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The future of infra funding: playing Cassandra

Paul Forrester - Mayer Brown

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Rare indeed is the opportunity to call out a journalist for understatement, yet recent editorials in Infrastructure Journal may require it. Specifically, there have been two recent articles: John Kjorstad's "The bumpy road ahead" on 07/10/11 [1] and Rene Lavanchy's "European project bonds: Maybe this time" on 12/10/11 [2] that expressed only mild concern regarding current "issues" in the bank financing markets for infrastructure and modest optimism concerning the availability of project bond financing to fill the bank "gap," respectively.

Unfortunately, neither view (at least in the mind of this author) is justified by current market developments and probable future regulatory events. In my view, the bank "issues" are much larger and more intractable than Kjorstad suggests and the prospects for European (and other) project bonds more pessimistic than Lavanchy describes for the reasons below.

1. Pending Bank and Insurance Capital Reforms – It's All About the Money, Honey…

While they have long-dated implementation schedules, pending bank and insurance capital reforms will have significant consequences for project lending. Solvency II (for insurance and reinsurance companies and the "quicker" of these reforms) is scheduled for implementation by 2013 and the fifth quantitative impact study (QIS) therefore has recently been completed. Current estimates suggest that these new insurance capital requirements will have only a modest impact on affected insurers.

In contrast, Basel III (for banks) has phased-in implementation to be completed by 2019 and an initial quantitative study has only recently closed. Early estimates of the impact of Basel III suggest a much larger impact on banks than Solvency. An analysis of the additional capital required for major European banks under Basel III was of the order of €200 billion.

Several material details of both Solvency II and Basel III remain unclear (and occasionally highly contentious – e.g., the Basel III surcharge of 1-2.5 per cent for "systemically important banks) and, as a result, make projections about impacts more speculative than usual.

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However, it is clear that, particularly for banks, that required capital will be greater and of higher quality (that is, more expensive) than under current capital requirements, the effect of which will inevitably raise costs for lending activities. Moody's has recently estimated that, holding other factors constant, the cost of Basel III will be an additional 80 basis points in interest cost to typical borrowers.

The more immediate impact of known increased capital and difficult or unattractive markets for bank common equities, is that banks will seek to sell riskier exposures to reduce risk-weighted exposures (the denominator in the regulatory capital ratio).

Early evidence of this is shown in the recent announcements that French banks (under some capital "pressure" due to their perceived significant Greek and other sovereign credit exposures) are seeking to shed project finance and other capital intensive exposure portfolios. This "forced" selling is unlikely to yield favourable returns for the sellers and, in any event, these sales inevitably will put upward pressure on pricing for new project financings.

2. "Natural" Funding at Risk – If It Ain't Broke…

Historically (and with demonstrable success), banks have provided financing for a wide variety of projects during construction and the related post-construction funding obtained in capital markets or from institutional investors, who provide fixed rate long-term funding.

The market has explored a variety of structures to accommodate this "natural" funding with borrowers assuming refinancing risk to a greater (e.g., mini-perm bank facilities with no committed long-term take-out) or lesser degree (more conservative bank construction facilities with committed long-term take-outs, which are usually more expensive due to the required compensation for the long-term take-out commitment).

Banks are well-suited for construction funding as they have the ability to provide flexible funding (sometimes required to accommodate the unforeseen exigencies of construction financing) and charge a floating rate (although for material construction periods this cost can be capitalised and/or hedged). However, longer financing tenors exacerbate their asset-liability mismatch and to offer fixed rates would expose them to substantial basis risk due to their usual floating rate deposit base.

In addition, the general discomfort of the capital markets with construction risk has occasionally been "bridged" by financial guaranty insurance issued by so-called "monolines," whose poor financial performance during, and as a result of, the recent financial crisis has caused many thereof to fail or, at a minimum, to return to their traditional "core" municipal financing guarantees.

It is unclear, what (if anything, with the possible exception of initiatives like the European Project Bond 2020 Initiative) will replace the monolines for this vital financial intermediation function. At some point in the future, it is possible that there is sufficient experience with,

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and resulting confidence in, underwriting of project construction risk that institutional investors are able to provide related financing, although even this would not "solve" the need for "natural" flexible and floating rate funding for project construction.

Moreover, even if institutional investors obtained such experience and confidence (although how they do so remains an important and unanswered question), it is reasonable to expect that they would require compensation for commitments to fund following completion on traditional long-term and fixed rates, which would also increase the costs of project finance.

3. Reforming the Rating Agencies – It's True They Whiffed on Subprime, But What Has that To Do With…

The recent financial crisis (and the perceived role of the rating agencies therein) has generated significant current and pending reforms of the rating agencies, the effects of which have yet to be fully felt (and, in fact, there may be different effects in the US and the EU due to these reforms being different between the US and the EU and, in some cases, substantially so); however, these effects generally include more requirements for transparency of related methodology(ies) and evaluation of the performance of assigned ratings.

Of course, these reforms substantially over-reach a relatively limited problem with the rating performance of a narrow asset class (subprime RMBS) and a very limited range of structured arrangements that invested therein (SIVs and multi-sector or ABS CDOs).

It is reasonable to expect that these reforms will make it more difficult to obtain desired ratings for project finance (regarded as an effective pre-condition to obtain capital markets financing and certainly a useful (if not necessary condition) to obtaining financing from institutional investors), since project finance methodologies are generally more subjective in nature, less susceptible to precise quantification than other asset classes and frequently require the exercise of significant discretion and professional judgment in the application thereof.

As a result, the ratings for project finance are likely to be less transparent and more difficult to compare for performance than ratings for other asset classes. At a minimum, this would seem to raise issues for rating agency regulation and the possibly draconian result that either the rating agencies no longer provide ratings for project finance or that their rating methodologies are or become so conservatively biased that there ratings no longer provide economic value to project sponsors and borrowers. As a further result, the "access" to capital markets and to institutional investors is likely to be more constrained.

4. Diversifying the Institutional Investor's Project Finance Portfolio – Say What?

It is a key tenet of modern portfolio management theory that proper diversification is required for consistent superior risk-adjusted return. What is appropriate diversification

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benefit for project finance within an institutional investor's portfolio? Attentive readers will see this as the same issue that I have previously noted for the proper structuring of a project finance CLO portfolio[3] and for which the rating agencies makes relatively untested assumptions.

This is an important question, however, as the premise of increased capital markets appetite for project bonds is that institutional investors will allocate portfolio capacity – this assumes that risk managers at institutional investors will be comfortable with the degree of correlation of project bonds with the balance of that investor's portfolio and the corresponding diversification "benefit" of investments in project bonds compared with other traditional or alternative investment opportunities.

Conclusion

For these (and other) reasons, there is some justification for scepticism regarding the prospects for increased bank funding for projects at a cost that borrowers will find acceptable, for project bonds to "fill the gap" if banks do not so fund, and for project bonds to find additional investors willing to invest therein in the absence of recognised ratings.

Paul Forrester is a partner in the Banking/Finance practice of Mayer Brown LLP, an international law firm, and is based at their Chicago office. He regularly represents developers, sponsors, lenders, investors and others in a wide variety of projects, including conventional and alternative energy and power, transportation and industrial projects. Forrester can be reached at jforrester@mayerbrown.com

NOTES:

[1] "The bumpy road ahead" by John Kjorstad, Infrastructure Journal 07/10/2011, available here.

[2] "European project bonds: Maybe this time" by René Lavanchy, Infrastructure Journal 12/10/11, available here.

[3] "Project Finance CDOs after the credit crisis" by Paul Forrester, Mayer Brown, Infrastructure Journal 25/08/11, available here

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