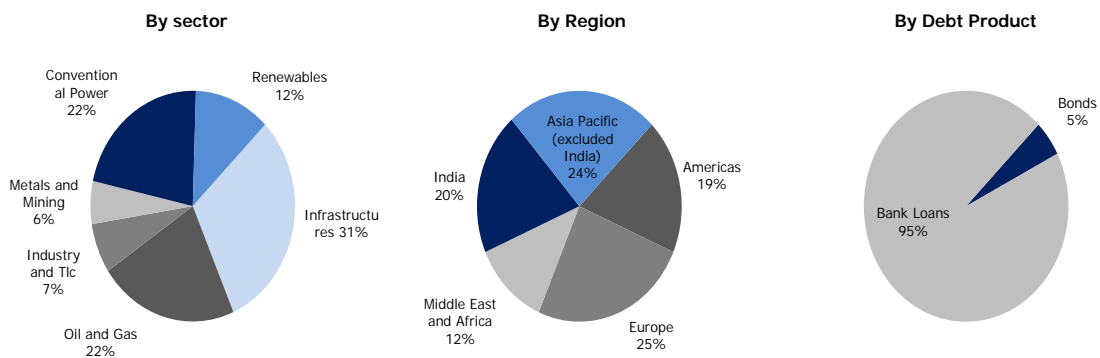
40 Trillion the Global Demand for Investment in Infrastructure, Energy and TLC in the Next 20 Years



Source: Dealogic

Figure 2.

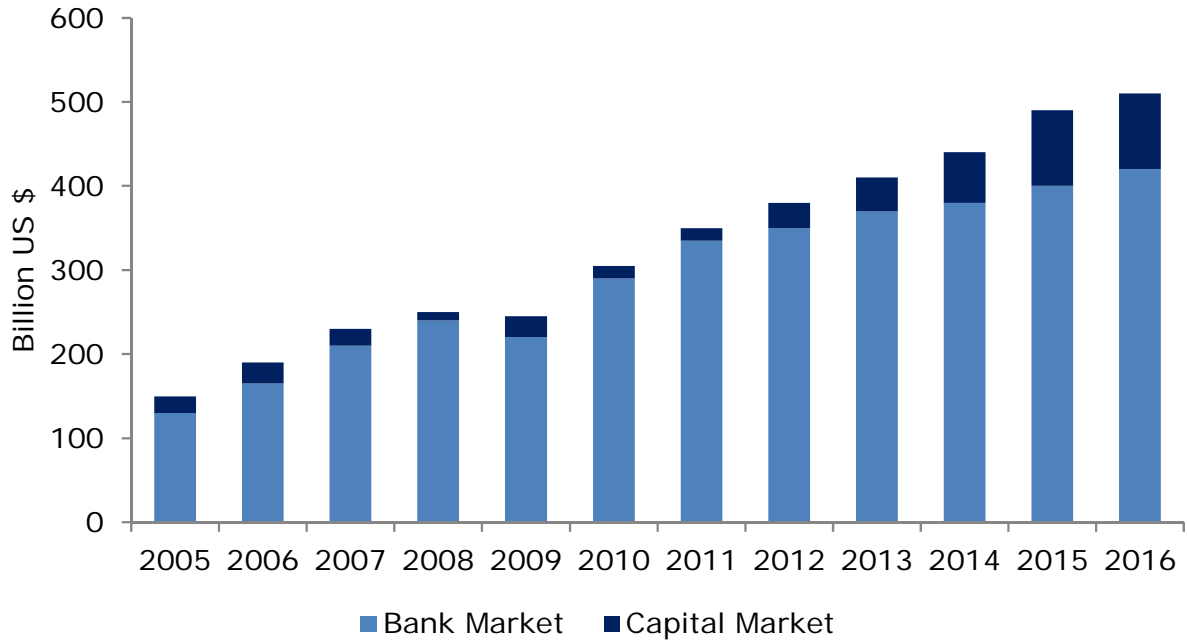
Global Project Finance Debt Market Profile (2011)



Source: Dealogic

Figure 3.

Historical Project Finance Volumes and Forward Outlook



Source: Dealogic and Citi