Energy project finance and bank capital constraints

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Three years have passed since the meltdown of the financial markets and the virtual collapse of the international banking system that continues to overshadow the global economic recovery to this day. The myriad of regulations and controls in the global banking system in 2008 failed to identify and rectify serious flaws inherent in the financial markets. Under the Basel II accord, in place during the run-up to the crisis, banks were discouraged from lending to risky enterprises and encouraged to hold apparently 'risk-free' assets that required minimal capital. In this lay the seeds of the crisis as many of the 'risk-free' assets banks held turned out to be packages of assets that were anything but risk-free. Unfortunately, the best of regulatory intentions appear to have been a contributing factor to the depth and duration of the 2008 financial crisis.

The crisis revealed deficiencies in financial regulations that have led to the development of the Basel III Accord, which aims to further strengthen bank capital requirements and introduce new regulatory obligations on bank liquidity and leverage. Basel III will come into effect in 2013 and will take many years to be fully implemented. However, the situation is further complicated by the fact that local regulators will likely have the flexibility to impose stricter measures as they deem necessary, although EU regulators, for instance, are trying to impose a single set of rules on their banks. The question we must ask is whether this new regulatory regime will prevent a repeat of the 2008 global financial crisis and more importantly, will the proposed 'cure' have the unintended consequence of stifling liquidity and hence future economic growth? In this article, I will examine the expected impact of Basel III on the financial markets as well as the impact on bank finance available to the oil and gas sector.

Post-crisis financing

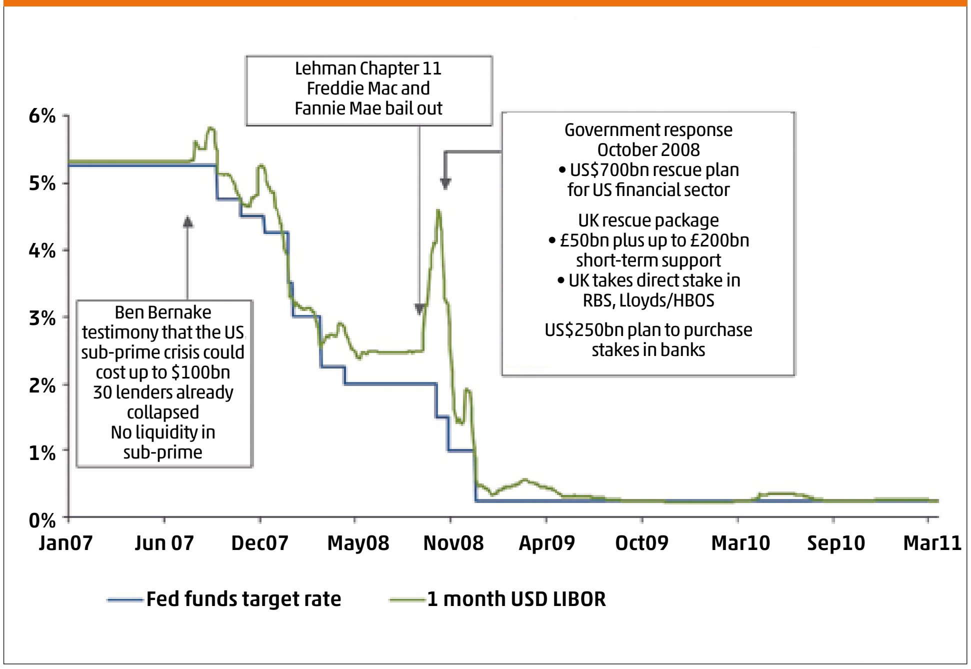
Subsequent to the 2008 crisis, financial markets worldwide witnessed a severe shortage of liquidity and a significant jump in credit spreads despite the virtual collapse in interest rates.

The widening spread in rates between the US Fed Funds Target Rate and one-month USD Libor rate, exemplified the instability during the period of the crisis. Post-crisis, the absolute level of the rates decreased substantially and the gap closed with the US Fed Funds Target Rate at 0.25 per cent, and the one-month USD Libor rate has remained at a similar level with only slight deviations. The market has clearly stabilised and spreads have contracted from the peak of 2008-2009.

While central banks across the globe increased money supply and bank access to capital, the banking market significantly contracted, preserving excess liquidity to manage down their own, often toxic, portfolios. This had a severe dampening effect on economic growth and global demand which, combined with the collapse of the commodities market, reduced access to liquidity in the oil and gas sector.

Oil and gas companies fared rather better than

Fed funds target rate vs LIBOR and other benchmark rates (%)



Source: FactSet

other sectors due to their collective strong balance sheets and cash flows even though the industry was faced with constrained bank liquidity at significantly higher pricing.

Across all sectors, access to corporate credit will be a vital factor in the recovery of OECD countries but with bank lending still restricted, bonds have become increasingly important. The timing of bond issuance is critical, especially with market volatility being exacerbated by sovereign debt uncertainties.

Oil and gas companies were able to raise capital in the bond and equity markets during the crisis because the energy sector was perceived to be underpinned by strong demand growth from China and other emerging markets. The oil and gas sector successfully raised over US$200 billion in new bond issuances in 2009 alone, which was higher than in 2010 and 2011 to-date. It is interesting to note that there was varying ease of access to capital within the industry. While large oil and gas companies with sizeable balance sheets and cash flows witnessed no major problems, the smaller, more entrepreneurial players, with limited cash flow and large capital expenditure programmes, faced a more daunting challenge. A number of these smaller players faced severe liquidity shortages and in some cases were forced either to raise emergency equity, consolidate with other players or to restructure in order to fund relatively large expenditure programmes.

Stabilisation in 2011

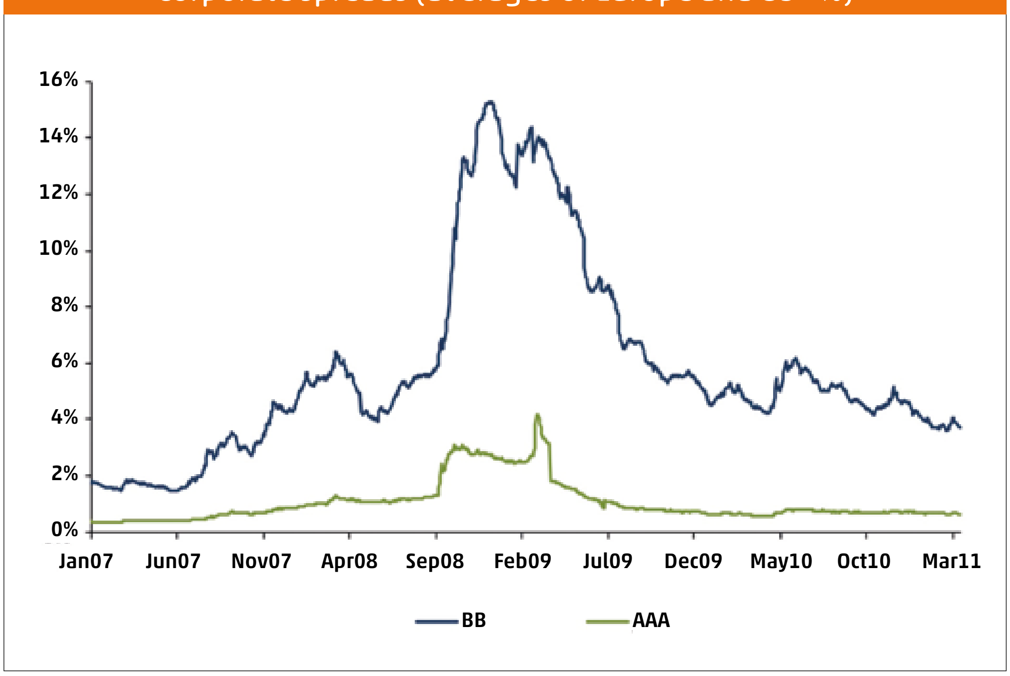
The spreads on corporate debt of AAA and BB rated companies (across all industry sectors in the US and Europe) widened over a similar period but have stabilised in 2011. The implication is that the market now has significant differentiation in the loan pricing and access to capital being experienced by companies with different credit ratings. Large corporates with strong balance sheets and cash flows have ample access to capital in the current market.

Overall impact of Basel III

During the financial crisis, an over-leveraged banking system was unable to absorb the systemic trading and credit losses. The interconnectedness of the financial institutions caused the weakness in the banking sector to spread rapidly to the rest of the financial system and to the wider economy. As a result, the public sector had to step in with liquidity injections, guarantees and capital support that exposed taxpayers to significant burdens. The objective of the Basel III reforms is to improve the banking sector's ability to absorb such shocks arising from financial and economic stress and hence reduce the potential spill-over from the financial sector to the real economy.

However, the likely net result of Basel III for the banks will be that they will be required to hold more capital and liquidity, and reduce their balance sheet leverage. Banks will be required to hold significantly more liquid, low-yielding assets, which will have a negative impact on their profitability. This has the potential to reduce banks' →

Corporate spreads (averages of Europe and US - %)



Source: IMF World Economic Outlook 2010

lending ability. In addition, banks will also need to reduce their dependence on short dated funding and increased the proportion of their funding with a maturity of over a year. These two measures will lead to an increase in the cost of borrowing that could eventually feed through to the wider economy and world trade. Once again, the law of unintended consequences can be quite harsh. The realities of Basel III will likely be higher costs, more selective loan portfolios, shorter tenors and less structured financings. It is also possible that the banks may be required by the market and the rating agencies to maintain a lower degree of leverage than required by the regulator.

In such circumstances, weaker banks may find it difficult to raise the required capital and funding, leading to a reduction in competition. Investors may also be less attracted by bank debt or equity issuance given that dividends will likely be reduced to allow firms to re-build capital bases, and therefore the banks will have no option but to shrink their balance sheets.

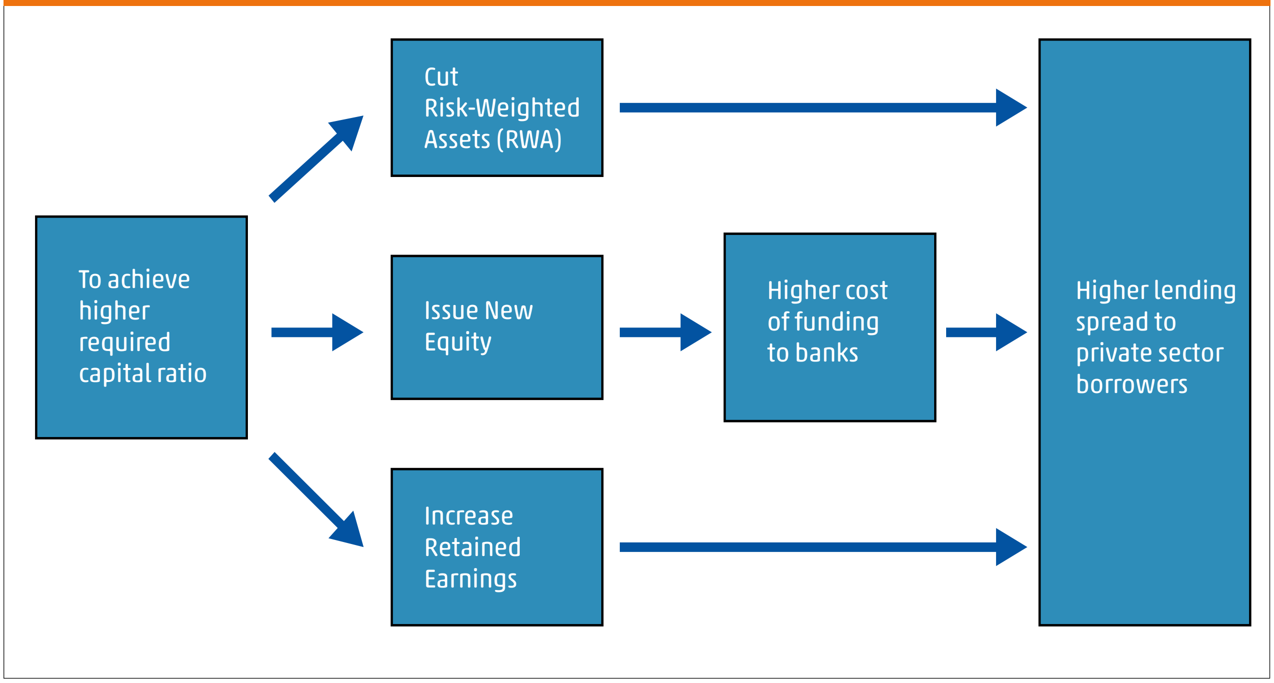
Implications for the oil & gas industry

While we have seen that the oil and gas industry has weathered the financial crisis rather well, we should be aware that the situation can easily take a turn for the worse.

To illustrate how the acceptability of certain financings can change rapidly, the precipitous drop in project financing in the oil and gas sector during 2009 reflected the realities of the stress that the banks were under and, to some extent, the reduction in discretionary spend by the industry. During this period the number of project finance banks diminished due to the risk profile, longer tenors and greater complexity of the asset class. Many banks rejected structured deals, looking more to 'plain vanilla' financing in order to improve their respective loan portfolios.

The vast majority of oil and gas project financing deals were for assets located in emerging markets but many banks pulled back from such markets in order to reposition their portfolios. Moreover, regulatory requirements in these markets demanded increasing local bank participation in the financings. The shortage of liquidity in these smaller, local banks, led to higher pricing for borrowers than could be offered by international banks – something which may be exacerbated by the regulations under Basel III. The irony of this strategy of pull-back from emerging market risk is that the financial crisis of 2008 had nothing to do with emerging markets or the project finance asset class.

The knock-on effect of higher capital ratios



Regardless, liquidity has returned to the market and the influence pendulum between issuers and banks that had shifted to the banks during the crisis is now shifting back to the issuer side.

Despite concerns about the possible impact of Basel III it must be remembered that the pricing of financings will continue to be dependent on credit quality and the availability of alternative sources of financing such as export credit agency ('ECA') financing. Changes to treatment of risk-weighting under the Accord might increase the price of ECA-backed loans as it is proposed that certain assets, such as ECA-backed loans should be exempt from the calculation of the 100 per cent conversion factor leverage ratio. This might negatively impact banks' ability to provide export credit facilities and trade finance. Recent history suggests however, that if the Basel III regulation had the effect of increasing corporate lending margins, we may see a shift from corporate lending to bond issuance.

Conclusion

The balance sheets and cash flow of the oil and gas industry are in very good shape following two years of robust commodity prices and the increasing non-OECD demand. This puts the industry in a positive position to raise capital, relative to many other sectors, as demonstrated by the rash of M&A activity over the past 18 months, increasing by 40 per cent after two consecutive years of decline.

Massive amounts of capital from multiple markets are required over the coming decade to meet the insatiable appetite of oil and gas development projects for both International Oil Companies (IOCs) and National Oil Companies (NOCs). With such high capital requirements (US$0.5 trillion of upstream expenditure is anticipated this year alone) it is possible that the banks' increased capital and liquidity requirements might constrain credit lines and reduce country limits. The knock-on effect might be a reduction in banks' lending capacity for the oil and gas sector overall or potentially in certain countries which will likely increase the overall cost of future capital (debt and equity).

Robust and relatively stable oil prices, underpinned by growing demand from emerging markets remain the dominant factors determining the financing appetite of the oil and gas industry. The impact of new financial sector regulation will likely have a greater impact on banks and less on the oil and gas sector as a whole.

Capital is unlikely to be a serious constraint for the industry over the medium term. The favourable risk outlook for the industry combined with the positive market perception (flight to quality) place the oil and gas sector in an enviable position. However, it is dangerous to assume that we are 'out of the woods' just yet. The fragile global economy, sovereign debt problems and anaemic Western economic growth, are clear warning signs for the future. ■

Bank loans and project financing in the oil and gas sector (US$ bn)

Source: Dealogic