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Impact of new financial regulations on Project Finance
State of the play and ways forward

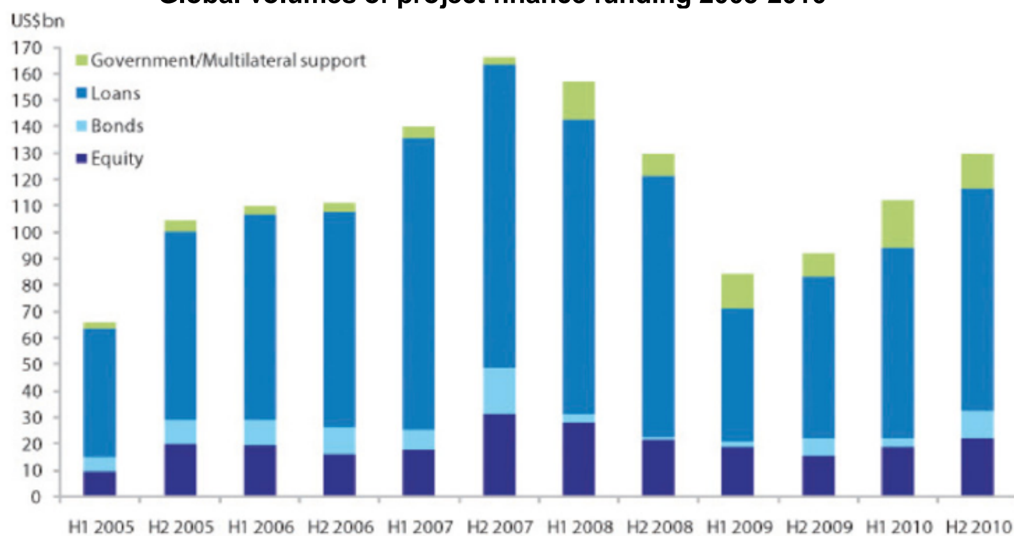
Project Finance activities usually refer to the long-term financing of infrastructure and industrial projects: strategically-important, capital-intensive assets, utilities, services and primary industries, fulfilling major economic and social needs.

Project Finance is vital to support economic activity and growth. According to a report published by the OECD, the average total annual infrastructure investment in road, rail, telecoms, electricity transmission & distribution, and water is likely to account for approximately 2.5% p.a. of world GDP through to 2030[1]. If electricity generation and other energy-related infrastructure investments in oil, gas and coal are included, this proportion is likely to rise to around 3.5% p.a. of world GDP. Over the next decade, it is estimated that some EUR 1.5-2.0 trillion of expenditure will be required across the EU to fund investment in transport, energy and information & communication networks.

What is Project Finance?

Project Finance has emerged as an efficient way to fund capital-intensive and strategically important industries where underlying business risk is relatively stable and predictable–typically matching stable, predictable net operating cash flows with long-term sources of funding. Project Finance is often used to fund the development of energy, natural resource, transport and social infrastructure assets, and the provision of associated public services.

Global volumes of project finance funding 2005-2010



Source: Moody's, Infrastructure Journal – Global Infrastructure Finance Review 2010

The financial sector has been subject to a very ambitious set of reforms coordinated at the global level by the G-20 countries and the Financial Stability Board (FSB) since the crisis of the US subprime mortgage market and the failure of Lehman Brothers. These reforms, many of which have already been translated into European law, aim at reinforcing the resilience of the financial institutions. They will however have a deep impact on the way the economy is financed, particularly in Europe.

[1] OECD (2006), "Infrastructure to 2030: Telecom, Land Transport, Water and Electricity", p.29.

1. How the new regulatory framework for banks and insurance companies will impact Project Finance

1.1. A flow of new regulatory constraints

Among the different regulatory initiatives adopted at EU level, two will have a direct and structural impact on Project Finance:

- **Basel III** has been adopted in December 2010 by the Basel Committee on Banking Supervision (BCBS) to create more resilient banks and banking systems and review the current Basel II framework that has been widely adopted in Europe. Basel III is being currently transposed in the EU with the adoption of a new capital requirement regulation and directive for banks and in the US (the US agencies in change of banking supervision have issued in June 2012 a Notice for Proposal to adopt Basel III in the US). Basel III introduces three changes that will have an impact on Project Finance:

    - Basel III aims at enhancing the quality and quantity of capital by requiring banks to hold a higher percentage of Tier 1 capital (completed by supplementary buffers for systemic banks) and putting in place a series of additional capital charges for different risks (exposures to financial institutions, derivative transactions).

    - The new Basel framework also requires that a bank meet both short-term and longer-term liquidity ratios. These two ratios (the Liquidity Coverage Ratio–LCR–in a 1-month horizon, and the Net Stable Funding Ratio–NSFR–in a 1-year horizon) measure the bank's potential cash outflows against hypothetical inflows derived from the activities of the bank or the sale of high quality assets. Both are calibrated to reflect a stressed-market situation. The Basel Committee has introduced specific observation periods (until 2015 for LCR and 2018 for NSFR) and reviews for these two liquidity ratios; however the pressure from financial markets is high for banks to respect the new ratios well before that.

    - Finally, Basel III aims at reducing the bank leverage by imposing a new gross leverage ratio with which banks must comply.

- **Solvency II** is an EU-wide common regulatory framework that will replace existing prudential regulation for insurance companies. It is a risk-based economic measurement of capital requirements for insurance companies organised under a three-pillar framework: quantitative requirements, supervisory activities & internal risk governance and reporting & disclosure to regulators and to the wider public. The two key principles underpinning Solvency II are market consistency (assets and liabilities valued at market price) and risk-based capital requirements (higher capital requirements with greater risks taken). The new regime represents a significant change in the basis for regulating insurance business in the EEA. Its target implementation date is January 2014.

1.2. Anticipated effects of Basel III and Solvency II on Project Finance

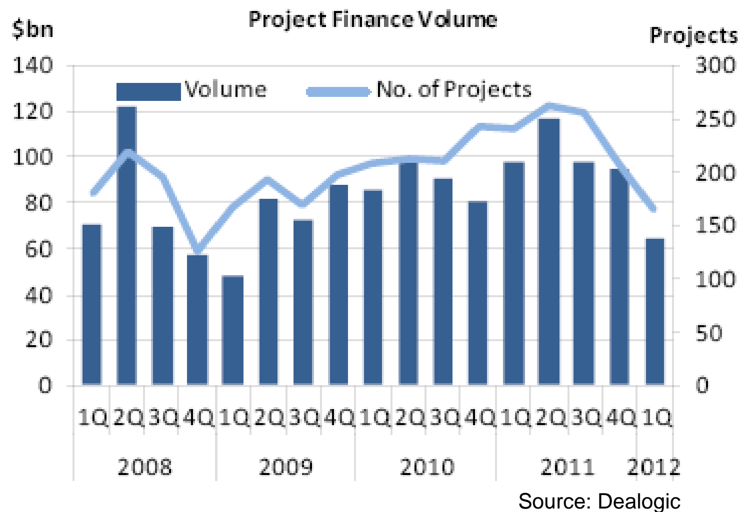
The new regulatory framework for the financing of long-term projects and infrastructure will have two major consequences:

1.2.1. An increase in the cost in capital of these activities for the banks, part of which will be reflected in the price of the debt for long-term projects

It seems almost inevitable that an impact of Basel III would be for cost of financing long-term projects to increase significantly. So far, the market has not reacted uniformly, some institutions have anticipated the new capital requirements while others have maintained their previous loan pricing models waiting for the final rules before making changes to pricing. Nonetheless, the global Project Finance market has clearly shown signs of reduction in volume in the first half of 2012, in a more challenging economic environment. In France, the programme of Public-Private Partnerships (PPP) is

now complete. In the Middle East and North Africa, a traditionally active area for Project Finance, the flow of infrastructure projects has reduced over the last few months.

Moreover, many financial institutions including commercial banks have been adversely impacted by the Eurozone crisis. The stress has been particularly acute for banks domiciled in euro area periphery countries such as Greece, Portugal and Ireland. Some banks have curtailed origination activity and/or sold sizeable portfolios of Project Finance loans (e.g. portfolio sales announced by Banco Espirito Santo and Bank of Ireland). Other banks have withdrawn from the Project Finance sector altogether (e.g. Royal Bank of Scotland).



Source: Dealogic

1.2.2. A significant reduction in the length of loan maturity

- **LCR**: The new short-term liquidity ratio may reduce the attractiveness to lenders of Project Finance packages that include letters of credit and revolving credit facilities (although the latter are less important in Project Finance deals).
  Letters of credit and revolving credit facilities are penalised by the net cash outflow assumptions under the current draft of LCR: a bank will need to secure high quality liquid assets in an amount at least equal to its liabilities in respect of the full amount of any undrawn revolving credit facilities and a certain percentage–to be determined by national regulators–of the amount of any undrawn letter of credit.
  Moreover, the bank issuing letters of credit will not benefit from any corresponding indemnity commitment from other banks as a liquid asset for the purposes of calculating the LCR. From a Project Finance perspective, this would inevitably have an impact on the overall attractiveness of any finance containing a significant LC element.

- **NSFR** will require banks to match their assets that have a maturity of greater than one year with liabilities that also have a maturity of greater than one year (in each case, allowing for certain weightings of different assets and liabilities). Whilst the typically long tenors of Project Finance debt need not necessarily be matched by funding of the same tenor, banks may feel the need to use relatively long-term funding to back Project Finance debt, in order to avoid the risk and cost involved in regularly rolling over shorter-term funding.
  Further, 100% of Project Finance debt which is due within one year (as opposed to, for example, only 50% of corporate debt which is due within one year) must be backed by liquidity with a maturity of over one year.

The change in structure of financing available for Project Finance will have a negative impacts on the cost and attractiveness of Project Finance debt. Commercial banks may move towards shorter-term Project Finance with large final repayments, with bank debt possibly being limited to the construction phase. It will be very difficult for a bank to provide the client a 30-year loan with no protection against pre-payment: as refinancing would only be possible if pricing goes down, therefore banks would

effectively be providing their client with a free option on long-term financing, which is incompatible with the Basel III liquidity ratios.

2. Way forward: how to finance long-term infrastructure projects in Europe

The present memo does not elaborate on the potential evolutions of the liquidity or the leverage ratios within Basel III. Both ratios are subject to a review by the Basel Committee before turning into minimal requirements for banks. However, it is too early at this stage to know what direction the global banking regulators will take–even if it is not the interest of anyone to hamper long-term lending.

As financial markets, banks and insurance companies are already anticipating the implementation of the new regulatory requirements–in particular for long-term products–we think it is of utmost importance to think about how we could foster project finance in this new environment.

2.1. Less players, more local ones

From what we can see today, several players are actively pulling out of the Project Finance market or limiting their business closer to their home market. This situation could be exacerbated by the difficulties to access funding in foreign currencies (such as USD for European banks).

Although there continues to be a competitive market for Project Finance bank debt, the liquidity and capacity of this market has been eroded by the Eurozone crisis and the potential funding gap between the demand for and availability of long-term Project Finance debt due to the new liquidity requirements will not improve the situation.

2.2. Technical adjustments to take into account the shorter tenors of project financings

As already mentioned, banks may move towards shorter-term Project Finance, mostly limited to the construction phase. However this does not make the refinancing issue disappear. To solve it, refinancing risk may be mitigated by cash sweeps and margin step-ups towards the end of a mini-perm (the short-term financing used to pay off income-producing construction or commercial properties). In addition, sponsors may be required to bear some or all of the refinancing risk by accepting direct recourse by banks.
If the timing and amount of refinancing costs and potential resulting increases in debt service costs can be anticipated, we may see sponsors exploring whether projects' revenue streams can be sculpted in advance, to enable borrowers to meet these additional costs when they fall due.

2.3. Enlarge the sources of refinancing for project finance debt

Project Finance is a desirable means of financing public infrastructure projects that might otherwise have been financed directly from government borrowing or tax receipts. In other words, PFI/PPP style lending helps reduce budget deficits, in the short term. In the medium term, staving off a credit crunch has positive net economic benefits.
A natural vehicle for this activity may be disintermediation of the banks' balance sheets via the sponsored development of the Project Bond market. Is there a potential to finance the construction phase (e.g. 5 years) via bank markets and the operation phase (e.g. 20 years) via the bond market?

- Project Bonds could be single projects (for big ones, such as bridges or prisons) or multi-project CLOs/SPVs for smaller projects (e.g. rail station improvement). The latter could resemble a specialised mini-bank; however, small projects (say EUR 30 million) could be financed locally via affinity marketing i.e. "the residents of Leicester invest in the 5% 30-year bonds to build the Leicester by-pass road"
- Sovereign wealth funds could also be a natural investor segment to expand liquidity

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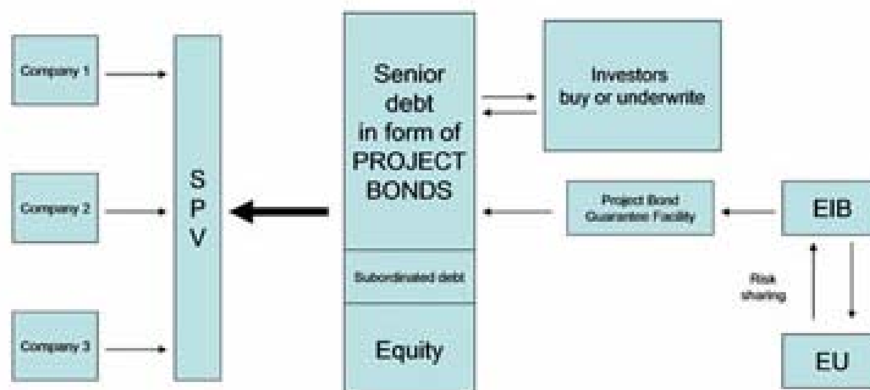
Reducing credit risk via state or supranational guarantees/wraps could also have a material impact on future investor demand and ability to expand the investor base away from banks.
Enhancing returns by giving tax breaks for both institutional and retail investors (something like the UK's NS&I exemption for savings) would create a natural public support for Project Finance lending.
Promoting Project Finance lending through adjustments to the ECB LTRO collateral eligibility or preferential risk weightings or capital requirements in bank/insurance regulations could also support regulated investors lending in this sector.

2.3.1. European Project Bonds

This field has been open in Europe with the Project Bond Initiative, with the European Investment Bank (EIB) playing a central role in the process. EIB offers guarantees within the EU for senior and subordinated debt. Under Basel II and most probably under CRD4, EIB guarantees attract a zero risk weighting which results in lower capital charges.

The Project Bonds Initiative aims to revive and expand capital markets to finance large European infrastructure projects in the fields of transport, energy and information technology.
The pilot phase of the Initiative will start soon, once the Trans-European Networks (TEN) Regulation the Competitiveness and Innovation framework Programme (CIP) Decision will be amended and budget allocations will be redeployed.

Structure of the Project Bonds Initiative



Source: European Commission

The Project Bond Initiative will certainly need to be improved in the coming months. In particular, it may be necessary to tackle some issues such as the level of subordination of the EIB (either towards other lenders or in terms of maturity). Indeed, the subordinated debt facility will need to be deeply subordinated to senior debt, such that the interests, rights and actions of the senior debtholders cannot be adversely affected nor constrained by the rights or actions of the subordinated debt provider.

Moreover, current proposals contemplate a maximum guaranteed amount under the guarantee facility of 20% of senior debt. This number may need to be reviewed, as it is the key factor enhance the average senior debt service coverage ratio of the project.

In case of an unfunded partial guarantee of senior debt service payment obligation, some issues also need to be clarified. In particular, it is unclear whether the maximum amount of the guarantee would change over the term of the senior debt, and if so, how, or whether unutilised amounts under the guarantee facility could be drawn to pay outstanding senior debt balances following an acceleration.

Finally, with just EUR 230 million of EU money in its pilot phase and no numbers yet for a full programme, the EIB Project Bond Initiative is certainly not sufficiently calibrated to take care of the funding needs of the Project Finance market in the coming years.

2.3.2. Finding new long-term investors

- **Pension funds**' funding may typically be longer term than funding raised by banks and thus be better suited to the long-term nature of Project Finance debt. However, pension funds have traditionally looked for a higher return than was available under pre-credit crisis project financing. Yet, as Basel III is implemented and the increased costs to banks of holding Project Finance debt feed through to higher bank margins, pension funds may find themselves able to compete on pricing.
  An obstacle to pension fund involvement in infrastructure projects may be their traditional lack of expert teams to evaluate and monitor such projects. If a critical mass of pension fund investment in infrastructure debt is reached, then any reluctance to establish such teams may be overcome. Infrastructure debt funds may help to target pension fund investment, due to the portfolio effect in relation to risk and enhancing stable returns.
  Pension funds typically look for inflation-linked returns. If an element of inflation linking can be introduced into a project's revenue entitlement, a financing or equity structure could be devised to ensure that the pension funds' return reflects such inflation linking.

- **Insurers and reinsurers** may also find that project finance debt is a good fit with their long-term liabilities.
  However, they may find their ability to hold Project Finance investments constrained by Solvency II, which limits the maturity of investments to ten years. It remains to be seen quite how it will treat Project Finance debt for the purposes of determining the value of an insurer's or reinsurer's own funds when calculating its solvency capital requirement. Similarly, if the European Commission brings pension fund investment rules into line with Solvency II, that may have an adverse effect on pension funds as a source of infrastructure funding.

- **Infrastructure debt funds**: such funds may prove a useful conduit for institutions to invest in project finance debt, whilst spreading the risk across a portfolio of assets (see the initiatives launched by Barclays and Sequoia in July 2011).