

## The Europe 2020 Project Bond Initiative

### *Innovative infrastructure financing: the Project Bond Initiative*

7 November 2012

#### **Europe 2020 Project Bond Initiative in short**

**The objective:** to stimulate capital market financing for large-scale infrastructure projects in the areas of trans European networks in transport and energy, as well as broadband telecommunications. The initiative is designed to enable promoters of infrastructure projects to attract additional private finance from institutional investors such as insurance companies and pension funds.

**How:** by providing credit enhancement to project companies raising senior debt in the form of bonds to finance infrastructure projects; The improved credit quality of the bonds will facilitate their placement with institutional investors.

The bonds will be issued by the project companies themselves, not the EIB or the Member States. The EIB will provide credit enhancement in the form of a subordinated instrument (either a loan or contingent facility) to support the senior debt issued by the project company. The project company will generally be a public-private partnership (PPP) established to build, finance and operate an infrastructure project.

**Expected results:** increased availability of private sector financing from the capital markets to finance key infrastructure.

#### **Background**

According to the European Commission, to meet the Europe 2020 objectives the European Union's infrastructure investment needs could reach as much as EUR 2 trillion in the sectors of transport (TEN-T), energy (TEN-E) and information and communication technology (ICT).

In his "State of the Union" speech in 2010, EC President J.M. Barroso proposed the "Europe 2020 Project Bond Initiative" to mobilise the necessary funding for project financing of infrastructure: "An EU initiative to support project bonds, together with the EIB, would help address the needs for investment in large EU infrastructure projects".

The legal base of the Europe 2020 Project Bond Initiative was adopted in the summer of 2012 by the European Parliament and the ECOFIN Council.

The objective of the cooperation with the European Investment Bank is to build on existing experience with joint EU-EIB Group instruments and utilise the EIB's expertise in EU infrastructure financing.

Project bonds are also one of the financial instruments foreseen under the proposed "Connecting Europe Facility" (CEF), which in turn is part of the wider "Europe 2020" strategy. The aim of the CEF is to provide a longer-term financial framework ensuring that energy, transport and telecommunications projects are developed and implemented in a timely and effective manner.

#### **What is the reason for this initiative?**

The main objective of the initiative is to create the conditions to attract additional private sector financing for individual infrastructure projects.

In the past, capital market issues were an important source of financing for infrastructure projects. Monoline insurance companies guaranteed the full credit risk of senior lenders. However, since the financial crisis there have been few new issues guaranteed by the monolines. Furthermore, the sovereign debt crisis and pressure on banks' balance sheets from higher regulatory capital and other requirements (Basel II and III) have constrained other sources of long-term infrastructure financing.

There is therefore a need to find new ways to promote private sector financing of infrastructure projects without increasing direct public funding and therefore public indebtedness.

The Europe 2020 Project Bond instrument is designed to provide an alternative to financing projects through bank loans or public sector grants in order to close the infrastructure financing gap. If a project can be appropriately structured, grants and project bonds could potentially be combined.

### **Who are the investors?**

Institutional investors such as pension funds and insurance companies, i.e. investors with long-term liability structures and regulated rating requirements for their investments. For these investors, project bonds represent a natural match for their long-term obligations.

Besides having access to a new asset class providing diversification and a good rating, investors will also be interested in project bonds because of the EIB's expertise.

### **How does credit enhancement work? Why is it different from the bonds wrapped by monolines?**

The initiative aims to provide partial credit enhancement to attract capital market investors.

The mechanism of improving the credit standing of projects relies on the capacity to separate the debt of the project company into tranches: a senior and a subordinated tranche. The provision of the subordinated tranche increases the credit quality of the senior tranche to a level where most institutional investors are comfortable holding the bond for a long period.

The subordinated tranche – namely the Project Bond Credit Enhancement (PBCE), provided by the EIB with EC support – can take the form of a loan, which is given to the project company from the outset, or a contingent credit line which can be drawn upon if the revenues generated by the project are not sufficient to ensure senior debt service.

The support will be available during the lifetime of the project, including the construction phase.

In contrast to the monoline model, the proposed mechanism of the initiative will:

- i) be limited in amount from the outset (capped at EIB and EC commitments under the instruments) with a maximum size of individual transactions of up to the lower of EUR 200 million or 20% of credit enhanced senior debt;
- ii) as subordinated debt, target an up-lift of the project rating to A-AA rather than AAA;
- iii) be based on the EIB's capacity to deliver subordinated loans, not necessarily its rating;
- iv) only target the EIB's core business, i.e. infrastructure financing;
- v) only support robust projects
- vi) benefit from the EIB's proven due diligence, valuation and pricing methodologies.

### **What is the timeline of the Project Bond Pilot Phase?**

In July 2012, the European Parliament and the ECOFIN Council approved the legislative proposal issued by the Commission in October 2011. The Cooperation Agreement between the EIB and the European Commission, defining the mechanism for risk and revenue sharing between the two institutions, was endorsed by the EIB's Board of Directors on 23 October 2012 and was signed on 7 November 2012.

The EIB/EC Project Bond Credit Enhancement instrument has been launched. Given the significant lead time required for infrastructure projects to reach financial close, the EIB and EC invite all market players to contact the EIB directly for project or instrument information.

Suitable projects will need to reach financial close between now and end of 2016, provided that the EIB obtains financing approval by its Board before the end of 2014.

### **Which projects can make use of EIB/EC Project Bond Credit Enhancement?**

In terms of projects targeted, the pilot phase will be looking at those fulfilling corresponding sectoral eligibility criteria: trans-European networks in the fields of transport and energy, as well as broadband and ICT projects.

Based on market demand and opportunities, the EIB is identifying projects that present reasonable prospects of successful closing within the pilot phase and will engage in its usual due diligence process.

As a good number of projects currently under planning with national authorities will not be ready during the pilot phase, the EIB is also engaging in up-stream project preparation work together with tendering authorities in order to position capital market solutions for the period 2014-2020.

Market and project opportunities are important factors when it comes to the geographical spread of the initial transactions. The first pilot projects will most likely be situated in one of the EU's more advanced PPP/project finance markets, but the objective is clearly to have standardised products enabling the Europe 2020 project bonds to fund projects throughout the Union.

**What is the rationale for the "pilot phase?"** The scope of the pilot phase is to test the project bond concept during the remaining period of the current multi-annual financial framework 2007-2013, before the next multi-annual financial framework 2014-2020 and the implementation of the CEF (Connecting Europe Facility)." . This testing phase will be funded by means of re-deployment of unused EUR 230 million of EU budgetary resources from budget lines for existing programmes. The sectoral split will be as follows: EUR 200 million and EUR 10 million will be dedicated to trans-European networks in the fields of transport and energy respectively; EUR 20 million will be dedicated to financing high-speed broadband projects. The budget of EUR 230 million should enable the EIB to provide financing to infrastructure projects worth more than EUR 4 billion across the three sectors.

### **What is the role of the EIB?**

While the European Commission's role is to define sector eligibility criteria and provide the EIB with the capital contribution required to enable the Bank to credit enhance project bonds, the EIB will:

- (i) select and appraise the projects according to its normal standards
- (ii) structure and price the credit enhancement instrument
- (iii) monitor the projects thereafter

Although the EIB will not be acting as a controlling creditor, a decision matrix is currently being developed and will need to be agreed on a project by project basis by the parties.

**APPENDIX:**

**For specific information for public authorities:** see "[Financing PPPs with Project Bonds - Issues for public procuring authorities \(10/2012\)](#)"

For information on the **pilot phase (Europa website):**

On 10 July, ECOFIN issued country-specific recommendations on the economic and fiscal policies of the Member States and a recommendation for the eurozone as a whole. Furthermore, it gave the go-ahead to the PBI pilot phase: [http://consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/131686.pdf](http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/131686.pdf)

**The pilot phase of the Europe 2020 Project Bond**

**Initiative:** [http://ec.europa.eu/economy\\_finance/financial\\_operations/investment/europe\\_2020/index\\_en.htm](http://ec.europa.eu/economy_finance/financial_operations/investment/europe_2020/index_en.htm)

**Q&A “A pilot for Europe 2020 Project Bond Initiative - legislative proposal adopted by the Commission - Memo/11/707:**

<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/707&format=HTML&aged=0&language=EN&guiLanguage=en>

For **background information**, see previous related documents:

**The press release announcing the initiative (28/02/2011):**

<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/236&format=HTML&aged=0&language=FR&guiLanguage=en>

**Introduction, Q&A and results of the consultation (Spring 2011):**

[http://ec.europa.eu/economy\\_finance/consultation/europe\\_2020\\_en.htm](http://ec.europa.eu/economy_finance/consultation/europe_2020_en.htm)