# Demand View: Elements of Investor Requirements and Market Drivers

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TRIFINIUM

# Elements of Investor Requirements and Market Drivers

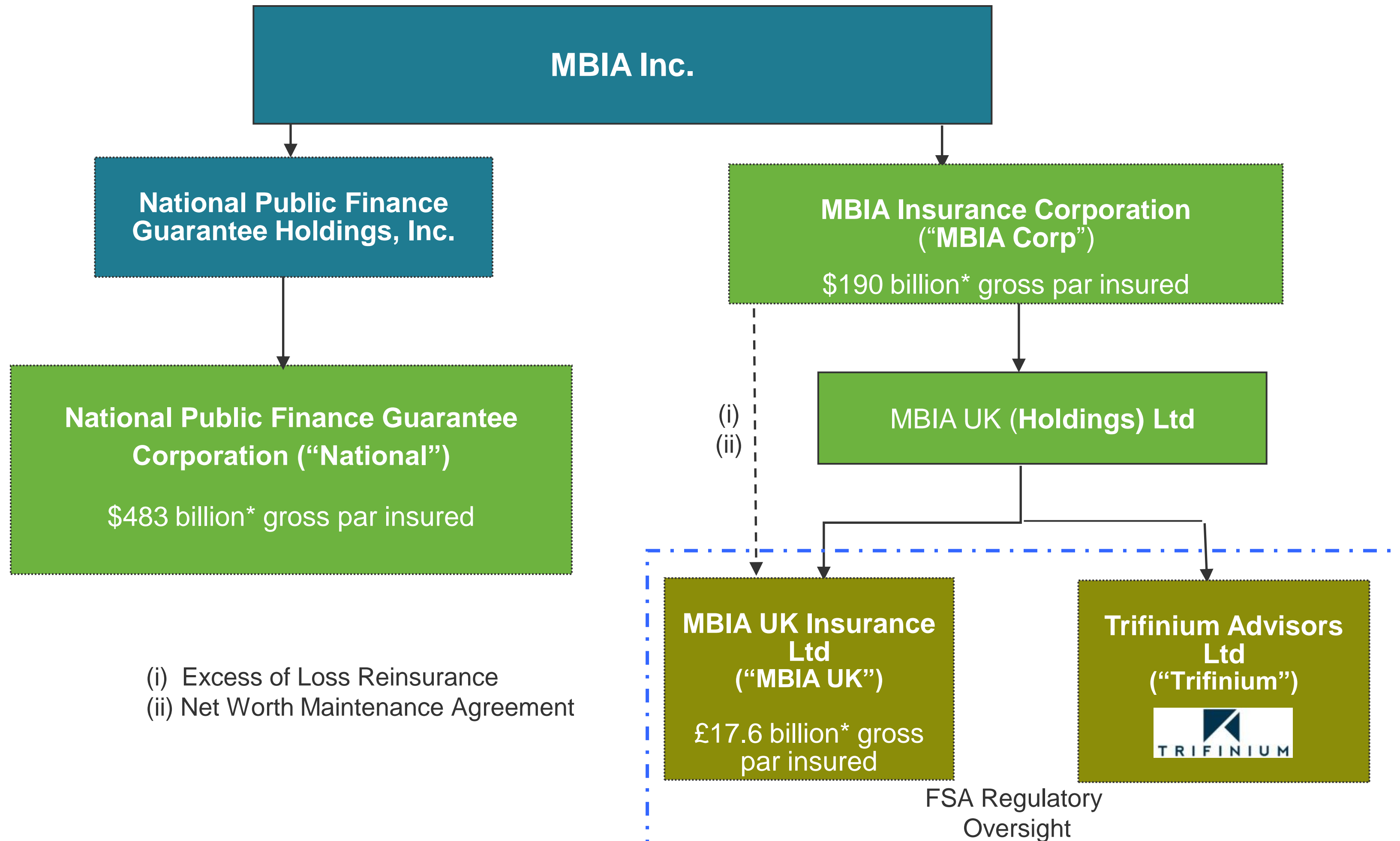
- Introduction to MBIA UK Insurance Limited and Trifinium Advisors Limited
- Observations on the Infrastructure Market
- Generic Overview of Bond Structures and the Controlling Creditor Role
- Solvency 2: Infrastructure Treatment
- Conclusions

# MBIA UK Insurance Limited (“MBIA UK”) aka: *What is a Monoline?*

- MBIA UK is a monoline insurer: Only one line of insurance: Financial Guarantee Policies
- MBIA UK’s financial guarantees generally provide an unconditional and irrevocable guarantee of the payment of the principal and interest on insured obligations when due
  - Serves as “Controlling Creditor”: Single point of contact for issuers on insured debt
- MBIA UK is the principal operating entity through which MBIA’s insurance operations writes financial guarantee policies in Europe
- MBIA UK performs risk assessment and active transaction management through an existing specialist team of European Analysts in London and Paris (MBIA Insurance Corp. also has an office in Madrid)
- MBIA UK currently insures and monitors £10.8 billion (gross par as of 31/12/2010) of Public Sector Debt including:
  - £2.5 billion of PPP Public Bonds and Private Debt
  - £1.3 billion of Transport Infrastructure (networks and single assets)
  - £4.0 billion of RAB based water and energy utilities (primarily structured water)
  - £1.0 billion of other including Regional and Local Government direct debt
- MBIA UK  has claims-paying resources of £733 million as of 31/12/2010 (Liquid assets* of £454 million)

** Liquid assets includes cash, investments and accrued interest*

# MBIA Inc.
## *Partial Organizational Chart*




* Gross par insured for MBIA Corp, National and MBIA UK are as at 31 December, 2010. Please refer to www.mbia.com for all latest disclosures relative to MBIA Inc. and its subsidiaries

# Trifinium Advisors Ltd

- Licensed by the FSA to advise on and arrange investments and to provide insurance mediation services to professional clients in UK and the EEA.
- Trifinium offers bespoke solutions to equity, mezzanine or senior debt and fund investors
  - Trifinium's solutions can be specially created or bolted-on to existing structures
- Trifinium provides the market with similar services to those which a monoline would provide itself when evaluating project finance risks:
  - **Due Diligence** on assets including review of credit fundamentals and modeling
  - **Structuring input** on finance documents, including with respect to complex intercreditor arrangements, often between three groups of creditors (Bond, Loan, Supra)
  - **Monitoring** of existing portfolios including making timely decisions on consent and waivers while undertaking required investor reporting
- Trifinium can be a permanent "insider": Provides issuers with an experienced counterparty to provide creditor feedback on public and non-public issues as they arise

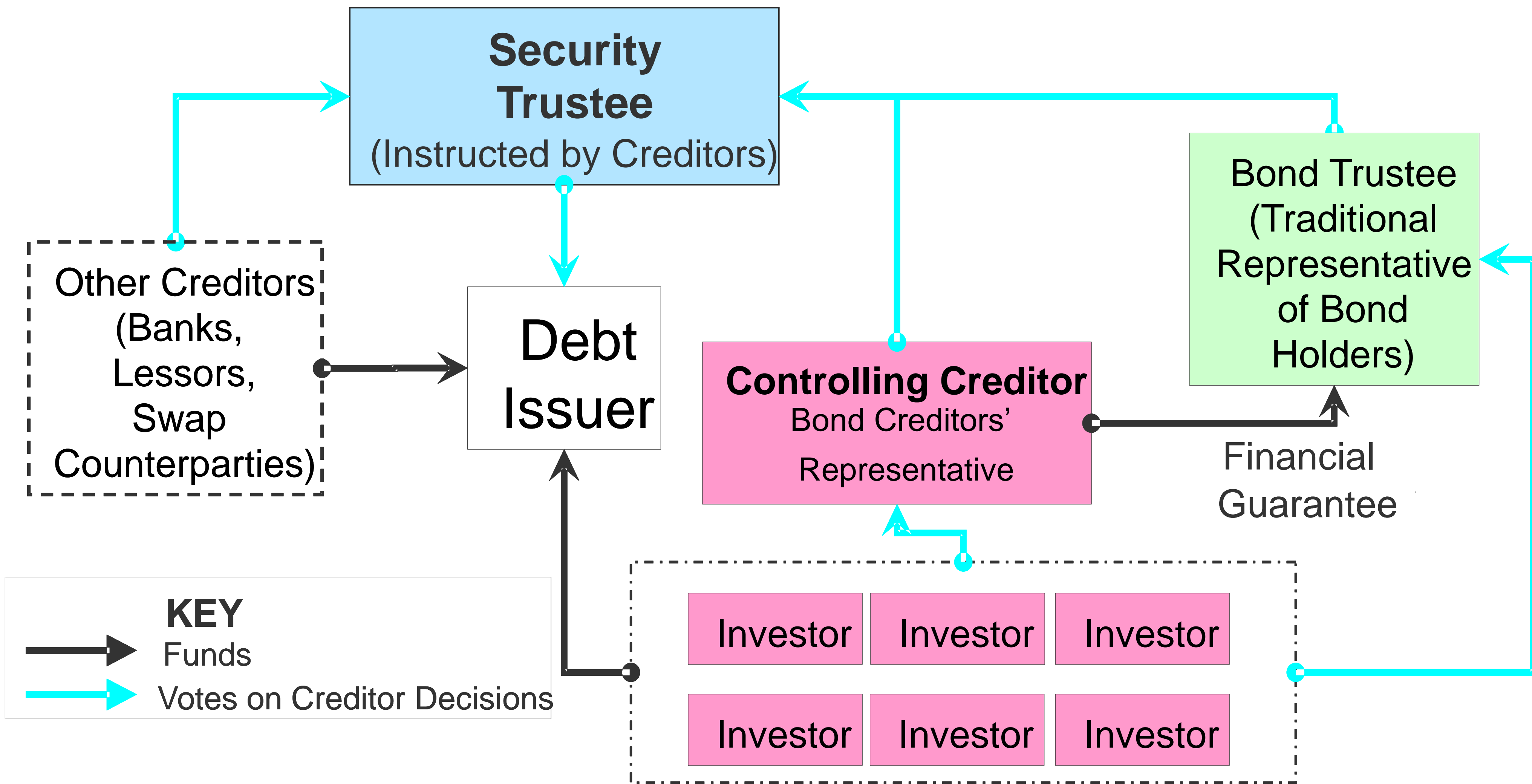
# Why Is There No Infrastructure Bond Market Today?

- Decline of monolines
- Procurement rules
- Impact and uncertainty of Solvency 2 and potential pension fund regulation
- Dominance of bank market:
  - Pricing
  - Internal rather than external rating agency requirements
  - Perceived flexibility of banks
  - Willingness of sponsors to selectively assume refinancing risk
- Limited secondary market for pricing and liquidity
- Complexity of new construction when compared to post-construction or existing assets

# Key Observations on State of Project Bond Market

- There was a long-dated, new issue, project bond market in the UK until late 2007
- Infrastructure is simple in concept but complex in its execution: No two roads are alike!
    - Construction, operations, contracts and finance structures are all devils in their details
- EU member states include a variety of approaches, laws, regulations and differing credit profiles
    - The credit analysis of financial support from local governments = additional credit considerations
- Investor appetite is diverse with respect to credit risk factors: traffic, construction, geography, etc
- Infrastructure is stable but it's no surprise that, through the transaction life, infrastructure financings require timely decisions from creditors -- "things change" and "things happen"
- Investors increasingly recognize the value of long-dated assets to match their long-dated liabilities but are often constrained by:
    - Lack of expertise to manage complex transactions
    - Lack of liquidity for infrastructure debt
    - Lack of supportive investor regulation to encourage infrastructure investments
- Investors need opportunities and experience to develop their own skills for the future

# Generic Bond Structure: Role of “Controlling Creditor”



# Controlling Creditors Perform a Critical role

- Typically assumes "monitoring" including site visits and consultation during construction
- Controlling Creditors can instruct Trustees on behalf of investors according to documents
- When a request for a change arrives, conversations are frequent and with multiple parties:
  - Reviews of request (using experts where required) to ensure change is not "material"
  - If the transaction requires "remediation" then the process becomes complicated
- Examples of commercial changes in long-term structured bond transactions requiring a commercial interface:
  - Change of Control and related documents (e.g. shareholder tax indemnities)
  - Changes in construction programmes
  - Debt tenders and exchanges as alternative to early redemption / defeasance
  - Introduction of energy derivatives to augment hedging via physical contracts
  - GIC unwinds, LC collateralisation, transfers of GICs & LCs during banking crisis
  - Settlement of subcontractor lawsuits/claims; calling surety bonds
  - Interest rate swap novations and modifications
  - Modifying intercreditor terms to allow increased EIB funding and/or leases
  - Remediation: Forbearing vs. Enforcement – working with non-bond creditors

# Solvency 2: Selective Highlights

- Scheduled for implementation on 1 January 2013.
  - Regulators are now considering what elements of Solvency 2 will or won't be incorporated in future pension fund regulation
- Under Solvency 2, the capital requirements of insurers are primarily calculated under a series of rules known as the "Standard Methodology". The final rules of Solvency 2 are not yet known
- However, an insurer can develop an internal model to be approved by its regulator.
  - An insurer's internal model may include some elements of the Standard Methodology (partial model)
  - Could contain a specific module to address infrastructure debt
- Under QIS5, there are four main asset classes that are included within the market risk module:
  - Equity, property, EEA sovereign bonds*, other bonds (corporate and non-EEA sovereigns)
- Capital charges are applied to bonds selectively according to four elements:
  - Interest rate risk; spread risk; foreign exchange risk (to the extent the asset is not denominated in the reporting currency of the insurer); and, concentration risk
- The following slides on the Standard Methodology are based on the latest tests (QIS 5)

* *Includes bonds issued by MultiLateral Agencies ("MLAs") located in the EEA ("European Economic Area").*

# Solvency 2: Infrastructure Debt Using Standard Methodology

- Under QIS5 infrastructure debt typically falls into "Other Bonds & Structured Credit" and is treated like corporate debt

| Risk / Asset Class | Equity | Property | EEA Sovereign Bonds | Other Bonds & Str. Credits * |
|---|---|---|---|---|
| Interest Rate | | | ✓ | ✓ |
| Spread | ✓ | ✓ | | ✓ |
| Foreign Exchange | ✓ | ✓ | ✓ | ✓ |
| Concentration | ✓ | ✓ | | ✓ |

- Solvency 2 also provides capital charge benefits to a well-diversified portfolio.

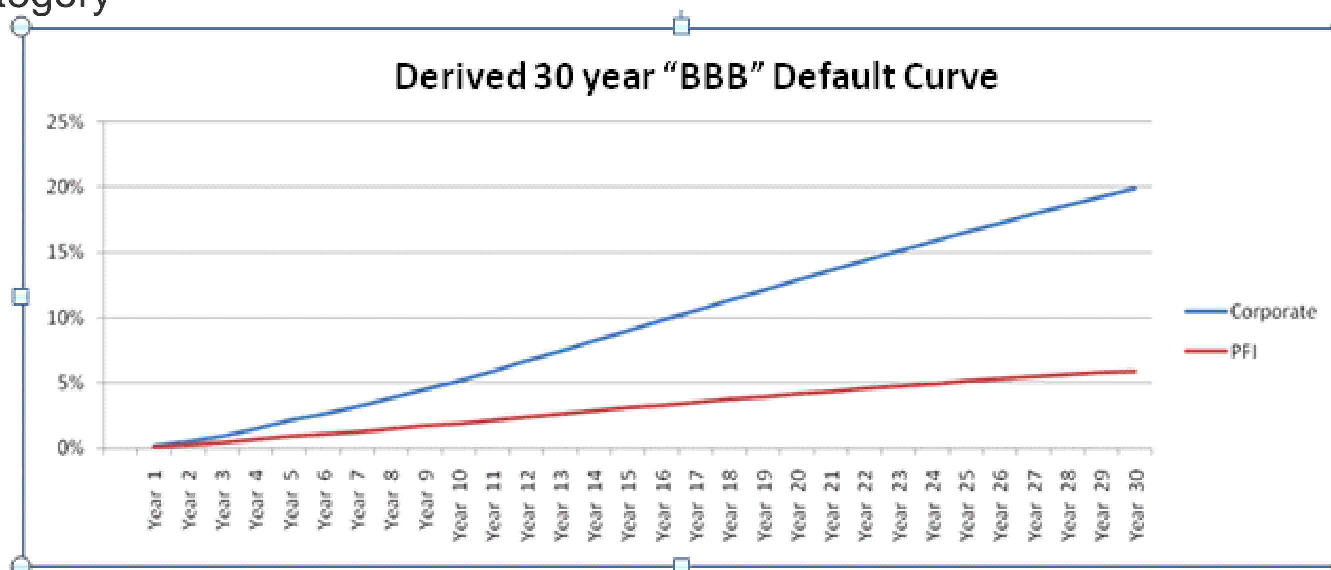
** Non-EEA sovereigns rated AA or above have 0% spread risk charge*

# Solvency 2: Infrastructure Debt Using Standard Methodology

- Spread risk capital charges are linked to ratings and duration
  - Triple-B rating: 2.5% per annum, with a 13-year cap on duration;
  - Single-A rating: 1.4% per annum, with a 23-year cap on duration.
- At triple-B, spread risk capital charge is capped at 32.5% for durations of 13 years or more
- When the duration is 23 years or more, the spread risk capital charge for a single-A credit (32.2%) and a triple-B credit (32.5%) are very similar
- Infrastructure Debt attracts a higher spread risk capital charge than real estate when the duration exceeds 10 years at a triple-B rating (real estate capped at 25%)
- Investment in long-dated infrastructure debt can improve the asset/liability duration matching, resulting in a lower interest rate risk capital charge.
  - Index-linked debt (vs. fixed-rate debt) should also be beneficial in matching index-linked liability cash flows
  - Offers yield enhancement over sovereign debt
- Infrastructure may give diversification benefits regardless of rating

# Project Finance/Infrastructure Bonds Are a Stable Asset Class

- Review of rating agencies' data suggest that project finance/infrastructure debt ratings, particularly with construction elements, are more concentrated around the BBB rating category




*Sources: PFI curve is derived using a blend of rating agency default data and transition matrices for representative asset classes.,MBIA data and surveys of market participants. Corporate curve is derived by extrapolating rating agency data*

- Limited data, but evidence that infrastructure bonds provide significantly higher recoveries than corporates, e.g. several sources suggest circa 80% for PFI compared to 40% for unsecured corporates

# Conclusions and Preliminary Observations

- **EU Project Bond initiative is an important acknowledgement that additional market support is required to develop Infrastructure Eurobonds**
  - Clearly there is a need for A-rated investments and multinational support is a positive on many levels of interest alignment
- **Funding needs are tremendous: Multiple solutions required**
  - There is room for everybody: No one solution will solve all the issues
  - Banks well suited for complex assets and short term funding
  - But investors should stay controlling creditor: “To each his own”
- **But the EU Project Bonds are just one part of the jigsaw puzzle: what else can be done**?
  - **Regulation:** An act of omission or commission for Solvency 2 treatment of infrastructure?
    - Multiple arguments for different treatment of project/infrastructure debt versus corporate or real estate
  - **Refinancing** existing transactions frees bank capacity and is good for investor development
    - Could the EU Project Bond initiative cover refinancings for outstanding debt?
  - **Execution and Liquidity**: Consideration might be given to the EIB/EU funds being used
    - Backstop capital markets within 50% EIB funding limitation
    - Creating a trading platform to improve liquidity and pricing
- **Procurement Policies**: Encourage Member States to consider procurement policies enabling project bonds to compete

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