

Creating capacity - Project finance lenders search for a new paradigm in changing regulatory times

We hear consistently about the existence of a ‘funding gap’ for infrastructure of many kinds in the UK and elsewhere¹. This shortfall exists against the backdrop of a number of high profile political statements from a variety of world leaders, perhaps most notably Donald Trump, about the need for increased investment in infrastructure.

One of the main reasons for the shortfall is undoubtedly a reduction in the volumes of available funding from traditional sources of funds namely the major project finance banks (the “**Commercial Lenders**”)².

In some markets, particularly in North America, insurance companies (including reinsurance companies), pension funds and investment funds (“**Institutional Investors**”) have begun to step in to the gap left by Commercial Lenders. But in most markets, including in Europe, whilst this trend has begun, it has yet to gain substantial traction as some Institutional Investors continue to shy away from construction risks.

It is clear from the decreasing margins for large scale projects that available ‘bankable’ deals in infrastructure are still strongly contested by Commercial Lenders. However, there is an acute funding gap at the smaller end of the market, especially where projects are being developed by sponsors who don’t have particularly strong institutional relationships with Commercial Lenders.

This paper looks at some of the regulatory challenges for specialised lending in the form of long-term project finance. It identifies some of the mitigants traditionally used to alleviate regulatory capital concerns and goes on to discuss how these techniques may evolve, especially in the context of increasing demand for exposure to infrastructure backed returns from Institutional Investors.

Specialised lending

The Basel Committee on Banking Supervision (“**Basel Committee**”) sets global standards to be adopted and implemented by national regulators, for capital requirements and other prudential regulation of internationally active banks. Within the Basel II framework for bank risk-based capital requirements,³ banks using the internal ratings-based or ‘IRB’ approach would treat project finance and similar structured financing for infrastructure and physical assets as ‘specialised lending’⁴.

³ Basel Committee, International Convergence of Capital Measurement and Capital Standards A Revised Framework Comprehensive Version (Jun. 2006) (BCBS 128). There have been a number of later additions and amendments, not yet directly affecting the provisions on specialised lending.

⁴ According to Basel II, “Within the corporate asset class, five sub-classes of specialised lending (SL) are identified. Such lending possesses all the following characteristics, either in legal form or economic substance:

- The exposure is typically to an entity (often a special purpose entity (SPE)) which was created specifically to finance and/or operate physical assets;
- The borrowing entity has little or no other material assets or activities, and therefore little or no independent capacity to repay the obligation, apart from the income that it receives from the asset(s) being financed;
- The terms of the obligation give the lender a substantial degree of control over the asset(s) and the income that it generates; and
- As a result of the preceding factors, the primary source of repayment of the obligation is the income generated by the asset(s), rather than the independent capacity of a broader commercial enterprise.”

BCBS 128 para. 219. “The five sub-classes of specialised lending are project finance, object finance, commodities finance, income-producing real estate, and high-volatility commercial real estate.” Each of these sub-classes is defined [in paragraphs 221-227].” BCBS 128 para. 220.. For calculation of capital requirements using the IRB approach, banks that do not have supervisory permission to use own estimates of probability of default (PD) are required to assign each specialised lending exposure to one of five supervisory categories (strong, good, satisfactory, weak, default), broadly corresponding to external credit rating categories (from investment grade through sub-investment grade to default) according to specified “slotting criteria”, and apply a risk weight (70%, 90%, 115%, 250% or 0%) corresponding to the assigned supervisory category. BCBS 128 paras. 275-276. The “slotting criteria” for the different types of specialised lending refer to, among other things, financial strength, political and legal risk, transaction or asset characteristics and security package). BCBS 128 Annex 6.

¹ The Greater London Authority has estimated this to be somewhere in the region of £4.6 billion per annum for London alone. London Infrastructure consultation documentation- GLA.

² It was estimated in a recent paper by Standard & Poor’s that project finance lending fell by 17% in 2016. Basel III Regulations Spark innovation as Project Finance banks try to stay in the game 31/1 2017.

Analysis performed by rating agencies shows that specialised lending exhibits a low risk of default when compared to other categories of lending⁵. This can, in part at least, be attributed to the fact that major specialised lending transactions have traditionally been carried out by experienced teams in Commercial Lenders, who have been able to structure deals in a bespoke manner to address, allocate and mitigate project-specific risks as they arise and often to provide for large amounts of collateral from counterparties.

It has been estimated that European Commercial Lenders had specialised lending exposures of over €1 trillion in Q3 2014⁶. Hence specialised lending can be seen as a particularly important tool for supporting economic growth through the financing of investment in infrastructure in Europe and given this level of exposure, the Basel III/ IV reforms discussed below are predicted to have a particularly restrictive impact on established lenders in Europe. We suspect, given the significant rankings of major Japanese banks in project finance 'league tables', that the reforms will also have a disproportionately acute effect on these institutions. American banks, which, in recent years have been less active in this type of financing, are unlikely to be affected to the same extent.

The new rules of engagement

The Basel III reforms, put forward by the Basel Committee following the global financial crisis of 2007 and 2008, aimed to strengthen the regulation of both capital and liquidity in global financial markets. Finalized in late 2010 and completed and revised in the following years,⁷ these reforms are in the process of implementation and scheduled for completion January 2019. Basel III includes:

- Increases in the amount and quality of capital that Commercial Lenders are required to maintain against their risk-weighted assets: While the basic capital requirement remains at 8%, under Basel III the criteria for eligible capital have been tightened; a higher proportion of required capital must be in the form of common equity; capital "buffers" effectively increase the capital requirement, and still higher capital requirements apply to globally systemically important banks (G-SIBs);

- Leverage ratio: Banks will be required to maintain at least 3% common equity tier 1 capital against gross assets and off-balance sheet items (without any risk weighting), effectively limiting their leverage to 33.33x. Again, higher leverage ratio requirements apply to G-SIBs; and
- Liquidity ratios: The liquidity coverage ratio (LCR) requires Commercial Lenders to hold "high quality liquid assets" at least equal to 30 days' projected net cash outflows in a highly stressed scenario, while the net stable funding ratio (NSFR) (to become mandatory from 1 January 2018) will require banks to have "available stable funding" at least equal to "required stable funding", meaning they will need to fund more of their longer-term assets (such as project finance loans) with more costly equity or longer-term obligations.

Of these changes, the heavier risk-weighted capital requirements and new leverage ratio constrain banks' lending overall, while the NSFR particularly affects longer-term assets including project finance loans.

Following Basel III, the Basel Committee has continued to revise the capital framework, publishing a series of proposals which market participants are already calling "Basel IV". These include:

- Proposed revisions to the "standardised approach" for calculating risk-weighted assets, including methods to determine risk weights using measures in addition to or instead of external credit ratings.⁸ Under these proposals, a project finance loan that does not have an "issue-specific" external credit rating (or where the use of such ratings is not allowed) would have a risk weight of 150% during the construction phase and 100% during the operation phase⁹ (for comparison, under the Basel II standardised approach, an unrated claim on a corporate borrower would have a risk weight of 100%¹⁰ and, under the Basel II IRB provisions on specialised lending, the risk weights range from 70% (for the supervisory category roughly corresponding to investment grade credit ratings) through 90% and 115% (for below investment grade) to 250% (for high-risk credits);¹¹

5 Moody's Default and Recovery Rates for Project Finance Loans, 1983-2015.

6 EBA Consultation on Slotting criteria for specialised lending, COREP data Q3 2014.

7 The main documents include: Basel III: A global regulatory framework for more resilient banks and banking systems (Dec. 2010, rev'd Jun. 2011) (BCBS 189); Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (Jan. 2013) (BCBS 238); Basel III leverage ratio framework and disclosure requirements (Jan. 2014) (BCBS 270); Basel III: the net stable funding ratio (Oct. 2014) (BCBS 295); Standard: TLAC holdings – Amendments to the Basel III standard on the definition of capital (Oct. 2016) (BCBS 387).

8 Basel Committee, Second consultative document – Standards – Revisions to the Standardised Approach for credit risk (Dec. 2015) (BCBS 347).

9 BCBS 347 para. 41.

10 BCBS 128 para. 66.

11 BCBS 128 paras. 275-276

- Proposed “capital floors” that would require Commercial Lenders using the IRB approach to maintain a minimum level of aggregate capital by reference to the aggregate capital that would be required under the standardised approach.¹² Thus, even Commercial Lenders using the IRB approach would be affected by higher risk weights applicable under the revised standardised approach; and
- Proposed restrictions on application of the IRB approach to certain kinds of assets.¹³ For project finance and other specialised lending, the Basel Committee proposes to remove the IRB approaches for specialised lending that use banks’ estimates of model parameters, leaving only the standardised approach and the IRB supervisory slotting approach.¹⁴

A summary of the current proposed changes is set out below:

BASEL III 2011

- Stricter definition of capital
- Higher required ‘equity’ capital
- Leverage ratio
- Liquidity Ratios:
 - Liquidity Coverage Ratio
 - Net Stable Funding Ratio

BASEL III/IV (CURRENT PROPOSALS)

- Revised standardised approach
- Capital floors based on standardised approach
- Limits on use of model-based approaches

How this all turns out in the final guidelines may have a significant impact on the availability of specialised lending exposures with low risk profiles. The removal of internal modelling under consideration and the introduction of standardised output floors would result in increases in specialised lending risk weights that would, compared to the present position, be highly penalising for such low risk exposures in particular.

This could mean a major increase in capital requirements for long-term project financing and other specialised lending products. As a result, Commercial Lenders could shift capital from project finance to other activities.

Institutional Investor appetite for infrastructure investment

In line with developments in North America and Australia, Institutional Investors in Europe have been showing an increased appetite in recent times for investment into the energy and infrastructure space.

Pension funds and insurance companies (especially those in the ‘Life’ sector) have long term liabilities and hence tend to focus on longer term stable returns over and above short term gains. In recent years, the returns from the traditional categories of investment which yield these kinds of return, such as gilts and blue-chip corporate bonds have been squeezed. However since many infrastructure assets display these risk/return profiles and often have the added benefit of a direct link to RPI/CPI (which is attractive to a range of Institutional Investors). As a result, many Institutional Investors are beginning to look for ways to increase their exposure to the energy and infrastructure sector.

Certain Institutional Investors, namely the Insurance Companies are subject to their own capital requirements pursuant to Solvency II. However, on April 1 2016, the European Commission recognised particular features for infrastructure debt and approved a reduction of 30% in Solvency II’s capital charge on qualifying rated infrastructure debt (when compared to similarly rated corporate bonds). Some commentators have pointed out that differing capital requirements between Basel III and Solvency II could provide an avenue for ‘regulatory arbitrage’ between Commercial Lenders and insurers. However, despite an increase of 22% in project bond issuances (bonds forming the preferred documentary architecture for many Institutional Investors) we are yet to see project bonds provide a significant challenge to traditional debt structures provided by Commercial Lenders.

Mitigating regulatory capital requirements

One way Commercial Lenders have sought to mitigate the requirement to maintain more capital under Basel III is to employ ‘originate-to-distribute’ models of financing. It seems likely that increased capital requirements will lead to an increased focus on these models in the coming years and we will discuss in the next section how these models may evolve further in the coming years and months to transfer exposures to institutional investors.

¹² Basel Committee, Consultative document – Standards – Capital floors: the design of a framework based on standardised approaches (Dec. 2014) (BCBS 306).

¹³ Basel Committee, Consultative document – Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches (Mar. 2016) (BCBS 362).

¹⁴ BCBS 362 para. 2.1.

LOAN SYNDICATIONS AND ASSET DISPOSALS

At the most basic level, these models allow Commercial Lenders to originate and underwrite transactions and to subsequently sell them down in the syndications market, thus reducing their original requirement to maintain capital. This allows Commercial Lenders to use their transaction skills to take loans on to their books and then to migrate them (often following construction) to a more capital efficient platform.

Rather than approach mitigation on a transaction by transaction basis in order to free up capital for future lending, Commercial Lenders are also increasingly looking to sell portions of their project finance books, either to other Commercial Lenders or to alternative investors such as Institutional Investors.

One particular issue for Commercial Lenders wishing to 'distribute' project finance loans comes where loan exposures are linked to derivatives exposures. Commercial Lenders often wish to retain derivatives exposures and may fear, on certain transactions, being left with 'orphan' derivatives following the sale of underlying portfolios of loans (such positions can be adverse from an administrative, regulatory and/or accounting perspective). Dealing with this potential problem has become an increasingly important issue in structuring new transactions with the intercreditor relationship between lenders and hedge providers in particular, coming under increased scrutiny.

SECURITISATION

Alternatively, Collateralized Debt Obligations ("CDOs") can be used by banks to facilitate the transfer of risk associated with long-term project financing to capital market investors.

CDOs enable Commercial Lenders to repackage multiple project risks associated with an underlying portfolio of bonds or loans into a single marketable security. The term CDO covers both collateralised bond obligations and collateralised loan obligations ("CLOs").

The latter of these, CLOs, can be split into cash CLOs and synthetic CLOs. In a cash CLO, the originating Commercial Lenders sells the underlying loans to a special purpose vehicle, which issues bonds secured on those loans to investors in order to fund the purchase. In a synthetic CLO, the originating Commercial Lenders retains the underlying loans but purchases credit protection in respect of them (often in the form of a credit default swap ("CDS")) from investors who thus take on the credit exposure in respect of those loans.

Structured credit products exposed to subprime mortgages or mortgage-backed securities, and especially those trading on market value of the underlying collateral, rather than CDOs backed by project finance loans, were predominantly responsible for the seismic losses suffered by many in 2007 and 2008. The prevailing stigma post-2007 treated all CDOs as being similarly responsible for these losses and as such the CDO market suffered as pools of new investors dried up. To this day, the CDO market remains depressed when compared to its pre-2007 levels.

New issuers are cautiously re-entering the market and it is hoped that more stringent regulations such as 'Basel IV' will boost issuer and, in turn, investor confidence in CDO products. There is, therefore, some cause for optimism with regard to the performance of CDOs moving forward, and as such, could we see appropriately structured CDOs backed by long-dated project finance loans (especially those linked in some way to inflation) emerge as an interesting investment opportunity for Institutional Investors?

Blazing new trails

As mentioned above, reducing returns in traditional sources of investment have meant that Institutional Investors are increasingly seeking exposure to infrastructure assets. However, such investors often don't have the transactional specialisations or the agency and asset management capabilities to originate and/or deal with large scale portfolios of project finance loans. This is particularly the case in markets such as the UK and Japan.

COMMERCIAL LENDERS AS MEDIUM TERM LENDERS AND LONGER TERM FACILITATORS?

The recent transaction between a Commercial Lender and one of the UK's largest pension funds perhaps flagged a new direction for sales of portfolios of loans to Institutional Investors in the UK, with the relevant bank retaining an interest in a \$3.1bn portfolio of loans sold (presumably for administrative and/or credit retention reasons) and undertaking to monitor credit and manage the portfolio for the relevant fund in return for a fee.

Does this perhaps herald a greater focus on formal relationships between Institutional Investors and Commercial Lenders? Will energy and infrastructure funding markets become characterised with Commercial Lenders providing advisory/agency functions on long term exposures and potentially bridging long term energy and infrastructure assets through construction before transferring them to Institutional Investors?

NON-PAYMENT INSURANCE POLICIES (“NPIS”)

Another approach (introduced to the market in 2012) that has taken off recently in response to rising regulatory capital requirements is the use of NPIS. This has brought major insurance companies into the market and in certain instances has allowed them to take the capital strain of energy and infrastructure investments.

NPIS take effect in relation to a set percentage (usually less than 50%) of a loan and may enable the Commercial Lenders to improve the credit rating of a loan by ensuring that the first loss from a default is transferred to the relevant insurer. By improving a loan’s credit profile, an NPI reduces the capital that a Commercial Lender has to maintain in relation to that particular loan. NPIS pay out in relation to the percentage of the loan covered should the borrower default under the terms of the loan, and are becoming increasingly popular as a relatively cost-effective method of averting the need to introduce further (potentially competing) parties to a loan agreement.

Elements of the market remain sceptical as to the suitability of NPIS for the wide scope of infrastructure projects that remain financed by long-term lending. For instance, whether it will prove cost-effective to obtain insurance in relation to the long term financing of infrastructure projects in emerging markets remains to be seen. Likewise, with investment grade projects, syndicating may prove to be more cost-effective than obtaining insurance.

It should also be noted that providers of NPIS are often careful to ensure that their policies are characterised as ‘insurance’ rather than ‘financial guarantees’. Mayer Brown’s specialised insurance finance team can offer advice on the subject.

CDS PROTECTION

A further approach that is worthy of consideration is the use of CDS. These allow entities that may not wish to deal directly with portfolios of project finance loans to nonetheless gain exposure to them.

CDS used in this way may allow a Commercial Lender effectively to sub-participate out the risk associated with the portfolio of loans to another entity in return for a premium. Although the economic effect of CDS can be similar to that of NPIS, crucially the provider of protection can be a non regulated entity such as an investment fund.

Careful note needs to be taken however, in relation to the various legal issues that can arise. For example, the risk of recharacterisation of CDS such as these as insurance products; the capacity of the entity to sell CDS protection more generally; and the increased regulatory environment that applies to OTC derivatives. Again, Mayer Brown’s specialised derivatives team can provide advice on the subject.

Conclusion

There seems little doubt that the coming years will see an increased need for Commercial Lenders involved in project finance to find solutions to increased regulatory capital requirements.

At the same time many other types of institutions including Institutional Investors are looking to meet their longer term liabilities by gaining exposure to an asset class that has a relatively robust risk profile and returns that match their liabilities.

Mayer Brown is watching developments with interest and we will continue to look for opportunities to bring Commercial Lenders seeking to ‘sell’ exposure to energy and infrastructure assets together with Institutional Investors who are keen to ‘buy’.

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