
AFME Position Paper

CRR2: Infrastructure finance scaling factor

27 March 2017

Background

Specialised lending transactions are an important asset class for financing infrastructure and physical assets, including transport infrastructure (roads, railways, etc.) and related assets (aircrafts, ships, rolling stock etc.), health and social infrastructure (hospitals, schools, etc.), environment and energy infrastructure (power plants, gas and electricity networks, water treatment centres, etc.), telecom infrastructure (satellites, etc.) and commodities (which include oil & gas, metals and minerals, agriculture, etc.).

They are specifically defined in the Basel and CRD frameworks and, according to the EBA, are exposures “to an entity which was created specifically to finance or operate physical assets or [...] an economically comparable exposure, [where] the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate and the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise”¹.

Specialised lending exposures include project finance, object finance, real estate and commodities finance. European banks had specialised lending exposures of over €1 trillion in Q3 2014². Specialised lending is therefore a particularly important tool for supporting economic growth through the financing of investment and trade, particularly when capital market alternatives are still in the process of developing.

On average, specialised lending exhibits low risk levels. This is particularly the case when the activity is carried out and monitored by specialised, expert teams within banks and is further backed up by analysis performed by reputable rating agencies³. This is due to a combination of the industry knowledge of the teams together with the tailored, structured and (over)collateralised nature of these products. For example, in project and object finance transactions, structures are put in place so that the lender controls the cash flows generated from the underlying asset(s) and/or benefits from the security of the asset itself. Banks also benefit from diversification across their specialised lending portfolios, where the values of different infrastructure assets, aircraft, vessels, rolling stock and various commodities are not correlated, which contributes to lowering risk levels overall.

More information about specialised lending is available from AFME through a suite of discussion papers⁴ describing the typical features of these products, how their structures contribute to lowering risk and their appropriate regulatory capital treatment. These papers also include historic loss data and case studies illustrating how underlying structures have protected lenders in practice.

¹ [EBA final draft RTS 2016/02](#), 13 June 2016

² [EBA consultation](#) on slotting criteria for specialised lending, COREP data Q3 2014

³ See for instance Moody's Default and Recovery Rates for Project Finance Loans, 1983-2015

⁴ The suite of discussion papers can be found here: <https://www.afme.eu/en/divisions-and-committees/regulation/about-specialised-lending/>

Capital treatment of infrastructure finance

Capital requirements for specialised lending exposures, including infrastructure exposures, are currently determined either according to the Standardised Approach for credit risk, or, if a bank has the relevant permission from its supervisor, under a slotting approach or one of the IRB approaches.

The current CRR2 proposals do not change the general treatment of specialised lending exposures in the EU prudential framework but introduce a scaling factor to be applied to a limited subset of such exposures under both the Standardised and Internal Ratings Based Approaches of the credit risk framework. This subset involves exposures aimed at **funding safe and sound infrastructure projects**, further defined as exposures to “entities that operate or finance physical structure, facilities, systems and networks that provide or support essential public services” (title of Art 501a of the CRR2 proposals).

According to the explanatory memorandum of the CRR2 proposals, the scaling factor is intended to promote viable infrastructure finance that is important for economic growth in line with the objectives of other initiatives such as the Capital Markets Union and the Investment Plan for Europe.

AFME views on the proposed scaling factor for infrastructure exposures

The scaling factor is positive for EU economic development

AFME very much welcomes these objectives and supports the scaling factor as a means of achieving them. Indeed, the scaling factor can play an important role in ensuring that EU investment levels return to historical growth trends via the following two channels:

- Capital consumption on new loans will be lower, resulting in a more competitive offer and ultimately cheaper-financing costs for such new projects
- Direct capital relief on the existing portfolio of such exposures can be used to reinvest in new projects

Its introduction should be accelerated

We also think that there is an urgent economic need for infrastructure investment to resume and we therefore recommend that the implementation date for the scaling factor be advanced so that it coincides with the adoption of the legislation proposal by the co-legislators (rather than after two years after entry into force as it currently proposed).

Refinements to the criteria for its application are necessary

We understand that the proposal is aimed specifically at encouraging investment in “safe and sound” infrastructure projects and that the criteria set out in the CRR proposals for achieving this draw on work performed by EIOPA in the context of capital requirements for insurers (Solvency II). Providing balanced capital treatment incentives to both banks and institutions investors is welcome and is particularly beneficial in the current market which sees a growing number of infrastructure projects financed with hybrid financing structures, involving different types of financiers at different project stages. In the CRR, these criteria would however benefit from refinements to ensure that an appropriate category of assets is covered by the scaling factor.

For instance, as currently drafted, para 1a and 1b of Art 501a appear to be contradictory, with para 1a allowing project-like corporate exposures and para 1b prohibiting such structures. Many infrastructure projects are undertaken without the creation of a special purpose entity (SPE). Under the current CRR, the financing of a corporate can qualify as a Project Finance exposure when it is set up as being de facto equivalent to an SPE, for instance by placing limitations on the borrower as to the types of activities it can undertake, having control over the underlying assets and their revenues, the level of permitted additional debt borrower may enter to, etc. via the underlying structure. Given that such exposures are economically equivalent to those currently covered by the proposals, we think it would be beneficial for them to be clearly included in the scope of the scaling factor as this will broaden the potential impact of the provision on the economy.

Another area of concern is that infrastructure finance also includes the acquisition and development of brownfield assets and, in some cases, it is not the assets themselves that are financed, but rather the rights to operate such assets. These are all important forms of infrastructure finance that should equally be covered by the scope of the scaling factor.

AFME is in the process of developing suggestions for possible areas of refinement to the criteria and will share these in due course.

Future regulatory capital treatment of specialised lending

Finally, we also wish to point out that, depending on their outcome, discussions at Basel level may have a significant impact on the availability of specialised lending exposures with low risk profiles and may offset the beneficial effect of the scaling factor. The removal of internal modelling under consideration and the introduction of standardised output floors would result in increases in specialised lending risk weights that would be highly penalising for low risk exposures in particular. In our view, any unjustified sources of RWA variability should be addressed in the context of a revision of internal models but it is essential to retain a risk sensitive capital framework for such exposures. This is best achieved via the continued use of internal modelling when institutions have been granted the permission to use such models by their competent authorities as this approach recognises the benefits of underlying proactive structures, risk management expertise and business sector knowledge when it is present. Conversely it also means higher capital requirements when these features are not present.

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.