

# GRID LINES

Sharing knowledge, experiences, and innovations in public-private partnerships in infrastructure

## Another lost decade?

### Effects of the financial crisis on project finance for infrastructure

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**R**apid growth in project finance, driven by huge increases in liquidity, helped fuel the gains in private participation in infrastructure (PPI) in developing countries in the past decade. But when the financial crisis hit, the excess liquidity began to dry up as lenders backed away from practices that had helped generate it. The effects are already apparent—in greater delays in financial closures, more cancellations, and higher financing costs for PPI projects. If full recovery of the project finance market takes much longer than expected, some of the measures that are now being adopted to avoid shutting down project pipelines might have unintended—and very negative—consequences.

After the Asian financial crisis, it took a full decade for private participation in infrastructure (PPI) to recover: 2007 was the first year in which investment commitments to PPI projects in developing countries exceeded the record level of 1997 (figure 1). Today's global financial crisis poses a new threat. Investment commitments to PPI projects are estimated to have dropped sharply in 2008 and are expected to drop again in 2009. Governments and development institutions are understandably concerned about returning as quickly as possible to the investment levels of 2007—and avoiding another “lost decade” of private investment in infrastructure.

### Structural changes in the market

Understanding how to regain the investment peak of 2007 requires an appreciation of what it took to reach that level in the first place. The growth of PPI in the developing world in 2003–07 was facilitated by a precipitous rise in the use of project finance in a variety of sectors, in developing

as well as developed countries (box 1). In just six years the international project finance market grew by four or five times, depending on the measure used (Abadie 2008).

Much of the growth of activity in that wider market was driven by huge increases in liquidity generated mostly in developed markets. Changing banking practices accounted for some of this liquidity growth. Project finance banks shifted from “originate and hold” to “originate and distribute” strategies: they would book project loans, then quickly distribute them into the market through syndication, securitization, secondary market sales, and other techniques. The emergence of a secondary market in loans (in contrast to securities such as bonds) was helped in Western Europe by the rapidly growing use of credit ratings on loans. These ratings made investors more comfortable about buying project loans while knowing little about the borrowers or the underlying projects.

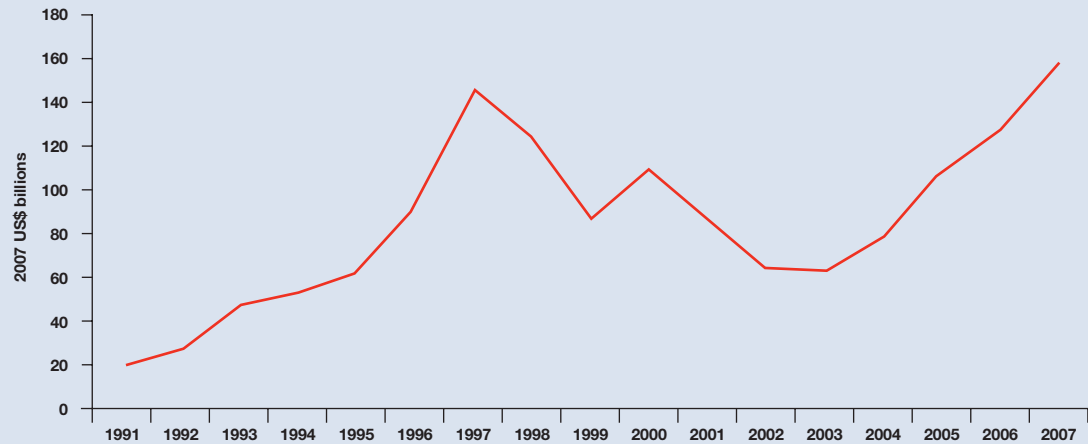
Bond issuance to finance larger projects in Western Europe or the United States was facilitated by monoline insurance, which passed on to the bond issue the strong credit rating (usually triple-A) of the monoline insurer. Again, investors had little incentive to conduct their own due diligence of the issuer or the underlying project as long as the bonds carried such strong ratings. These monoline “wraps” were also critical for the sale of all kinds of asset-backed securities, some of which bundled project finance debt for off-loading to secondary investors.

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**FIGURE 1****A lost decade followed the Asian financial crisis**

Investment commitments to infrastructure projects with private participation in developing countries, 1991–2007



Source: World Bank and PPIAF, PPI Project Database.

These methods of distribution created space in the originators' balance sheets for new lending and helped banks make money without holding onto loans. The resulting increase in liquidity generated tremendous competition among lenders, driving down the price of loans and giving borrowers the upper hand in negotiations.

### Liquidity spillover

Most of this excess liquidity for project finance was generated in developed markets and helped fuel the large PPI programs in Western Europe. In the United Kingdom the government's Private Finance Initiative reached record levels of investment. But not all the liquidity could be absorbed in these markets, and some spilled over into developing countries. Much of it went to Eastern Europe, where Western European lenders were quick to take advantage of the need for project finance for public-private partnerships and privatization in infrastructure, reforms driven by EU accession. The surge in project finance liquidity also benefited Latin America, with a long tradition of using international credit ratings and monoline insurance to access project finance from international banks and bond markets.

Larger projects in poorer regions like Africa also benefited. Banks in Africa tend to be less tightly integrated into the global banking networks than those in East Asia or Latin America. Apart from

a few in South Africa, they have little long-term money available at affordable interest rates for infrastructure investment. And what capital markets exist in the region are shallow. But the huge amount of international project finance liquidity in 2002–07 meant that international lenders had space in their balance sheets for the occasional riskier loan in emerging markets, and some larger African projects benefited directly. In other cases the spillover was more indirect: local or regional African banks borrowed from these international banks or from capital markets to raise financing needed to make loans to PPI projects, or used credit lines from international banks to back lending to large African projects.

### From syndicates to clubs

This project finance liquidity began to dry up when the mechanism for distributing it shut down. The interbank borrowing market was the main way in which international banks raised money for project finance, and when that market was disrupted as the subprime mortgage crisis began to raise doubts about the ability of banks to repay their own debts, the distribution of project finance came to a stop. But the underlying mechanism for generating this liquidity also collapsed. By early 2009 the "originate and distribute" model was no longer working because originators could no longer distribute project loans into the market. The secondary market for this debt collapsed because

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**BOX 1****A note on terminology**

Most but not all of the projects included in the World Bank–PPIAF PPI Project Database both involve project finance and can be classified as a public-private partnership (PPP). *Project finance* normally means that project loans are secured by project assets and repaid from project cash flows rather than from the sponsor's corporate balance sheet. *PPP* normally implies a risk sharing relationship between public and private project partners, formalized in a contract. The database includes projects, particularly in telecommunications, that are corporate-financed “merchant” projects without PPP-type risk sharing contracts between public and private partners. It also includes divestitures (including partial share sales) that do not involve project finance.

credit ratings of loans lost credibility and triple-A monolines virtually disappeared as a result of credit downgrades.

Even normal loan syndication techniques were no longer being used. Previously, one or two lead arrangers would reach agreement with a borrower on the size and pricing of a loan, then syndicate parts of the loan to banks or other investors. In the new environment most big project finance deals began to involve expensive and time-consuming “club” arrangements in which borrowers negotiate with a set of potential lenders to put together a total financing package. When such deals could be done, borrowers had to tolerate lower “lender hold” levels, shorter terms, higher pricing, and greater requirements for sponsor equity.

In addition, the borrower-friendly “covenant light” lending that accompanied the intense competition among banks quickly gave way to the growing reappearance of legal boilerplate clauses that protect lenders from market changes but also reduce borrower certainty about the ultimate cost and terms of financing. “Market disruption” clauses allow lenders to increase prices during loan drawdown, and “material adverse market change” clauses allow lenders to walk away from deals after closure on the basis of a determination by the lenders of seriously disadvantageous market changes. The syndication that is still possible is complicating government PPI project reviews that require early-

stage forecasts of value for money, because “market flex” arrangements allow lenders to change prices and other terms at the time of financial closure and sometimes even afterward.

Competition among lenders has lessened, and bank credit committees have regained control over lending decisions and pricing from origination teams. The balance of negotiating power in the markets has shifted back from borrowers to lenders. Excess liquidity is no longer being generated in developed markets nor spilling over into the developing world. Many of the world's leading project finance lenders are sharply reducing their activity in the project finance market (Royal Bank of Scotland, Lloyds Banking Group, DEPFA Bank, Fortis, Dexia, Halifax Bank of Scotland). In addition, Basel II banking regulations, which require banks to hold more assets in reserve against the risks of longer-term lending, are already leading to a general repricing of project finance credit risk. The additional regulation that is likely to come in response to the crisis will probably push the big international project finance banks even further away from PPI projects.

### Impacts in developing countries

In developing countries the effects of the crisis are already apparent. PPI projects in most developing regions are seeing greater delays in financial closure, more cancellations, and higher financing costs (Izaguirre 2009). In Eastern Europe and East Asia project finance has come to a standstill. In Latin America some large deals are still closing through “mega-club” arrangements involving nine or more banks. In Chile PPI projects in transport are on hold—this in a country where traditionally about 40 percent of highway concession investments have been financed by bonds guaranteed by triple-A monolines, most of which have now been downgraded. In India normal loan syndication by private banks has slowed, and so has the pace of financial closures for the government's “ultra-mega” power projects. The government has struggled to keep toll road and energy projects afloat with lending, guarantees, and refinancing pledges by public financing institutions that have been allowed to raise less expensive funding for their clients.

In Africa club arrangements are evident in a variety of project finance sectors. The Nigerian press has reported that international banks have rejected dozens of requests by local banks

**But with the onset of the financial crisis, the liquidity began to dry up**

for guarantees and credit lines needed to allow lending to local infrastructure projects. Some local banks and investment funds in Africa, particularly in South Africa, still have the liquidity needed to participate in syndicated or club deals. But there are fewer such lenders now, their interest rates are increasing, and their hold levels decreasing. Many lenders simply do not want to make commitments because of near-term market uncertainties.

### Returning to “normal”?

Banking practices such as interbank lending and loan syndication will eventually return to some semblance of normal functioning, and many of the banks that now forswear project finance will eventually return to the market. But some of the other recent changes in the structure of the market for project finance are likely to affect liquidity and pricing for a long time to come. The secondary market in project debt that drove liquidity generation at the top of the project finance cascade in developed countries will likely take years to rebuild, and that is likely to have long-term downstream effects on PPI in developing countries.

But some lenders recently quoted in financial publications are not at all sorry to see the generation of liquidity slow down. They maintain that loan pricing in mid-2009 better reflects underlying credit fundamentals than it did when excess liquidity was fueling lender competition and fire-sale pricing in the buildup to the record project finance levels of 2007. Given these considerations, the recent market low point in 2002 (or perhaps even the early 1990s), not the peak level of 2007, is beginning to look more like the “normal” market level of PPI investment.

If it takes much longer than expected for the market for infrastructure project finance to fully recover, some of the measures now being adopted by governments and development agencies to avoid shutting down project development pipelines might have unintended—and very negative—consequences. For example, governments are

looking for ways to streamline their internal procedures for approving PPI projects in a “market flex” environment where firm information on debt pricing is not available (and therefore cannot be evaluated) in advance of financial closure. Governments are also considering temporarily replacing scarce commercial finance with public money from government budgets or donors. But the risks associated with many of these emergency measures are substantial if a “return to normal” means a stabilized project finance market with much less liquidity and much higher prices for debt than in 2007. Governments risk huge contingent liabilities on projects that may not have been vetted as thoroughly as necessary—and risk being trapped as long-term investors in projects that cannot be refinanced with commercial debt.

Many governments, particularly in developing countries, will need help in identifying and managing these kinds of risks. They will need to do at least three things: carry out the kind of prudent due diligence that banks do to identify commercially viable projects, determine the optimal mix of public and private money in these projects, and avoid accepting so much project risk that private partners no longer have incentives to meet performance expectations. Given the likely long-term effects of the crisis on infrastructure project finance, this kind of rigorous appraisal, selection, development, structuring, and implementation of projects will be essential to ensure that aggressive rescue measures do not end up transforming contingent liabilities associated with poorly prepared projects into huge financial burdens for governments that cannot afford them.<sup>1</sup>

#### Note

1. A companion note (Leigland and Russell 2009) discusses in greater detail the need for PPI-related technical assistance.

#### References

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