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Speech at the Commission Consultation on Project Bonds

Thank you for inviting me to speak – as you will know it was very short notice and I only read the documents last night, so you will get rather more of a stream of consciousness than a crafted position statement. However that might be more exciting!

We are in difficult times. The financial crisis has become an economic crisis and also a sovereign crisis. Economists tell us this is the usual progression.

What is unusual is the ongoing interconnectedness of these three phases.

This morning, the Commissioner said that the economy is improving, but uneven. Often the crisis is talked of in medical terms and we are certainly in the phase of having to suffer an unpalatable treatment to cure an otherwise fatal illness.

It has at last become fashionable to recognise the interaction between microprudential regulation and macroeconomic effects. But just because it is fashionable, it does not mean there is yet the collective political will to do anything about it looking at the effect of regulation. Where it is being done the effort is still directed towards spotting wrongs rather than looking at the effects of new regulation.

We are about to have the second round of bank stress tests and although the new EBA is standing up to pressure to keep the tests tough, the banking book is not being stressed.

Some Member States seek a solution to the fact that banks are undercapitalised and not recognising impaired assets by forcing exemptions and special treatments in CRD4.

My message on this, and that of the Parliament - is that bank recapitalisation has to be done. Denial is not an option. Further, I would add there will be no end to the Eurozone problems until there is recapitalisation because - in some instances quite unfairly - fear will freeze vulnerable markets.

We got into the sovereign crises in part because of the special treatment of sovereign debt in capital requirements - zero risk weight is not appropriate in a monetary union, and was in part a driver for the mess we are in. Although there is at least some recognition of this now, most are still shying away from it.

The wave of new regulation agreed at G20 level moves forward but it does not calm markets because there are many unknowns and still more unknown unknowns of unintended consequences.

So that is the background to the 2020 Project bond proposal - the fact is that previous sources of private finance have dried up and this is a way to try and replace them, albeit in a limited and specific way.

I have a feeling of déjà-vu about coming to speak here at short notice because I did a similar thing in March last year at a conference on 'financing Europe's energy needs' and almost everything I said then is relevant – so you can look it up – but for example one passage said

"We are on CRD 3, having done CRD 2 last year. CRD 4 and maybe 5 are in the pipeline. These all load further requirements onto banks capital base. And as everyone here probably knows for each Euro tucked away in capital that is some 10 Euros that can not be lent. And of course the cost of capital will rise. Certainly some of the measures are necessary, but some - such as the constant rehash of measures on securitisation - will not aid recovery of all the good securitisation (which is the main bulk of it) and of course this has impact on the energy markets and front loaded funding."

So, as the Commission says in its documents, there is drying up of project finance through banks and - put bluntly - what we seem to be trying to do is make the EU and EIB into the replacement for the monoline insurers which previously were used in similar initiatives.

The Commission is keen to distance this proposal from the debate around Eurobonds and that is right, and certainly in the resolutions and reports of the ECON committee that distinction is well drawn. Investment has been, and still is, the hottest part of our debate on the Economic Governance package and while Eurobonds in the sense of a common sovereign issue remain highly contentious there is a general consensus that Project Bonds represent a very exciting initiative.

We have already given positive support to Project Bonds in the context of EU 2020 in the Podimata Report on innovative financing and the Cutas Report on the EIB.

At this stage, when Parliament's calls are of a general policy nature ahead of any specific detailed proposals, there certainly are some quarters that would like a wider application of project bonds with a specific part of the EU budget allocated for this and also for the EIB to assist also where there is co-financing. So the Parliament position is that the principle is clearly accepted that if we can use project bonds for achieving investment, leveraging benefit from EU funding then we certainly give the green light to investigate all possibilities.

This is easier said than done, and of course the Commission is trying to make a start here with a narrowly defined project bond linked to specific infrastructure, and then if that can be made to work the next step could well be to look a little wider, but still in the realms of project bonds.

So that's the easy bit.

Now we come to the delivery part – we have no reports on this – so rather like quite a lot of the economic governance matters having gone ‘off- Treaty’ as it is politely termed, this is where I go ‘off road’ and explore my thoughts on the rugged terrain that lies around the smooth ideological principle on which we have just agreed.

My first thought is ‘read our markets financial regulation agenda and weep.’

Basle 3 has already been spotted as a source of problems and one of the reasons why insurance and pension funds might be looked to as alternative investors to replace banks. Of course the banking problem is not just one of having to find capital it is also to do with the emphasis that is being put on liquidity.

It is not entirely clear to me that the Commission has spotted Solvency 2 creates many of the the same problems too. Last Friday at the informal Ecofin I was reminding ministers of the problems in sameness of prudential regulations and that insurance companies were bailing out of equities and corporate bonds. Again there is an emphasis on liquidity.

IROPS offers opportunities for us to make this even worse and trap pension funds the same way.

AIFM may still cause some problems, and the securitisation due diligence and retention requirements that are pasted into everything going may well rear their head on any bond purchase too.

EMIR and derivatives – oops another problem along with collateral posting and of course it is also entwined with hedging

Then there is accounting and IFRS and MiFID 2.....

Maybe I should stop, but there is plenty there to think on.

This is not to say these matters create a bar to project bonds, but there are many interactions. Potential investors will be wondering about them and what credit risk will be assigned to any bonds and how that will interact with all these prudential regulations. What will be the liquidity of the bonds – they may be designed for holding to maturity but our regulations are not dealing very well with such matters. As well as my list above, I also cite the absence of business model approach in accounting standards where making loans and collecting interest would need to be seen as different from trading in loans which requires mark to market.

In the consultation paper I note the statement that the proposed steps would not be stand alone in the area of debt financing but would be complimented by measures to promote development of equity markets to obtain better coverage of the financing needs of infrastructure projects. We all want that, but the same questions arise – how, and is our regulation making it progressively more difficult?

A further element in the mix also seems to be reference to ratings, to produce an A rated bond, so just as efforts are made to rely less on ratings, maybe, they are coming back in somewhere else.

Another thought – which I said in the introduction, is that the role of the EU and EIB, seems to be to replace the monolines. I have a little list of thoughts that popped into my head in that connection.

First is the issue that there will in essence be a limited EU guarantee for the first loss. We must recognise that this is only a graduation of the potential losses for private holders of the bonds and does not represent a removal of risk in the regulatory sense. Also it is likely this guarantee, in the context of infrastructure, will be used in the construction years before

returns leading to a moral hazard under threat of loss of a needed project at later stages.

Then in the consultation paper it acknowledges that pension funds and insurers do not have the expertise to appraise projects and carry out the analytical and administrative follow ups that used to be performed by the monolines. So the proposal is to perform a credit enhancing operation with senior and junior tranches, selling on the senior debt. There seems to be here some implication of "so no need to check then", which makes me pose the question have you not been looking at the due diligence requirements we have been putting into things? Some may also say this sounds a bit too familiar, but of course credit enhancing is not all bad. However at the least, as I said, due diligence provisions on the investors will click in.

What then caught my attention a little more was the suggestion that there would be security for the guarantor from the diversification of a portfolio of projects.

Diversification is always helpful but as the portfolio is all long term infrastructure – albeit in different fundamentals of transport, energy and communications, there might be higher correlations than you would want. Now I know some of you nwill begin to think I am on a bet to mention correlations in every speech, but this was where the monolines went seriously wrong and frankly we do not seem to have a grip on how to get correlations right – I cite ongoing solvency 2 struggles on catastrophies as an example and something I seem to have been mentioning for four years.

The next eye catcher as I wandered through the consultation document was the up front premium on risk taking. Although at this stage I fully understand the Commission does not want to get bogged down in how this mechanism could be used to help countries struggling with deficits, it is clear that some are already thinking along those lines. Pricing will certainly be key

element and without wishing to muddy the water in the area where the Commission specifically does not want it muddied - I am a little worried that when looking to some of the wider ranging ideas that incorporated grants or co-funding areas, some of the bad pricing choices being made in the various stability mechanisms might rear their head.

My final concern is to keep both a cool and hard head when it comes to the conditionality that private companies or investors might wish to place on the financing structures. These are long term projects and care must be taken not to be dazzled by a seeming short term prize. Take a look at worst case scenarios. We must not be fleeced up front and then we find nothing was gained, or as in Portugal, find ourselves eternally paying as a consequence of moral hazard.

Last word on timing: 2014 is ambitious, not least because we will not know the impact of all the regulation and this will inevitably be reflected in pricing.

However, the 2020 project bonds may be constrained enough to work, simply because they will be limited.

As yet I have doubts over it leading a charge to get capital markets re-involved, but getting something moving has to be done so I commend the initiative.

What this also highlights as a matter of urgency is that those planning regulation must lift their eyes to the future and deal with long term investment as a priority, now simultaneously with other regulation, so that any alternative treatments are done properly, and not as an afterthought or exemption that could become the next sovereign risk weight mistake.

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