## 2B or not 2B

**The implementation of Basel 2 began this month in Europe. What does regime change mean for project lenders and is there an advantage to early compliance? By Justin Pugsley**

Basel 2 came into force in Europe on 1 January and with it a greater emphasis on separating and better defining various types of risk. This new approach could have a substantial impact on yields for different asset classes as well as influencing, in the short term at least, the competitive dynamics between banks engaged in project finance.

Although, the US is unlikely to implement Basel 2 until 2009 or later, it will be in the interest of all international banks to adopt it as quickly as possible.

Basel 2 aims to make capital allocation much more risk sensitive and therefore improve the quality of bank lending. For instance, A-rated debt should require less allocated capital from lenders, whilst substantially increasing allocations for B-rated tranches. For each loan, and for the overall loan portfolio, banks must be able to calculate separately the probability of default (PD) and the loss given default (LGD). There must be greater scrutiny of the value of any collateral, the strength of future cash flows and of the legal clauses governing a concession, if relevant. The aim is to bring about a closer overlap in the use of risk and financial information.

The new framework calls for a clearer separation between operational and credit risk and then qualifying both of them. It also looks to reduce the scope for regulatory arbitrage and to bring supervisory practices among member states more in line with each other. Related to that, the new accord seeks to increase international co-operation between financial regulators.

For project finance the consequences of making capital allocation much more sensitive to risk were potentially profound. Indeed, the Bank of International Settlements (BIS) was initially looking to treat project finance as more risky than generic corporate finance, which would have resulted in substantially larger capital allocations, thereby making the business a lot less profitable for banks. However, a consortium of around 30 banks – with the assistance of Standard & Poor's – managed to demonstrate that project finance on average is not only safer than generic corporate finance, but has much higher recovery rates on defaulted loans.

**Better returns?**

Seen in this new light, returns for near or fully compliant Basel 2 lenders dealing in high-quality debt could be substantially increased and, according to some lenders, the pricings of some recent transactions have taken into account this potentially beneficial impact.

Furthermore, for banks specialising in public sector financing this could turn out to be a big boost to the bottom line – or at least for those which become compliant earlier than their peers.

Part of the incentive to become Basel 2-compliant more quickly is the opportunity to grab market share from those slower to comply, since compliant banks will have the capacity to lend more aggressively. A sliding scale of compliance has been established, starting with standardised, slotting, foundation and then finally advanced. The higher up the scale the lender is, the greater the sensitivity of capital allocation to risk. Also, once on foundation upwards, the bank can apply its own internal rating based (IRB) approach, where their own risk teams evaluate LGD and PD. Naturally, the

models used would have to be approved by the domestic regulator.

Currently, most project finance divisions are either on standardised or slotting. However, over the course of this year some are expected to reach foundation level or higher.

Part of the problem with project finance is that there are not enough loans to construct accurate algorithms similar to those used for credit card or mortgage debt. Project finance deals tend be high value but low in number, and most of the projects on bank books may are unique.

Also, the legal and financial structures tend to be constantly evolving, which has an impact on risk profiles. This makes constructing stress tests, assessing risk and building forecasting models harder. This means that banks are having to rely to an extent on simulation, rather than just historical data, to make the necessary evaluations.

"Our experience is that purely quantitative approaches for measuring risk based on a limited set of financial metrics, such as regression and static cash-flow models are not effective for assessing highly complex project financings," says Ingrid Weston, associate director with Standard & Poor's Risk Solutions. She adds that using an expert-judgement framework linked to external benchmarks is key to constructing and validating a bank's methodologies in the context of regulatory approval.

"The banks may have to apply a comfort cushion on top of those models until they prove their validity. This may mean temporarily setting aside some extra capital," says Maged Fanous, senior executive with Accenture's financial services practice.

"We are yet to see the FSA [Financial Services Authority] approve simulation for specialised finance, but that's largely because they have not yet got down to dealing with this more detailed asset class. That should happen this year," explains Chris Marrison, chief executive officer of Risk Integrated. He adds that the Irish and German financial regulators are at a more advanced stage in dealing with specialised finance.

**Risk evaluation**

The more sophisticated banks are starting to structure deals to minimise PD. They are looking more closely at contractual frameworks and cash flows, and this should lead to increasing differentiation between pricing for different types of projects, as the BIS intended.

However, Basel 2 also makes greater demands on quantifying operational risk. This means systematically addressing those risks, reviewing and monitoring them and quantifying the potential impact of operational problems across the bank's portfolio. The bank has to ensure that it has robust systems in place for mundane tasks such as collecting interest payments on time and keeping accurate and up-to-date records. It also means making sure its systems are not vulnerable to fraud.

An example where this could have a considerable impact is when it comes to making adjustments to capital requirements for credit risk mitigation tools such as netting, guarantees, credit derivatives and collateral. The bank must demonstrate that all the relevant documentation is legal in the correct jurisdiction, enforceable and up to standard.

Market risk also needs to be fully accounted for, and in some cases that may mean setting aside more capital to cover for unexpected currency or interest rate changes, for example. Previously, these factors where internalised in the deal, now they have to be separately accounted for and assessed.

Another area is swaps. Although, lenders do not expect much change in the way these are structured, they will need more information on counterparty risk.

Credit default swap use is are expected to grow strongly on the back of the new framework. Banks will be keen to offset risk so they can get the lowest capital allocations. They may also grow on the back of synthetic securitisations – but so far there has not been a headlong rush to securitise portfolios on the back of Basel 2. Those that have occurred have been driven by the need to recycle capital to get higher returns elsewhere. And for banks, which rapidly become Basel 2 compliant, securitising to achieve capital relief may not be necessary anyway, say bankers.

In a quest to reduce allocated capital, some bankers are predicting more involvement of the monoline insurers in wrapping debt. For example, for PPP or PFI projects a wrap can deliver a lower cost of capital to the public sector. For

lenders there would potentially be an even greater incentive to do so because it would provide higher returns on equity.

**Quality bias**

However, there is some concern that the framework's bias towards encouraging higher quality debt may negatively affect lending in emerging markets.

Many developing countries have credit ratings in the region of a single or double-B. In general, it is difficult for domestic borrowers to pierce the sovereign ceiling without the use of external enhancements. And a country's unique regulatory environment and lack of historical data make modelling and stress testing difficult.

Nonetheless, project finance banks already make regular use of a wide range of risk mitigants to pierce the sovereign ceiling. These include project cash flows being remitted to offshore accounts, which works particularly well with resources projects, which rely on export earnings. Other mitigation tools include political risk insurance and guarantees from export credit agencies. Under Basel 2, these various tools could play a more important role in structuring transactions, and this could feed through into more competitive pricing in some cases.

"Where you have strong documentation and a strong insurance package along with other mitigants, prospects for recovering capital tend to be high," says S&P's Weston. She adds that many defaults tend to occur because of legal and structural difficulties. Under Basel 2, banks will have to quantify those risks more clearly.

Another view is that emerging market-based banks will be at a disadvantage to international lenders from developed countries. For example, many countries in the Middle East are not expected to implement Basel 2 until around 2010. Yet loans in that region have very tight margins.

The theory goes, that being less risk sensitive, local banks could end up being loaded with below investment grade debt. But opinions are divided on that point. "I wouldn't overplay that, because we're used to having multi-tranched facilities with the participation of local banks, where debt is priced according to the appropriate terms and conditions of the local market," says Dublin-based Paul Leatherdale, head of infrastructure with Depfa Bank.

Moreover, the regionals' unique selling proposition is unrivalled knowledge of their local market, not to mention the high level connections to make deals come together in the first place. Also, depending on the country, the local regulator is likely to interpret the Basel regulations in a way that will not massively disadvantage local banks.

**More lending discipline**

The biggest impact of Basel 2 may well be on the internal workings of project finance teams. The new framework requires a lot more data crunching and analysis of projects at the origination stage. Legal structures will have to be studied more closely as well and have to demonstrate that they provide the necessary protection to lenders.

The various risks need to be separated out, better qualified and understood. In a sense Basel 2 imposes a greater degree of thoroughness and discipline on the process of lending.

It is generally believed that those reaching the more advanced stages of compliance first will have an edge over laggards. But for many lenders, project finance represents only a small proportion of their overall business which may mean becoming compliant will take a lot longer, as internal risk teams dedicate their resources to making the more important divisions of the bank compliant first.

Some in the market foresee this leading to more project finance portfolios being sold off or securitised – this would basically be an exercise in capital relief and or risk transfer. In some cases banks may even exit the business altogether. Indeed, if other divisions are Basel 2 compliant, but the project finance division is not, competing for internal capital may become a lot harder as well.

In the meantime, it may be too simplistic to state that there will definitely be a much greater disparity in the yields of different types of asset classes, partly because risk has to be segmented, recognised, qualified and accounted for, and also because there are many available risk mitigation tools to lower the percentage of allocated capital. It could be several years before the full impact of Basel 2 on project finance is appreciated.