
Specialised Lending

Pre-CRR3 AFME position paper

June 2019

Introduction to Specialised Lending:

Specialised Lending (SL) is widely used to finance many aspects of the economic value chain, for example in the areas of:

- the exploration, extraction and processing of essential natural resources, raw materials (*Project Finance*);
- the financing of trade flows supporting import and export of raw materials, commodities and products (*Commodity Finance*);
- the transportation equipment used to move these around, like ships, aircrafts, rail cars, containers (*Object Finance*);
- infrastructure and utilities that support these activities such as: hospitals, power plants, water treatment plants, ports, airports, roads, etc. (*Project Finance*);
- the facilities required to accommodate these activities, like production, logistics and warehouse facilities, offices, housing etc (*Commercial Property Finance*)

As the above demonstrates, SL provides the financing towards activities and enterprises widely considered essential to the everyday functioning and running of economies and society and where the cost is typically too great for corporate or government sponsors to finance on their own balance sheets. SL structures have therefore been developed such that finance packages can be put together with banks to finance these assets and facilitate the continuing development of the economies these assets support. SL is done through a mixture of transferring risk to the party best able to mitigate it and structuring the financing with security packages to lenders which give control over the cash flows, management, debt capacity and enhanced financial reporting to manage the risks such activities entail over time. Lenders have built risk models over time that have been rigorously reviewed and approved by Regulators and as proven these risks are effectively evaluated and RWAs set by these internal models. These allow banks to assess the risks, mitigants, debt capacity and pricing of the activities, thereby avoiding disproportionate capital allocation which would ultimately result in higher costs for end users (e.g. the cost of electricity generated by a power plant) through higher loan margins or the inability to develop these projects as banks can no longer lend to support such projects. By definition, SL is not standardised, and a standardised approach would restrict banks' abilities to finance SL either increasing the price of the service SL provides or preventing the development of public and private infrastructure and other development for EU member states.

It is therefore welcome that Basel III recognised over the course of its consultation and finalisation that banks should be able to continue to use the advanced approach and model for specialised lending. Nonetheless, the final text raises a number of concerns which could curtail

banks' ability to provide this form of financing in future in Europe. In this respect, it should also be recognised that SL is generally a European focused asset class and this will significantly impact European banks' ability to offer this financing, in particular with regard to the lowest default (and least risky) portfolios (n.b. the results of the IIF/ISDA impact assessment can be shared on a confidential basis demonstrating some of this impact). Irrespective of banks being able to continue to model, all banks will be required to calculate RWAs under the SA for the purpose of the Output Floor. Consequently, if there is not enough risk sensitivity reflected in the SA to SL then the SL calculation is expected to contribute to the Output Floor being a binding constraint for a number of banks.

More generally, as proposed the treatment for SL will in some cases be more penal than for unsecured corporate loans, even though for SL transactions lenders are able to exert control over the use of funds and the assets created, and ensure that contingency risks are addressed in advance. It is possible to restrict debt capacity and change of ownership and should a project run into difficulties, take it over through step in rights which enable banks to continue to run the project as a going concern, return it to health and potentially then sell or refinance it once cured. This is supported by long running studies conducted by the rating agencies that evidence default and recovery rates that are stronger than the corporate loan book.

AFME therefore strongly advocates:

- Under the Standardised Approach lower risk loans should attract lower risk weights and EU legislators should consider introducing a more granular lever of RWs.
- Under the Advanced approach the Basel input floor formula needs to be further refined to reflect the quality and collateral of transactions
- Refinements to the slotting approach (such as recognition of all forms of eligible CRM) and the perimeters of the SA and IRB
- Maintenance of the Infrastructure Support Factor which will help towards maintaining lending to some SL financing but does not compensate for the overall significant increase in RWs for SL

The rest of this paper sets out in more detail how the changes to the SA and IRBA proposed by Basel could do so and potential ways European regulators may wish to address this in the forthcoming CRR3.

Standardised Approach

Lower risk loans should attract lower risk weights: more granularity in the SA required

SL historical losses¹ show that SL is a low risk asset class:

¹ *Aircraft, Shipping* : source GCD, risk free discounting rate ; +5 added very conservatively added to the average LGD in order to get an equivalent loan rate discounting.

	Observed Default Frequency	Observed LGD	Loss Rate ²
Aircraft finance	1,96%	16%	0,31%
Shipping finance	3,13%	13%	0,41%
Commodities finance	0,89%	13,3%	0,12%
Project finance	1,50%	23%	0,35%
<i>Unsecured</i>			
<i>corporate loan</i>	1,80%	40%	0,72%

- SL loss rates are roughly two times lower than those for unsecured corporate exposures but the revised Basel III framework will apply the same RW under the standardised approach and does not take account of the lenders security over the asset in SL exposures.
- Within the SL asset class, different levels of credit risk attached to specialised lending exposures are assigned the same RWs. e.g. **Project finance**: High quality = 80%; Operational projects: 100%; Pre-operational phase: 130%
- RWs do not fully take into account security packages and covenants which allow for **control over future cash flows**.
- Industry therefore recommends more granular RWs to consider the quality of the project, transactions, contractual structure, LTVs (where appropriate for the SL sub-sector) and structuring features (e.g. reflecting self-liquidating trade related exposures). Legislators should also consider adapting the eligibility criteria for applying the different RWs.
- In addition, the perimeters of the SA and IRB are different – under the SA specialised lending does not include exposures to real estate. This should be aligned with the IRB which does include IPRE and HVCRE.

[See Annex 1 - Alternative proposals for SL under the SA](#)

Project Finance : source S&P Capital IQ, 2015 Annual PF Default and Recovery Study.pdf , loan rate discounting; (S&P Capital IQ Global Risk Services provides a data pooling service to banks).

Commodities Finance : source AFME Discussion Paper, Dec 2015, GCD.

Unsecured corporate loans : PD from S&P, LGD of 40% used corresponds to the IRBF unsecured LGD and is roughly also generally used on capital markets.

² Loss rate = ODF x LGD observed. Equivalent to sum of losses divided by sum of portfolios exposures, supposing equal exposures.

Advanced approach

Proposed Basel input floor formula needs to be further refined to better reflect quality and collateral of transactions

- The IRB introduces LGD input floors for SL which were designed for unsecured corporate exposures and have not been subject to a QIS, indeed, the changes introduced to the IRB approach to SL during the 2015-17 review were not subject to any impact assessment or formal industry consultation. European legislators should therefore consider further QIS alongside taking into account the changes industry proposes.
- 10/15/25% LGD floor levels are too high for the best quality/ collateralised transactions
- Basel III formula is aimed **at transactions with liquid collateral and publically available market prices:**
 - In specialized lending, security is rarely exercised: focus on restructuring and cure. Market value of collateral is not the only protection.
 - Moreover, collateral market value is not relevant for project finance in particular, including high-quality infrastructure projects
 - In these transactions the strength of contractual commitments and future cash-flows and the step in rights that would give lenders access to this, the ability to cure and then restructure or sell the project without loss is the primary driver of reduced LGD.
 - The formula needs to be adapted to avoid applying unsecured LGD floor (25%) to all these transactions
- The fixed 40% haircut of collateral in the LGD calculation formula does not differentiate between the quality of collateral and transaction structures despite the clear mandate of the Basel committee to maintain IRBA for SL. **Internal modelling should therefore be reflected in the calculation of the haircut** or the haircut should at least reflect different levels of collateral quality and transaction structures

[See Annex 2 – Alternative proposals for SL under the IRBA](#)

Slotting Approach

Under the supervisory slotting approach, Basel III sets a national discretion for the risk weights for PF, OF, CF and IPRE. This means supervisors may allow banks to assign preferential risk weights of 50% to “strong” exposures, and 70% to “good” exposures, provided they have a remaining maturity of less than 2.5 years or the supervisor determines that banks’ underwriting and other risk characteristics are substantially stronger than specified in the slotting criteria for the relevant supervisory risk category (*BIS Dec 2017, ¶58, p64*).

- In footnote 3 of the [high-level summary of Basel III](#) reforms, the Committee will review the slotting approach for specialised lending in due course, we welcome early clarity on when this will take place and urge for the wider SL framework to also be re-considered as per the our concerns above.

- In order to ensure **uniformity of the rules are applied consistently across the EU**, industry proposes the national discretion to apply 50-70% RWs should be adopted EU-wide. We would also recommend that the EBA give stronger guidance on what specific underwriting and strong risk characteristics would qualify for use of preferential risk weights.
- Regarding the granularity of the slotting approach, AFME supports the use of the EBA questionnaire for SL to determine the slot. More importantly we consider there is also a need to add more granular RWs beyond 50% - 70% for very high quality, mature operations, and to add at least one additional slot between slot 4 and 5 – currently the increase in RW is from 115% to 250%.
- We also consider there is need for clarity on the use of how to take into account UCP for the supervisory slotting approach. The CRR is silent on whether UCP (other than those already specified in the slotting approach like completion guarantees or guarantees provided by public entities in PPPs), can be recognised for specialised lending exposures treated under supervisory slotting. The EBA's slotting guidelines also do not take into account the treatment of additional guarantees, i.e. other than those already specified in the slotting approach, such as those provided by Export Credit Agencies for political and commercial risk or insurance policies covering the risk of a loan. Regarding ECA guarantees that effectively convert the guaranteed exposure to ECA or sovereign risk – we would like to understand how their impact can be reflected in the slotting approach, when the framework allows this to be done only through PD and LGD adjustments, but under the slotting methodology there is no PD/LGD to adjust. This anomaly could potentially be adjusted by either tranching the exposure in the context of ECA guarantees and risk weighting the guaranteed portion per the PD and LGD of the eligible guarantor, and using the Slotting risk weight for the uncovered portion and by revisiting the granularity of the of the slotting approach to allow for other risk mitigation to be reflected better in the risk weights. We note that in footnote 3 of the high level summary of the Basel III reforms the Committee that will review the slotting approach for specialised lending in due course, we welcome early clarity on when this will take place and urge the EBA to engage on any such review and consult industry in the process.

Proposals for alternative treatments for Specialised Lending

The following proposals are intended to reflect on how legislators could maintain a risk sensitive framework for SL in Europe.

Annex1: Standardised Approach

Industry strongly support an additional, lower level of risk weights/“upper grade exposures” for all categories of specialised lending in the standardised approach, which would be applicable to the top-quality transactions based on revised eligibility criteria proposals.

These upper grade exposures should benefit from weightings differentiating between levels of risk, as already proposed by the Basel Committee for Project finance and Income-Producing Real Estate.

Upper Grade Exposures

Project Finance			
Phase	Pre-operational	Mitigated pre-operational	Operational
Standard	130%	100%	100%
High quality	NA	80%	80%
High quality +	NA	60%	60%

Object finance (aircraft, rail and shipping)				
LTV Range	LTV <=70%	[70% ;85%]	[85% ;100%]	Criteria not met
Risk Weight	60%	80%	90%	150%

Income Producing Commercial Real Estate (IPCRE)				
LTV Range	LTV <=60%	[60% ;80%]	LTV > 80%	Criteria not met
Risk Weight	60%	80%	100%	150%

For **Commodity Finance** we propose the following table for RWs which account for the quality of the collateral and the structuring features of the transaction:

Commodity Finance		Structuring Features	
		Very good	Average
Collateral Quality	Very Good	60% ³	80%
	Average	80%	100% ⁴

Adaptation of Eligibility Criteria:

In order to set out which transactions fall into the relevant buckets set out above, industry has considered relevant eligibility criteria and definitions in detail below.

Project Finance

Operational phase of the project:

Project financing transactions receive different terms of financing depending on what stage of the cycle the project is at. Consequently, in the ‘operational phase’ paragraph 47 of the Basel III framework sets out that “Project finance exposures in the operational phase which are deemed to be high quality, as described in paragraph 48, will be risk weighted at 80%. For this purpose, operational phase is defined as the phase in which the entity that was specifically created to finance the project has (i) a positive net cash flow that is sufficient to cover any remaining contractual obligation, and (ii) declining long term debt”.

We propose refining the definition of the “Operational phase” as “the phase in which the entity that was specifically created to finance the project **or which is economically comparable**, has (i) positive net cash flows **to be generated over the asset life**, that are sufficient to cover any remaining contractual obligation, and (ii) **the project is operating**”.

We also propose introducing a further category: “Mitigated pre-operational” defined as follows: **“the phase in which satisfactory due diligence on construction risk is undertaken, with notably experienced and credit worthy constructors providing adequate protections in case of delay or underperformance, as reviewed independently”**.

Quality of the Project:

A high-quality project finance exposure refers to an exposure to a project finance entity that is able to meet its financial commitments in a timely manner and its ability to do so is assessed to be robust against adverse changes in the economic cycle and business conditions.

³ For a typical commodity finance counterpart with a PD of 3% such a ratio corresponds to an LGD of 20%

⁴ For the same type of counterpart, such a ratio corresponds to an LGD of 40%

We would also consider the following conditions must be met:

- The project finance entity is restricted from acting to the detriment of the creditors (e.g. by not being able to issue additional debt without the consent of existing creditors) or additional debt cannot be issued beyond a predetermined threshold without the consent of existing debt providers. Such thresholds are being expressed for example as a fixed amount or as a financial covenant (such as a ratio of Debt to Equity, or of leverage (Debt to Ebitda) or a Debt Service Cover Ratio (Cash Available for Debt Service/ Debt service), etc).
- The revenues are availability-based or subject to a rate-of-return regulation or take-or-pay contract; or the indemnity to be paid by the grantor of the concession in all cases of default, enables to fully repay the debt and the grantor is either (i) a central government or (ii) a local authority or a PSE benefiting from the central government guarantee; or part of the revenues are regulated or contractually fixed and the project is resilient to downside sensitivities regarding price and/or volume risk (like low demand risk or variable production).
- The project finance entity has sufficient reserve funds or other financial arrangements to cover the contingency funding and working capital requirements of the project;
- The project finance entity's revenue depends on one main or several counterparties and these main counterparties shall be a central government, PSE or a corporate entity with a risk weight of 80% or lower. In case of regulated tariffs passed through to consumers (whereby the off taker only acts as a pass-through entity and regulation provides for the substitution of the offtaker by another entity in case of financial difficulties, e.g. for renewable energy in some jurisdictions), the off-taker can be rated lower than investment grade and should have a minimum risk weight of 100%; **or** the project finance entity's revenue are derived from a pool of offtakers/counterparties guaranteeing each other's part of offtake, and one of these offtakers shall be a central government, PSE or a corporate entity with a risk weight of 80% or lower; **or** the project finance entity's revenue are derived from a pool of offtakers/counterparties and the majority of this pool shall be a central government, PSE or a corporate entity with a risk weight of 80% or lower.
- The contractual provisions governing the exposure to the project finance entity provide for a high degree of protection for creditors in case of a default of the project finance entity. This can be obtained through the pledge of assets and/or of the shares of the borrower, limitations for the borrowers' activity and additional indebtedness or of additional investments, negative pledges where appropriate". The main counterparties or other counterparties which similarly comply with the eligibility criteria for the main counterparties will protect the creditors from the losses resulting from a termination of the off-take contract where appropriate. Where there is a market or other possible off-

takers for the sale of the production of the project, no termination amount would be needed in the off-take contract;

- All assets and contracts necessary to operate the project, or the shares of the borrowers have been pledged to the creditors to the extent permitted by applicable law;
- “Creditors may assume control of the project finance entity in case of its default”.

In order to better and more risk sensitively differentiate between projects, we propose to define a “high quality” and a “high quality +” categories, on the basis of revenues structure and counterparty quality:

Subject to fulfilling the criteria listed above, projects would be considered in these two categories as follows:

High quality +: A project with a very good certainty of cash flows with no price or volume risk regarding debt repayment, and with the main counterparties regarding revenues, with a max RW of 80%, like PPP availability based , with sovereign type counterparts with a max RW of 80%, availability based purchase agreements with utilities with a max RW of 80% or corporates with an 80% RW, or Regulated Asset Base revenues in a jurisdiction (located in a high income OECD country) benefiting from an established regulatory regime

Typically, this “High Quality +” category would include for example an availability-based Public Private Partnership with the Federal Republic of Germany for a motorway extension with no traffic risk and payments only based on fixed costs plus limited operation and maintenance qualitative criteria; or an electricity distribution network in Sweden under an established and proven regulatory framework ensuring predictable return, power transactions; or waste / water treatments projects with availability based purchase agreements.

High quality: projects with a very good sustainability of cash flows like, ie with a low risk on debt repayment regarding volume or price risk, like projects with regulated tariffs or Regulated Asset Base revenues in a jurisdiction benefiting from an established regulatory regime but not located in a high income OECD country, or projects with monopolistic position with a good historical track record, or projects with contract for volume of production and with a comfortable buffer in terms of break-even compared to historical prices over at least a decade or renewable projects with regulated tariffs.

Typical transactions falling under “High Quality” would include renewable projects benefitting from a regulated tariff and exposed to volume risk but mitigated by historical data studies and conservative assumptions in terms of expected production.

Object finance

To achieve an appropriately risk sensitive approach for object finance we propose greater

Asset liquidity: Generally, object finance loans are secured by liquid and valuable assets which generate cash flows over the long term. Examples of aircraft receiving such finance include passenger, regional and cargo aircraft. Examples of vessels included in the SL shipping category would include container tankers, dry-bulk, box carriers, cruise vessels. Rail assets would include wagons, locomotives, high-speed trains. Liquidity of these assets can be observed through order books, assets already delivered and a number of operators. Values are observed through expert guides and appraisals.

Residual Economic life of the asset: this is the total remaining economic life span once the loan is fully repaid. This would also provide a buffer to adverse market conditions if and when necessary.

External support: External support is provided through corporate recourse and/or secured cash flows.

reflection on the quality of the transaction. This would consider an “upper grade” classification of an object finance transaction as one which meets the following three drivers:

ICPRE

To achieve an appropriately risk sensitive approach for object finance we propose greater reflection on the quality of the transaction. An upper grade ICPRE exposure would be expected to meet the following conditions:

Location: Property is located in a highly desirable location regarding services offered by it to its users (e.g. ease of access, transportation, energy and communication networks).

Property Features: Property favoured by clients due to its external design, internal configurations and maintenance status and is <10 years old or can remain competitive with new properties.

Market conditions: The demand for the property’s main type of use in its location is well-established. New or refurbished competing properties coming to the market are not expected to negatively impact this in a significant manner.

Commodity Finance

The BCBS proposes a RW of 100% for all unrated commodity Finance transactions under this approach. Furthermore, physical collateral is not recognised in the SA. The 100% RW does not consider structure, self-liquidating short tenors and the nature of the collateral which is pledged as security for commodity finance transactions.

We therefore consider this should be more granular to take account of the following:

Quality of collateral

Very good	
Very good	<ul style="list-style-type: none"> - No limited price risk (either presold goods, fixed price or hedged goods) - Limited counterparty risk on receivables (e.g. only investment grade type of counterparties) or receivables benefitting from credit enhancement (LCs or insurance cover from IG first risk banks or insurers) - Good liquidity (e.g. MSCI indexed crude oil or aluminium)
Average	<ul style="list-style-type: none"> - Potential price risk with average liquidity e.g. proto-chemicals - Average counterparty risk on receivables (non investment grade counterparts)

Structuring Features	
Very good	<ul style="list-style-type: none"> - Strong control of the bank over the collateral e.g. 3/3 B/L blank endorsed or in the name of the bank, WH receipt in the name of the bank - Local pledge or global pledge but for WHs in OECD countries
Average	<ul style="list-style-type: none"> - Bank has less control over the collateral (2/3 B/L; intragroup etc) - Global pledge but in non-OECD countries

Short term nature of the transaction:

Many commodity finance transactions have a limited maturity of 3-6 months, as they only cover the period of transportation. The IRB formula takes into account this short-term nature by means of the maturity adjustment but the SA and slotting approach do not.

Annex 2: Advanced Approach

Regarding the A-IRB approach we consider that the 15% LGD input floor is too high given the data on the actual risk for these types of transactions, and that the top-quality Commodities, Object and Project transactions should benefit from a 10% floor similar to that proposed by the Basel Committee for Income-Producing Real Estate.

SL Activity	Asset Quality	Input Floors*
Object Finance	Standard	15%
	Upper Grade with LTV <85%	10%

*Input floors applying to the part of the loan covered by the asset after haircut

SL Activity	Asset Quality	Input Floors**
Project finance	Standard	20%
	High Quality	15%
	High Quality +	10%

**for project finance, input floors that apply directly to IRBA LGD (difficult to value project finance transactions)

In the calculation formula for the project finance LGD floor, we consider the uniform 40% haircut proposed by the Basel Committee (which mirrors the level proposed in the F-IRB approach) undermines the policy intention to maintain the A-IRB approach for SL, as it does not allow A-IRB banks to reflect differences in the quality of collateral and transaction structures between various transactions. Internal models should be allowed in the calculation of the haircut level or, at the very least, that variations in the quality of the collateral should be reflected in the applicable haircut. Furthermore, it is not possible to apply the proposed LGD floor formula to project finance in practice, as the LGD cannot be calculated from a market value of the assets, despite project finance generating sustainable cash flows and shows strong recovery rates. (N.B. In the case of aircraft finance, market prices are available as estimates are published by different appraisers, which should be recognized).

For **Object finance and IPCRE** we propose the following more risk sensitive haircut levels:

SL Activity	Asset Quality	Haircut
Project finance	Standard	40%
	Upper Grade	30%

ICPRE	Standard	40%
	Upper Grade	30%

For **Commodity Finance** transactions based on underlying criteria we suggest adopting the following grid as applicable haircuts. This provides a more risk sensitive approach towards the short term, self-liquidating and highly collateralized structures (either through physical collateral, guarantees or ECA insurance) with low observed defaults of average 0,89.

Commodity Finance		Structuring Features	
		Very good	Average
Collateral Quality	Very Good	10%	25%
	Average	25%	40%

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