

## Basel III and project finance

In this article, published by *Project Finance International* (Issue 460), Edward Chan and Matthew Worth go through what Basel III means and the impact on projects going forward.

In December 2010, the Basel Committee on Banking Supervision published its report “Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems”. Expressly set out as a response to the global financial crisis, the Basel III framework represents a substantial step forward from its predecessor regime, Basel II. It introduces a package of reforms aimed at strengthening the regulation of both capital and liquidity, to improve the stability and resilience of individual banks and the banking sector as a whole.

Basel III is expected to be adopted worldwide, and will be phased in from 2013 to 2019. It is expected to pose significant challenges for banks. In particular, there will be a marked increase in the quantity of capital – particularly common equity capital – that banks will be required to hold. Individual asset classes or areas of activity, especially on the trading book, are expected to be significantly more expensive for banks in future. Banks will need to meet rigorous funding requirements for their long term asset bases.

All of this will have an impact on those who borrow from banks, as well as on the banks themselves. Stricter capital requirements will cause cost pressures for lenders and therefore for borrowers. The banking landscape may change, as major players scale back in some areas and invest in others, in response to changing capital and liquidity requirements.

In the context of project finance, concerns have been raised about the impact of Basel III, and in particular its treatment of long term lending. Certainly, there may be challenges, as this article explores. However, these must be kept in proportion. While it is too early to draw firm conclusions, it is likely that their impact will be moderated, or accommodated, by innovation in the way that project financings are structured and documented.

This article provides an overview of the content of Basel III, and explores at an early stage some of its potential impact, both in general and on project finance in particular.

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## Basel III – Background and overview

The financial crisis was widely seen as exposing a number of weaknesses in the existing global regulatory framework, as embodied in the Basel II regime. In particular, the regulatory capital regime was seen as somewhat too permissive, and the definition of capital too broad; trading book risks and off-balance-sheet exposures as insufficiently covered; and Basel II did not regulate liquidity. To address these and other issues, Basel III introduces five main “planks” of reform, as follows.

### *Enhancing quality and quantity of capital*

Regulation of capital has been at the core of the Basel regime since the days of Basel I. Under Basel III, as under its predecessors, banks are required to main a minimum ratio of capital, on the one hand, to risk-weighted assets, on the other. This is referred to as the minimum capital ratio. The aim is to maintain stability, by ensuring banks at all times retain enough capital to absorb losses incurred during periods of stress.

Basel III will require that a bank’s capital ratio must be 8% at all times, made up as follows.

- (a) At least 6% must consist of Tier 1 capital, of which at least 4.5% must be in the form of common equity, meaning ordinary shares and retained earnings. The remaining 1.5% may be made up of “additional going concern capital”. The latter is subject to strict conditions to ensure it is equity-like in its ability to absorb losses.
- (b) 2% may consist of Tier 2 capital. This may have more debt-like characteristics than Tier 1 capital, but must nonetheless be deeply subordinated and meet strict criteria as to its loss absorption.

In addition Basel III imposes a “capital conservation buffer”, which requires another 2.5% of common equity to be maintained. A bank will be constrained from paying dividends or bonuses if this buffer is not maintained, meaning no bank is likely to treat it as optional.

Altogether, Basel III represents a material toughening of capital requirements when compared with Basel II. While the “headline” minimum capital ratio under Basel II was also 8%, only 2% was required to be common equity. By 2019, including the capital conservation buffer and certain new deductions from capital, banks will need to hold nearly four times the amount of common equity currently required to cover exposures. Additionally, under Basel II, numerous sophisticated hybrid instruments were permitted to count as Tier 1 capital. Under Basel III, these will be phased out.

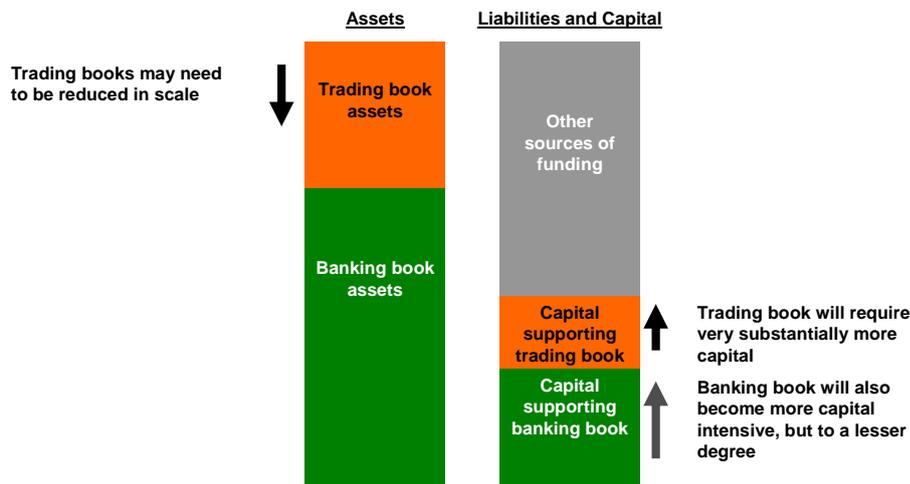
### *Changes to risk coverage and weightings*

A bank’s capital ratio is applied to its risk weighted assets. Under the risk weighting scheme, a weighting factor is applied to asset values, such that “safer” assets are discounted, and can therefore be backed by less capital.

In the wake of the financial crisis, it was widely felt that Basel II failed adequately to capture the risks posed by, among other things, off balance

sheet risks, derivatives exposures, and other aspects of a bank's trading book. To address this issue, Basel III puts in place a series of additional capital charges for different risks. The overall effect of this is to increase the relative amount of capital that banks will have to allocate to their trading book, as opposed to their lending book, in future, as shown by the chart below.

**Figure 1 – Effects of the changes to risk coverage**



**Reducing leverage**

In addition to the minimum capital ratio, Basel III imposes a new gross leverage ratio with which banks must comply. Once fully in force, this will require that banks' capital is at all times equal to at least 3% of their total assets; or, to put it another way, maximum leverage for a bank will be 33.33 times capital.

Assets are not risk weighted for the purposes of the leverage ratio, and collateral is not taken into account. Off-balance sheet items are to be included in the test, as are net derivatives exposures.

**Liquidity management**

Basel II dealt primarily with capitalisation. However, as the financial crisis showed, liquidity or funding issues can be just as challenging to a bank in times of stress, if not more so. Basel III requires banks to demonstrate adequate liquidity in both the short and the medium to long term.

In the short term, the Liquidity Coverage Ratio (LCR) requires that banks have sufficient "high quality liquid assets" available to enable them to meet anticipated outflows over a 30-day period of acute stress. High quality liquid assets include cash, central bank reserves, and assets of similar quality. The assumed outflows will include a variety of outgoings including withdrawals of retail deposits and drawdowns by borrowers on committed loan facilities.

One key feature of the LCR is its differential treatment of undrawn but committed facilities such as revolving loans and liquidity facilities. An undrawn revolving loan will require 10% liquidity cover if made to a non-financial corporate borrower, but 100% cover if made to a special purpose vehicle (SPV).

A liquidity facility, however, (i.e. a back-up facility put in place expressly for the purpose of refinancing the debt of a customer in situations where such a customer is unable to obtain its ordinary course of business funding requirements in the financial markets) will always require 100% cover.

The Net Stable Funding Requirement (NSFR), on the other hand, requires banks to demonstrate stable funding over the longer term. Broadly speaking, banks will be required to keep funding in place of at least one year in maturity to cover their assets of one year maturity or more. Not all assets will require the same degree of coverage. In particular, high-rated bonds will require a lower proportion of stable funding under the NSFR than similarly-rated loans.

It is not the case that the maturity of funding need precisely match the maturity of the asset, so for instance a 25-year loan need not be backed by a 25-year deposit. Such a requirement would negate the “maturity transformation” function of the banking sector, namely that it can lend longer than it borrows.

However, it is likely that for longer term loans, funding considerably longer than one year in maturity will be sought in future. This, indeed, is the purpose of the NSFR, which seeks to reduce banks’ reliance on the volatile wholesale funding markets that dried up so rapidly during the critical phases of the credit crisis.

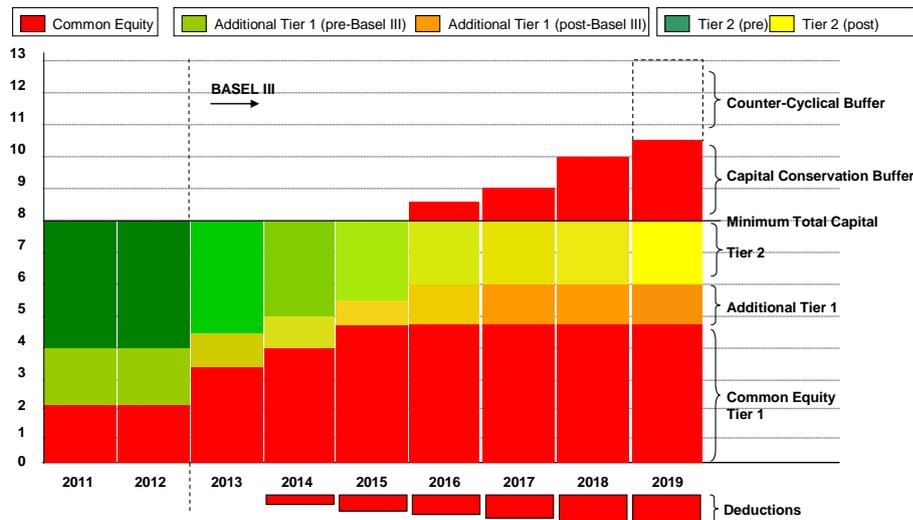
### ***Addressing pro-cyclicality***

Two additional “capital buffer” regimes are put in place by Basel III, with the aim of managing cyclicality. The first is the capital conservation buffer, discussed above. The broad idea of this is to require banks to build up capital reserves which can be drawn upon during cyclical downturns, to absorb losses without imperilling the minimum capital ratio. Second, a “countercyclical buffer” (an additional extension to the capital conservation range, of Tier 1 capital equivalent to up to 2.5% of risk weighted assets) may be set by individual national authorities where there is excess credit growth in a particular country.

### **Some general reflections and implications**

It is widely expected that one result of Basel III will be an increased cost of lending for banks, and therefore upward price pressure in the loan market. As the chart below shows, under Basel III once fully implemented (and taking into account its various limbs) the quantity of common equity that banks will require to back assets could quadruple. Since common equity is an expensive form of capital, this could have a significant economic impact.

Figure 2 – Basel III capital requirements phase-in



The capital-hunger of the banking sector can be expected to increase markedly. A McKinsey report<sup>1</sup> recently estimated that the European banking sector is likely to require an additional €1,050 billion of capital as a result of Basel III, and the US banking sector a further €600 billion. This increased need for equity capital is likely to coincide with a reduction in the availability of central bank funding, while the recovery of wholesale funding markets remains uncertain.

It is widely anticipated that the global banking sector as a whole may have some difficulty raising the amount of capital required. As a result, banks may need to make difficult choices as to how to ration their capital. Given the differential treatment of different types of asset and exposure under Basel III, many banks can be expected to change their business models or seek to exit different product lines. Those banks who wish to operate a large trading book may need to allocate significantly more capital to this than was previously the case.

We may see the entry of non-bank lenders to different segments of the lending market, using their relative regulatory advantages to compete with the banks and meet demand that the banking sector cannot. So far, however, this trend has been slower to develop than some predicted during the financial crisis.

**An early view of the implications for Project Finance**

As described above, Basel III treats different asset types, and exposures, quite differently. What, then, are the aspects of project finance that will affect its treatment under Basel III and what might be the impact? It is of course very early to be making predictions in respect of a regime which is to be phased in over eight years. However we are able to explore some of the possible effects.

<sup>1</sup> “Basel III and European Banking: Its impact, how banks might respond, and the challenges of implementation”, McKinsey & Company, November 2010.

Early discussions of Basel III in the project finance context have focused on the length of maturity (tenor) of project debt and the interplay with the NSFR. It is true that, under the NSFR, banks are likely to seek longer term funding for long term debt. The letter of the Basel III requirement is, broadly, that funding of at least one year be in place to match assets of one year's maturity or more. However, were banks to back long term assets with the bare minimum funding – which would have a maturity of, say, 13 months – this would effectively impose a rolling funding requirement from month to month. It seems likely that banks will seek longer term funding, and there is debate as to what “longer term” will mean. It is not the case, however, that a 25-year project loan will require locked-in 25-year funding.

It is nonetheless likely that banks will seek to manage their commitment to very long term exposures in various ways, and project debt structures may evolve as a result. The current market reflects these trends. Currently, the marketplace of willing lenders does grow smaller at tenors greater than, say, seven to ten years, particularly for larger loans (above say £100 million). However, deals can still be done provided they are well structured and priced. We have seen an increased move towards “semi-perm” structures, under which the borrower is given incentives to refinance, after several years, through the use of “cash sweep” mechanisms and increases in margin. Or banks may succeed in persuading sponsors to accept refinancing risk, at perhaps seven or eight years, by structuring loans that mature at that point. Tenor can be expected to remain a key negotiating point for some time, until a new market standard is achieved that accommodates Basel III and other post-crisis concerns.

Certain discrete elements of project financings may be adversely affected, in price terms if nothing else, by Basel III. We mentioned, above, the differential treatment of revolving or working capital facilities under the LCR regime. Since the use of SPV borrowers is very common in project financing, it is likely that working capital facilities in the projects context will require 100% short term liquidity cover, which will make them expensive for banks. Since these types of facility are often a relatively small proportion of a project's overall debt, this may not be a critical issue.

More important may be the impact on letters of credit, demand for which is significant in the projects market. Basel III allows national regulators to specify the level of LCR cover they will require for letters of credit, and many, including in the UK, have yet to specify what level they will demand.

Liquidity coverage requirements of 25%, 50% or more could make it difficult for banks to provide these products economically. It would probably be too pessimistic to say that letters of credit will disappear, especially given the key role they play in project finance. It is quite likely, however, that banks will tie any offer of a letter of credit facility to concessions from sponsors.

Various changes can be anticipated to loan documentation as a result of Basel III. Perhaps the most significant for sponsors will be an increased focus by banks on transferability. Traditionally, transfer restrictions on banks have been relatively common, and onerous, in project lending compared to other forms of loan. In future however, banks are likely to focus on liquidity across their portfolios, and on the need to be able to adjust their asset base and leverage quickly, including through asset or portfolio disposals.

It will be increasingly important to banks both that their loans are readily transferable – without borrower consent – and that the terms of transfer are standardised. The tight-knit club of banks who are effectively committed to a project financing right through to maturity may become a thing of the past.

Arguably the most profound shift that is under discussion in the projects market in light of regulatory change is the potential role of project bonds. Highly rated bonds are treated relatively favourably under Basel III in two ways. Firstly, they require a relatively low proportion of stable funding under the NSFR. Secondly, bonds of sufficiently high rating can themselves be used as short term liquidity cover under the LCR, because they qualify as high quality liquid assets.

It is therefore quite likely that project financiers will seek to increase the proportion of debt that is offered in bond form, as opposed to loan. There are a number of challenges to be overcome, however, if the bond market is going to assume this greater role. For example, there can be challenges persuading bondholders to accept construction risk in the early phases of a project, although these may not be insurmountable.

Additionally, bondholder voting is an unwieldy way of making key creditor decisions on issues such as waivers, particularly since the retreat of monoline insurers (who used to act as coordinating creditors) from the market. It is yet to be seen what market standard will emerge to address this latter issue. It is possible that a “bondholders’ agent” concept will evolve and/or that electronic voting among bondholders will be made workable and efficient.

It should also be noted that it is unclear what impact other regulatory changes – such as “Solvency II”, the new regulatory regime for European insurers – will have on the project bond market. Overall however, there is cause to be optimistic that the use of project bond structures will to an extent alleviate some of the impact of Basel III on project finance. Perhaps what is required at this stage is a significant push from governments or other infrastructure buyers to get one or two path-finding deals done.

## Conclusions

Undoubtedly, Basel III will have an impact on project financing, just as it will on other areas of banking activity. The cost of project debt is likely to be affected by the increased capital-intensity of lending generally. Discussions over tenor can be expected to be complex while banks resolve how to meet the NSFR in respect of long term lending, and debt structures may change. The availability and cost of letters of credit may well be adversely affected.

However, there is little need to believe, at this early stage, that the impact will be crippling for the market. Like other forms of loan business, the capital intensity of project lending relative to the trading book may actually decrease, increasing its relative attractiveness to banks. Assuming demand for infrastructure is robust, it seems likely that the project finance market will adapt and evolve, as capital markets tend to, to overcome the challenges posed by Basel III.

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