

# The Europe 2020 Project bond initiative

This document was drafted by Eurofi with input from its members. It does not engage in any case the EU Polish Presidency or the Polish financial authorities.

There is an urgent need to revive and expand capital markets to finance infrastructure projects. As most of member states have to reduce their public deficit and their level of debt, they will be constrained to optimise their involvement in long term investment in the coming years. The new regulatory framework for banks and insurance companies weakens their appetite for long term investment: Basel 3 puts pressures on maturity transformation whereas currently around 2/3 of the amounts are provided by banks<sup>1</sup>. Solvency 2 makes the holding of long term assets bonds by insurers quite expansive in terms of capital requirements. In the meantime few infrastructure projects (Public Private Partnerships) have been wrapped by monolines since the financial crisis.

This significantly reduces the available long term funding for infrastructure assets. Europe needs therefore to think about new ways to attract private finance to support the financing of growth-enhancing infrastructure project transport, energy, telecommunications, and renewable energies infrastructures. According to the Communication on the EU Budget Review published in October 2010, an estimated € 1.6 trillion will be needed in the transport and energy sectors alone over the next 10 years.

Institutional investors (insurers, pension funds, sovereign funds, asset managers...) will increase their contribution in long-term infrastructure financing if its rating is at least A.

In such a context the "Project Bonds Initiative" would provide part of the solution to funding Europe's 2020 strategy. As mentioned by P. Maystadt, President of the European Investment Bank EIB in the Eurofi newsletter (September 2011) "We should not have misconceptions: like PPPs, project bonds do not offer a silver bullet to Europe's budgetary problems. In an environment where regulation and business strategies in the financial sector are rapidly changing, we need to be alert and to adjust public policy instruments. We are thus open to consider other initiatives to catalyze the support of the private sector and of long-term asset managers that would be required to support the achievement of the EU2020 agenda"

Indeed, the EU project bond initiative underlines the need for setting up complementary tools in an EU action plan for financing infrastructures.

## 1. The concept

« Project bonds were first proposed by EU President Barroso in his « State of the Union" speech in Strasbourg on 7 September 2010: "An EU initiative to support project bonds together with the EIB, would help address the needs for investment in large EU infrastructure projects".

The "project bonds" concept has not to be confused with Euro bonds which would be issued by a new European public debt agency. The

"project bonds" proposal does not imply any burden on public domestic budgets and would not increase sovereign debts.

Before proposing an EU framework to materialise the idea of a new risk-sharing instrument which would aim at facilitating the debt raising activities of companies on capital markets, the Commission has launched a consultation in February 2011 (closed in May) to test the idea and get the views of all participants in such infrastructure investments, public and private. The answers to the consultation support the completion of an impact assessment before a proposal for its implementation will be done.

The "project bond" model is intended to provide an alternative to the "monoline-wrapped" infrastructure bond market. The project bond facility would either provide guarantees directly to senior debt holders or introduce a junior debt layer underwritten by the EIB between the equity and the senior debt.

This initiative would attract additional private sector - Institutional investors and banks - financing toward infrastructure projects by improving the rating of the senior debt tranche.

Indeed if properly structured, the EU backed-EIB's intervention will credit enhance the Senior bonds by the Project company into a A-AA rating, thus making these bonds eligible for the portfolios of institutional investors. It is anticipated that the credit enhancement provided by EU-EIB could go up to 20% of the senior securitised project debt.

The fact that the EIB will carry out the due diligence and financial appraisal in the structuring phase and monitor the selected projects represents an additional benefit for banks and investors.

The size of targeted projects should be higher than € 100-150 million. The EU Commission and the EIB' s estimated targets for EU project bonds ' issues are in the range if € 1-5 billion per annum at the beginning of the initiative and in the range of € 10 – 20 billion by 2020.

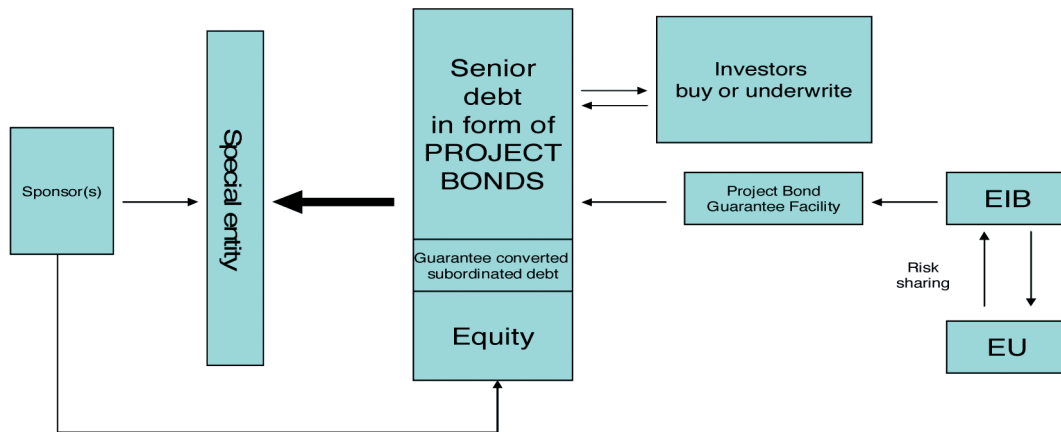
## 2.2. The current project bond initiative partially improves the financing of EU infrastructures

In their portfolio management mandates, the investors usually include a minimum-A rating. Similarly for ALM purposes insurers are also interested in long maturity high quality assets (> BBB). More generally the minimum rating required by institutional investors in order to buy EU Project Bonds would be A, which is the rating targeted by the project bond initiative

According to the contribution of CDP to the consultation of the Commission, institutional investors would be prepared to allocate

1. Cf. Agefi Hébdó, 21 July 2011

## EU Project Bond - Guarantee drawn



approximately 3 to 5% of their portfolios to EU project bonds. Such contribution from life insurance and pension funds is estimated by CDP to account for 22- 30% of the total estimated infrastructure investment needs.

Unfortunately Solvency II reduces the added value of the EU initiative. Indeed the EU-backing and the involvement of an organisation such as the European Investment Bank are not sufficient to offset the prudential regulatory incentives for insurers to prefer short maturities. For example, under Solvency II standard formula, a five-year BBB listed debt requires a capital charge of about 12%, lower than the level required by the 10-year operation raised to A by the EIB backing, which reduces the appeal of the EIB's planned involvement. Moreover a A-rated bond and a BBB-rated bond with the same duration of 25 years would attract exactly the same capital charge<sup>2</sup> of more than 32% actually vanishing the EU-supported credit enhancement<sup>3</sup>

In the same vein the Basel 3 liquidity framework discourages banks to hold long-term assets in particular as far as they will be deterred to use deposits to finance them (see Eurofi paper on liquidity regulation prepared for the Wroclaw Forum).

Beside this it is important to make the project bond issues easy to analyse, to increase their transparency and the liquidity and promote credit lines of significant size. In that respect, it appears important to "standardise" issues as much as possible.

Some Eurofi members mention that the success of this initiative depends on EU institutions granting sufficiently long-lasting public resources to guarantee that this EU initiative will effectively contribute to the 2020 EU Strategy.

It is also essential to ensure the access to both large and small projects to address the EU long-term infrastructure need. Small and medium-sized projects are indeed a source of growth. One solution suggested might be to delegate the task of selecting national projects to national financial institutions, or possibly a group of national institutions with solid experience, in the case of cross-border projects.

Moreover it is critical to build-up a significant and reliable pipeline of potential infrastructure projects to be financed by EU Project Bonds. This would also mitigate the potential concentration risk that institutional investors may perceive for their portfolios<sup>4</sup>.

To become operational, the rules for accessing to this new EU facility and more generally the project selection criteria should be clarified (cross border or domestic projects, eligible areas for projects; the targeted level of capital that projects should have to be eligible to the EIB project bond support and subsequently their overall debt and equity structures. Etc)

2. More precisely, 32.2% for an A-rated bond and 32.5% for a BBB-rated bond. Under Solvency II, the market (spread) risk factors for bonds as of the QIS 5, lead to the following capital charges: 5 year BBB 2.5%x5=12.5% - 10 year A 1.4%x10=14%; 25 year BBB 2.5%x13 (duration cap 13 years) = 32.5%; 25 year A 1.4%x23 (duration cap 23 years) = 32.2%.

3. F. Bassanini, G. del Bufalo and E. Reviglio, Financing Infrastructure in Europe. Project Bonds, Solvency II and the "Connecting Europe" Facility, [http://www.astrid-online.it/Dossier--d1/DISCIPLINA/Studi--ric/Bassanini-Del-Bufalo-Reviglio\\_Financing-Infrastructure-in-Europe.pdf](http://www.astrid-online.it/Dossier--d1/DISCIPLINA/Studi--ric/Bassanini-Del-Bufalo-Reviglio_Financing-Infrastructure-in-Europe.pdf)

4. Ibidem

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Last, it seems attractive to some Eurofi members if the same bonds could finance a bundle of projects and not just one. The risk diversification may improve their ratings and potentially reduce the cost of the credit enhancement for the European authorities. In this case controls must be put into place to ensure that each loan in the bundle continues to receive necessary oversight and administration.

### 3. An EU action plan for enhancing the financing of infrastructures

In its paper “Capital markets in PPP financing – where we are and are we going” published in March 2010, the EIB has listed 8 barriers reducing the attractiveness of PPPs securities:

1. The value impairment of existing PPP bonds due to the downgrading of several monolines
2. The concentration limits to which fund managers are submitted due to the decline in the value of certain securities (ABS...) which raises mechanically the share of the investments in PPP
3. The PPP investment are competing with EU utility companies securities to which they are assimilated by institutional investors
4. Institutional investors have no expertise within their organisation to structuring negotiating and controlling PPP projects financing
5. The investment management community has no benchmark for measuring the performance of fund managers investing in PPPs. In addition there is no single definition of infrastructure assets what impedes defining and monitoring the fund allocation
6. Most PPP projects are below the investment grade which is mandatory for investors.
7. The absence of AAA bonds resulting from the downgrading of most monolines reduce the pool of investors
8. Whereas a large part of the available capital is not denominated in €, existing forex hedging techniques are not easily accessible to PPPs SPVs.

In such context, to respond to the financial needs required to develop the EU infrastructures, many suggest further improvements to the diverse EU infrastructure financing-mechanisms are also mandatory.

Infrastructure bonds – including project bonds – should become an asset class per se between government and corporate bonds. This would avoid inappropriate classification or comparison with other types of assets (e.g. ABS, equities of utilities companies etc. . .), which have different investment features and risks. This would also favour the emergence and the development of an expertise among investors.

To this end, among infrastructure bonds, the EU Project Bonds could deserve some form of regulatory relief. As a consequence of the credit enhancement provided by the EIB, by analogy to the specific capital charges imposed to the insurance companies for holding EEA government bonds or covered bonds<sup>5</sup>, the relief would take for example the form of reduced spread risk factors: some suggest a 20-30% haircut.

In addition it would be beneficial to maximize the effectiveness of the program and to better reflect a clear regulatory incentive to increase exposure to this asset class

To this end, regulatory frameworks should impose specific capital charges to infrastructure bonds, which take in particular into account their lower risk profile. The incoming calibration adjustments of liquidity requirements for banks and the review of the pension funds regulatory framework represent an opportunity to create these specific capital and liquidity requirements.

Such asset class would benefit from a well-organised secondary market (market makers). Similarly, considering the long term maturity of this asset class, hedging techniques should made available. A pool of financial institutions should be gathered under the chairmanship of the EIB in order to define and set up those financial products and services.

Member State schemes based on domestic financial resources could also be envisaged to issuing junior debt on a similar basis than the EU/EIB-initiative, Such domestic schemes would offer the opportunity to leverage scarce fiscal resources by making more attractive infrastructure projects to private investors.

According to institutional investors, some IFIs and/or Member States public financial institutions or a pool of banks role may in the short-term play a key role as “EU Project Bonds market-maker”. In the medium term the creation of a Pan-European Infrastructure-Bond Financial Agency may be necessary to provide liquidity to the secondary market.<sup>6</sup> Some institutional investors<sup>7</sup> advocate the creation of one or several EU public financial bodies inspired by the model of the French Caisse Nationale des Autoroutes (each dedicated to infrastructure sectors), which could directly finance the diverse PPPs. They would issue large amounts of very high quality bonds

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5. Some assets receive special treatment under the spread risk sub-module. There is no capital requirement for borrowings by or demonstrably guaranteed by the national government of an EEA state, issued in the currency of the government, or issued by a specified multilateral development bank or international organization. Mortgage covered bonds and public sector covered bonds are also treated differently. If they meet certain requirements and are rated AAA, they are subject to a stress factor of 0.6 percent and a duration cap of 53 years.

6. Ibidem

7. See the contribution of the Caisse des Dépôts et des Consignations to the consultation on the Europe 2020 Project Bond Initiative

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(AAA). These financial resources would be channelled toward to both large and small projects selected on the basis the expertise of these Agencies on the various infrastructure sectors. This would also contribute to the improvement of the liquidity of the infrastructure asset class.

To develop the role of capital markets in PPP financing, Eurofi members also suggest the revival and the consolidation of the monoline model by the creation of public guarantee schemes involving International Financial Institutions.

On the savings side, asset managers propose to attract individuals creating a specific EU fund regulation for financing EU infrastructure projects. It should be well-regulated funds with many qualities that have made UCITS a highly regarded product – safekeeping of assets by a depositary, diversification, transparency and governance standards. Different from UCITS, however, they should not be subject to the requirement to redeem units as requested by holders. The aim is therefore to promote an EU standard for closed-ended vehicles.

The project bonds initiative is clearly perceived as a positive contribution to better financing infrastructures. This initiative of the EU Commission and the EIB underlines the need for an EU action plan for financial infrastructures encompassing the setting up of such complementary tools.

In any case some suggest that it should be appropriate to send a clear and unquestionable signal to the market in general and to institutional investors in particular that buying/underwriting EU Project Bonds is not a one-off potentially high-risk investment but it is rather participating in a new and necessary future liquid market for investment strategies<sup>8</sup>.

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8 F. Bassanini, G. del Bufalo and E. Reviglio, Financing Infrastructures in Europe: Project Bonds, Solvency II and the «Connecting Europe» Facility, 2011 [http://www.astrid-online.it/Dossier--d1/DISCIPLINA/Studi--ric/Bassanini-Del-Bufalo-Reviglio\\_Financing-Infrastructure-in-Europe.pdf](http://www.astrid-online.it/Dossier--d1/DISCIPLINA/Studi--ric/Bassanini-Del-Bufalo-Reviglio_Financing-Infrastructure-in-Europe.pdf): “A specific and exclusive commitment of about € 15-20 billion within the “Connecting Europe” Facility (European MFF 2014-2020) to support the EU Project Bonds, would contribute (together with EIB resources) to the creation of a Pan-European EU Bond Market of about € 200-250 billion within seven years”

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