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Fostering long-term investment in Europe in favour of infrastructure – Project bonds and beyond

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1. The future of Europe depends on delivering together three objectives: fiscal consolidation, social inclusiveness and durable and sustainable growth. Only a steady and substantial economic growth can ensure debt sustainability in the long-term and at the same time create favorable conditions for improvements in labour markets and welfare.

As you well know, one way to increase potential growth, job creation and social inclusion is to enhance long-term investment in tangible and intangible infrastructure and in the real economy.

Policies for enhancing investment in infrastructure, energy, environment and TLC, but also in innovation, high education. R&D and SMEs, should become one of the central pillar of the new European "Growth Compact". However, these policies cannot be financed mainly by public resources. Under the Fiscal Compact rules, public budget constraints are going to be binding in the coming years. Unless we decide to finance infrastructure and growth by issueing Eurobonds. Such a solution, however, will be politically feasible only after a significant reinforcement of the political integration and of the democratic governance of the European Union. In any case, the involvement of private capital markets and, more generally, of global long-term private saving, is crucial to ensure the resources necessary to finance this huge investment projects.

In the coming years, the demand for long-term investment in project financing is expected to grow globally at very high rates. Volumes in project and infrastructure debt reached around 350 billion US dollars in 2011 and grew at 15% annually over the last few years. As the world population continues to grow, emerging countries become industrialized, and developed countries need to replace aging infrastructure, the need for project financing will continue to grow. It is estimated 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[1]. Current estimates point to European infrastructure investment needs of about € 2.0 trillion until 2020, in NGN and Trans-European Networks (Transport as well as Energy), to achieve the 2020 Agenda targets.

Then, the worldwide long-term capital investment is going to grow, while the supply of long-term saving may not be keep up with the demand. This means higher costs for the projects and more competition on the global financial markets to attract private saving to finance investments.

[1] OECD (2011), *Infrastructure in 2030: Telecom, Land Transport, Water and Electricity*.

There is, therefore, a general need to increase the global 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 and international regulators should create the best and most favorable conditions for foster LTIs with strong positives externalities for the economic growth and the human well-being. Or, at least, to remove the regulations that, nowadays, penalize them in favour of the short-term speculative finance and investment.

2.- Historically 90-95% of all project financing debt globally has been funded by banks. In particular, European banks still have around two thirds of the global market in this sector. At the same time, long-term institutional investors backed around 40% of long-term (LT) banking financing for infrastructure (mostly *via* corporate and structured bond). The financial crisis and the resulting new regulatory framework have undermined, and ultimately almost disrupted, this well-functioning model. After the crisis (which has today its main focus in the European banking system), the European banks have significantly scaled back new credit activities. The European banking system is still suffering from systemic as well as regulatory-induced liquidity constraints also due to low capitalization and hidden risks in banks' balance sheets.

The project finance bank market is still open for new financings, but tenors and amounts have been strongly reduced. 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 growing attempts, by many European banks, to sell their project financing portfolios on the secondary markets.

This is also due, of course, 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 trillion euros.

Moreover, the new liquidity ratios, which are very important for project financing, do not help; similarly, long dated floating swaps will have higher spreads. On liquidity, Basel III promotes two prudential ratios that entail minimum binding standards: a Liquidity Coverage Ratio (LCR), aimed at promoting banks' resilience to liquidity risk over the short-term (a 30-day period); and a Net Stable Funding Ratio (NSFR), aimed at promoting resilience over a one-year horizon[2]. In addition, a leverage ratio computed as shareholders' capital over total assets was introduced to ensure a hard minimum capital level, regardless of the structure of risk-weights in bank balance sheets. [3]

[2] The LCR is defined as the stock of high-quality liquid assets divided by total net cash out-flows over the next 30 calendar days (≥100%); the NSFR is defined as the available amount of stable funding divided by required amount of stable funding (>100%).

[3] It should be noted that the short-term and long-term liquidity ratios are related. The short-term funding ratio is driven by two factors: the liquidity buffer on the asset side of the balance sheet and the outflow on the liability side. More long-term funding on the liability side means less outflow, hence a higher liquidity ratio and a smaller liquidity gap.

Industry analysts[4] estimate the total shortfall in short-term liquidity due to the LCR at about €1.3 trillion. This represents about 40%t of the average liquidity buffer held by banks in Europe. The expected shortfall in the US is estimated at € 570 billion.

Although the Net Stable Funding Ratio (NSFR) consultation is still in progress, and the ratio is widely expected to be less punitive once it is finalized, the effects of the NSFR are currently expected to lead to a shortfall of about €2.3 trillion in long-term liquidity for European banks, which is equivalent to about 10 to 15% of the currently available funding. In the US, the expected shortfall is estimated at € 2.2 billion.
Of course, in order to comply with new regulatory requirements, and with exacerbated liquidity constraints, banks will be encouraged (a) to put on the market their long-term, and above all project finance portfolios; (b) to seek long-term funding in difficult market conditions; (c) to avoid long-term financing by focusing on short-term liquid assets.[5]

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.

3. - Are we, in Europe, at the edge of a structural change, i.e. moving from a purely bank-based to a mixed financial system, in which the role of the banks will be replaced, as in the U.S., by the institutional investors and the capital market?

The institutional investors could become a powerful financial long-term engine for a strong, balanced and sustainable global growth. In 2010, they hold assets worth around € 53.5 trillion globally, with the three largest investors being insurance companies, pension funds and mutual funds[6]. Large long-term institutional investors are in fact potential recipients of financial instruments for initiatives in project financing. Potentially their balance sheets could have room for over 6.5 trillion of dollars in long-term assets (and over 12 trillion when including the investment funds)[7].

Despite a recent increase in allocation to infrastructure, the institutional investments in infrastructure has been estimated at less than 2% of total assets worldwide[8].

Of course, Solvency II does not help the holdings of infrastructure assets by traditional long-term institutional investors such as life insurance, pension funds and SWFs. So, the only LT players still

[4] McKinsey (2010), *Basel III and European banking: Its impact, how banks might respond, and the challenges of implementation*, McKinsey Working Papers on Risk, Number 26, November.
[5] "Basel III introduces new liquidity requirements for banks through its liquidity coverage ratio. In its current form, the LCR could penalize undrawn revolving credit facilities made to special-purpose vehicles by requiring 100% coverage. However, the impact on banks will be minimal because, as the law firm Linklaters points out, these facilities represent a relatively small percentage of banks' debt exposure. On the other hand, the LCR could threaten the use of letters of credit, which are prevalent in project finance. Local country regulators can set the Basel III liquidity coverage ratio requirement, and Linklaters has indicated that a coverage level of 25% or higher might make letters of credit economically unattractive to banks unless they were tied to concessions from sponsors." *Basel III And Solvency II Regulations Could Bring A Sea Change In Global Project Finance Funding*, Standards & Poor's, October 2011.
[6] Together, these three categories of investors hold an estimated total € 48.8 trillion of assets at the global level and about € 16 trillion at the European level (33% of total and more than 1.2 times the region's GDP).
[7]See World Economic Forum, *The Future of Long-term Investing. A World Economic Forum Report*, 2011.
[8] Estimates provided by Morgan Stanley (2011).

active on the field are nowadays, in Europe, the large development banks (EIB, EBRD, KfW, CDC and CDP), but they cannot make it alone.

4. - Therefore, we must necessarily come back to the question which I raised at the beginning of my speech. How to create the best conditions to foster LTIs in infrastructure? And which are these conditions?

Among these conditions, I would like to highlight, as many OECD Reports have shown, 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. We should 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.

To support PF and PPP initiatives ECB may take into consideration a 6-9 years LTRO. Binding condition to be eligible to this especially dedicated facility should be the presentation of full documentation proving that it will be used only for long term investment with public guarantees (in exchange of long term collateral, including the best guaranteed PFIs). This new type of EIB facility may be granted to large development banks (EIB, KfW, CDC, CDP, etc.) and/or to all European banks. Moreover, the facility maybe approved only at the condition that the project to be financed is - not only long term - but also fully bankable, following a satisfactory due diligence process.

Moreover, the EIB capital increase, already decided, should now be implemented.

On the equity side, the Marguerite and the InfraMed Long Term Infrastructure Fund, as well as the Energy Efficiency Fund, have been well received by the market. They should be taken as prototypes of a series of LT Funds (providing both equity and mezzanine, as is the case for the Energy Efficiency Fund) for infrastructure and/or in other sectors, such as innovation and mid-cap high growth SMEs, venture capital, public utilities, urban development, health, etc. After the crisis, in fact, there is, in general, a great need for LT equity to stimulate LTIs in the economy. Moreover, the large national development bank,s which have created the Marguerite, InfraMed and the Energy Efficiency Fund (EIB, KfW, CDC and CDP), may also consider to join forces on the debt-side, with a common fund (backed by guarantee schemes) for infrastructure and, and more generally, for LTIs.

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.

To be neutral (or positive) from a fiscal point of view, the incentive should be designed as a “tax credit” for those projects which are not immediately bankable because their Business Plan is not fully sustainable. So the tax incentive would have two advantages: (1) make the project sustainable and (2) produce fiscal revenues which would come from the new infrastructure and from the positive externatilies which it would eventually generate.

A tax incentive scheme clearly included in the tender for the contruction work would be in line with European "state aid" rules. At the same time it would easily be understood by the market.

On the European broadband target, in particular, we need to invest more in the New Generation Networks (NGN). To facilitate those investments we may design special systems of tariffs based on Regulatory Asset Base (RAB) – at the coindition that the infrastructure is open to all operators in the market.

5.- 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 significant 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.

It must be stressed that the US Build America Project Bonds model is based on the concept that authorities and municipalities in the public sector can finance PF intitiatives by issuing project bonds (with a subsequent bundling of several projects) because they are not counted as public debt. In Europe such a model could not be replicated and this is why in the Project Bond Initiative the issuer must be a project companies and not a public authoritiy or a municipality or the State itself. The Eurostat rules, then, represent clearly a limitation to the development of a large European market for project bonds.

Within the long-standing debate on the "Goldel Rule"[9] – recently raised again at the EU level by Mario Monti – we may evisage the possibility that the Euroeapan strategic projects, and only those (TEN-T, TEN-E and NGN), may be deconsolidated from the public debt, even if the financing is partly issued by entities of the public sector. After all, PFIs are self-financing projects and do not have direct impact on public debt and, more generally, on the stability of national systems of public finance. One the principal reason why the Golden Rule has been adversed by many in the past, was the difficulty of individuating exactly what is fixed investment from what is not. If we were to limit the "Golden Rule" just to well defined strategic projects, such as are the Trans-European Networks,

9 The Golden Rule is a guideline for the operation of fiscal policy. The Golden Rule states that over the economic cycle, the Government will borrow only to invest and not to fund current spending. In layman's terms this means that on average over the ups and downs of an economic cycle the government should only borrow to pay for investment that benefits future generations. Day-to-day spending that benefits today's taxpayers should be paid for with today's taxes, not with leveraged investment. Therefore, over the cycle the current budget (i.e., net of investment) must balance or be brought into surplus. The justification for the Golden Rule derives from macroeconomic theory. Other things being equal, an increase in government borrowing raises the real interest rate consequently crowding out (reducing) investment because a higher rate of return is required for investment to be profitable. Unless the government uses the borrowed funds to invest in projects with a similar rate of return to private investment, capital accumulation falls, with negative consequences upon economic growth.

or even extend it to all public works financed by PF, then the "individuation problem" would be naturally solved.

The success story of the Obama's BABs is due also to 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. But no tax incetives has been so far contemplated by policy makers at the European level. 10 Moreover, 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.

According to the rating agency Standard & Poor's[11], project finance transactions have performed well in the past three years even as economic conditions worsened and corporate default rates accelerated.

In addition, there is evidence that, from 1992 to 2008, project finance ratings performed better than corporate issuer credit ratings for several reasons. In particular, the collateral and security packages - typically present in projects -increase credit protection providing also a stable revenue stream.

Many project finance transactions have long-term supply agreements with various counterparties, which mitigate many of the risks associated with operating in merchant markets.

As a matter of fact, Standard & Poor's analysis shows that recoveries from defaulted projects have been relatively strong and have averaged 72% since 2001, with significant sectorial heterogeneity. Transport and the power sectors have the highest recovery rates, 90% and 85% respectively.

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.

[10] "The neutralization of the withholding tax applied in some EU countries would facilite the interest of a large base of international real money investors.", Natixis, *Infrastructure Debt*, July 2012.

[11] Standard & Poor's (2010), *Figuring The Recovery Rates When Global Project Finance Transactions Default,* Global Credit Portal – RatingsDirects, October.

At European level, however, the current regulatory proposals, CRD IV (the Capital Requirements Directive which introduces Basel III principles in the European financial services industry) and Solvency II Directive (which reflects similar principles for the European insurance industry) are basically based on market risk evaluation (that is interest rate risk and spread risk).

In this contest, long term assets, like infrastructure project bonds, are treated as assets with a low credit quality thus leading to higher capital charges in order to fulfill general requirements. For the insurance the pensions funds industry, market risks evaluation does not reflect its business model based on long term liabilities and well-predictable payments to beneficiaries,

Life insurers and pension funds typically have a negative duration gap, with liabilities of longer duration (hence more interest-sensitive) than their assets. This is in sharp contrast with banks, which provide maturity transformation and accordingly face greater liquidity risk.

The nature of their liabilities in principle allows pension funds and life insurers to play the important role of long-term investors in financial markets.

Moreover, Solvency II 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. While capital requirements under Solvency II tend to be higher than under current regulation, the difference hinges on whether insurers use the standard formula or apply an internal model.

Small and medium companies usually do not have advanced internal models suitable to pass the validation criteria of regulators because the building costs of these models is very high. While, the standard model produces similar results in terms of capital requirements, it does not allow to incorporate in the model the company specific risk profile[12].

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 bonds[13].

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. Some countries, such as Canada, are leading the game, with up to 15-20% infrastructure assets in

[12] Serbanescu C. et *al* (2007), *SOLVENCY II – a Tool of Risk Management for Insurers,* Review of Management and Economical Engineering, Vol. 6, No. 6.

[13] 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. See Bassanini F., del Bufalo G. and Reviglio E. (2011), *Financing Infrastructures in Europe: Project Bonds, Solvency II and the «Connect ing Europe» Facility*, www.astrid-online.it/ and Bassanini F and Reviglio E. (2011), *Financial Stability, Fiscal Consolidation and Long-Term Investments after the Crisis*, in OECD Journal of Financial Trends, Issue 1.

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.

7. - But to give a strong boost to investments in infrastructure it is crucial 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 was suggested by the Jacques de Larosière and Mario Monti Reports. At the institutional European level, the need of a new regulatory framework, more favourable to LTI, has been strongly emphasized by the European Commission in the Communications on *A New Single Market Act*14, on *A Comprehensive European international investment policy*15, and on *The EU Budget Review*16.

In fact, without a substantial increase in investment in infrastructure, energy, environment, innovation and research, and therefore without major changes in prudential, accounting and tax regulations, the objectives set in the EU 2020 strategy and in the Growth Compact could hardly be achieved.

However, even though a broad consensus can be registered (among the majority of experts, scholars, bankers and politicians) on the need of a new regulatory framework and new instruments more favourable for LTI, the international and European regulators seem to be still prisoners of a pro-cyclical and short-termist cultural approach. So, this general consensus is still waiting to be translated from words into deeds. The time to do so is now!.

[14]EUROPEAN COMMISSION COMMUNICATION, *Towards a new Single market Act,* 27th October 2010 – COM(2010)608.
[15]EUROPEAN COMMISSION COMMUNICATION, *Towards a comprehensive European international investment policy*, 7th July 2010, COM(2010)343.
[16]EUROPEAN COMMISSION COMMUNICATION, *The EU Budget Review*, 19th Oct. 2010, COM(2010) 700.