

# Potential Effects of US Financial Sector Reform

*Five experts spoke a week after the United States enacted a massive financial sector reform bill in late July about the potential effects on the project finance market. They spoke on a conference call, hosted by Chadbourne, to which more than 1,100 people listened. The following is an edited transcript.*

*The five are John Eber, managing director of energy investments for JPMorgan Capital Corporation, Thomas Emmons, managing director and head of project finance lending at the New York branch of Rabobank, James Metcalfe, global head of power & utilities at UBS Investment Bank, Marshal Salant, managing director, Citigroup Global Markets, and John Shelk, president and CEO of the Electric Power Supply Association. The moderator is Keith Martin with Chadbourne in Washington.*

MR. MARTIN: The bill is a massive statute; by some estimates it is over 2,000 pages. I looked this morning at the official version that is on the banking committee website. That's 861 pages, but it is single spaced and densely worded and has small type. The table of contents alone is 12 pages.

The bill was borne out of frustration that the US and other governments had to bail out a number of large financial institutions in the fall of 2008 and into 2009 and a determination by Congress to bar banks and other systemically-important financial institutions from engaging in risky activities that might require the US government to have to spend public funds again.

The bill will take effect in stages. Even at 861 pages, an enormous amount of detail has been left to the federal bank regulatory agencies to fill in. The bill requires 243 separate rulemakings and 67 studies; 10 different federal agencies will have to write regulations. The US Securities and Exchange Commission will have to write 95 regulations and 17 one time reports. The Commodity Futures Trading Commission will be the next busiest, with 61 regulations and six one-time reports.

There are four main parts to the bill that are of particular interest to the project finance community.

The first is a Volcker rule that is supposed to bar banks from engaging in proprietary trading and taking equity positions in private equity funds. The second is a ban on banks dealing in swaps and other derivatives by taking away their access

to federal deposit insurance and their ability to borrow from the Federal Reserve if they keep those businesses. The third is a requirement for swaps and hedges to be cleared through central exchanges, and the fourth is increased capital adequacy requirements for banks, including foreign banks operating in the US market, and for large non-bank financial institutions that are considered important players.

The views you will hear today from the panelists represent their own individual views; they are not speaking for their institutions.

## Tax Equity Market

MR. MARTIN: John Eber, there has been a lot of talk in the press about the Volcker rule that was adopted as part of the financial sector reform bill. What is it?

MR. EBER: It is a rule that prohibits insured depository institutions and their affiliates from engaging in proprietary trading, from acquiring or retaining equity or partnership interests in hedge funds or private equity funds and from sponsoring hedge funds or private equity funds.

MR. MARTIN: What is proprietary trading?

MR. EBER: We were very concerned about how it was being defined because a broad definition had the potential to affect the ability of banks to participate as tax equity investors in renewable energy projects. The final bill narrowed the definition considerably. It is now defined as “engaging as a principal for the trading account of a banking organization in any transaction to purchase or sell or otherwise dispose of securities or derivatives.” The key concept was trading for the trading account of the bank.

MR. MARTIN: So the definition of “trading account” is pretty important. Do you recall what it is?

MR. EBER: Trading for the bank’s trading account means short-term transactions.

MR. MARTIN: I have the definition here. What the Volcker rule proscribes is trading by a bank through “any account used for acquiring or taking positions in securities” — which is a very broad term — “principally for the purpose / continued page 2

## Financial Sector Reform

*continued from page 1*

of selling in the near-term or otherwise with the intent to resell in order to profit from short-term price movement.” So you take comfort from that definition that what you do in the tax equity market for renewable energy would not be considered proprietary trading? You take long-term positions?

MR. EBER: Yes. We were fairly concerned during debate on the bill that tax equity investments might be considered proprietary trading, but the final bill makes clear that they are not. However, keep in mind that the regulators can expand or narrow the scope of that definition in the rulemaking to come.

MR. MARTIN: Marshal Salant, you are also a tax equity investor at Citigroup. Are you comfortable that proprietary trading has been defined in a way that does not cover tax equity investments?

MR. SALANT: We are. As John points out, many, many details have to be filled in by the bank regulators in regulations that are still to come. This will be a dynamic process. There will be technical corrections. There will be rules and regulations. People will challenge them. There could be new laws. There could be lawsuits. It may take years for some of these things to get resolved completely, but Congress seems to have made clear that the intention is not to treat tax equity investments as proprietary trading.

MR. MARTIN: Going back to John Eber, the other part of the Volcker rule was— I will read the language — banks may not “acquire or retain any equity partnership or other ownership interest in or sponsor a hedge fund or private equity fund.” The final bill limits a bank’s investments in hedge funds or private equity funds to no more than 3% of the fund’s capital. Those investments could also total no more than 3% of the bank’s tangible equity. I gather your view is that nothing you do in the tax equity market is considered investment in a private equity fund?

MR. EBER: We do not believe it is. We have looked at that closely, and the way the terms are defined suggests to us that tax equity investments are not investments in private equity or hedge funds — again, with the caveat that the bank regulators still have to write implementing regulations.

MR. MARTIN: The regulations will take some time to write. There is a coordinating committee that has six months after the bill was enacted on July 21 to organize its thoughts. Then the bank regulatory agencies have another nine months to write regulations. The bill itself does not take effect until July 2012. I imagine there will be a lot of scrambling during that period in Washington. The lobbyists will be busy.

MR. EBER: Banks will not want to make any investments that might be prohibited during that period because they would then be required to dispose of them.

MR. MARTIN: Has there been any slowdown in work or other noticeable effect so far on the tax equity market for renewables?

MR. SALANT: Not as a result of the financial sector reform bill. Again, based on things you were just saying, we went through an analysis very similar to John’s. Our investments in renewable energy projects are not short-term plays where we are intending to profit from quick price movements. We are not buying into projects at par thinking that the paper will trade at 110 in a couple of weeks. We are not buying distressed paper at 30¢ on the dollar with the intention of holding the paper for a couple of weeks and then selling at 50¢. That is just not the way this business works.

Things like whether or not the Treasury cash grant will be extended are having a much bigger effect on tax equity than this bill.

MR. MARTIN: John Eber, you deal with a lot of banks in the secondary market for tax equity paper — not that there is that large a market, but you have been trying to develop one. Have you sensed any hesitancy on the part of potential secondary market investors due to this bill?

MR. EBER: Not yet. I think everybody is watching with great interest to see how the rules are interpreted, but at this stage, we are optimistic that the market will not be affected. We worked hard with the American Wind Energy Association and both the Senate and the House committees that were prominent in putting the Volcker rule in the bill to clarify the intention was not to bar bank tax equity investments in renewable energy projects.

MR. SALANT: We are more worried about what I will call the second-order or third-order effects. It would be incorrect to say the bill will have no effect whatsoever. The second and third order effects are that the bill will add transaction costs and friction to what financial institutions do that may not be immediately bad. Some provisions in the bill are expected to reduce bank profits. If the financial institutions are making less money, then they will be paying less taxes. If you have less tax capacity, then it could eventually affect your ability to do tax equity. There are second and third order effects that will become visible over time, but in terms of direct immediate impact, we are not as concerned.

*/ continued page 3*

## Financial Sector Reform

*continued from page 2*

### Private Equity Funds

MR. MARTIN: Next topic: are there any large private equity funds or hedge funds that invest in the renewable energy sector or independent power or infrastructure projects that anyone on this panel expects to be affected by the Volcker rule because the funds are backed heavily by banks?

MR. METCALFE: Maybe the focus should be on the next round of funds because the Volcker rule will not take effect until 12 months after issuance of rules or, if earlier, two years after the bill was enacted.

For future funds, it will be harder to raise capital from banks. Banks may still arrange these funds under their flags or mastheads, but they may put less of their own capital into them. We may see more third party investment by limited partners and less direct bank sponsorship of funds. Rather than changing who owns what, it may change the way in which investing occurs.

### Swaps and Hedges

MR. MARTIN: Let me move to another topic, which is swaps and hedges. John Shelk, let's break this down into small pieces. Start with the context. How do you expect the bill to affect hedges and swaps in the power sector? People do interest rate swaps; they hedge currency, electricity, gas, and other commodity risks.

MR. SHELK: We are fairly pleased with how the legislation turned out, considering where we started from and what the administration, and particularly Chairman Gensler of the Commodity Futures Trading Commission, originally tried to do. The one caveat is that so many of the details have been left, in this case, to the Commodity Futures Trading Commission, and until those rulemakings are undertaken, there is still some risk.

MR. MARTIN: Tom Emmons, any general thoughts before we dive into specifics?

MR. EMMONS: I think most companies in the renewable energy sector will be considered end users and, since they are not swap dealers and they are hedging for their own accounts, they will have to notify the regulators of what they are doing but they will be exempted from most of the new restrictions.

MR. MARTIN: Let me dig into specifics. As a general rule, swaps and hedges must be cleared through a central exchange, and John Shelk, why was this such a big deal?

MR. SHELK: It is a big deal because swaps and hedges are an essential tool for power companies to manage risk. If you read

any of the recent analyst reports and listen to earnings calls, the substantial drop in wholesale power prices the last two years would have had a huge effect on this industry were it not for swaps and hedges.

The concern was not the potential need to clear swaps and hedges on a central exchange. The concern was that clearing would have meant posting huge amounts of collateral and margin that today is handled on a customized and bilateral basis. Sometimes the collateral in bilateral trades is in cash; a lot of times, it is liens on property.

Our pitch to Congress and the regulators was that the industry cannot afford to have so much dead capital. We would have been parking huge amounts of cash at the clearinghouse that would be better invested in new power plants and other infrastructure.

MR. MARTIN: Didn't I hear you say that companies are posting collateral in bilateral hedges and swaps? What's the big deal if they have to post it under a standardized regime on a central exchange?

MR. SHELK: The standard clearinghouse terms would have required the collateral be posted in cash while the parties to the swap or hedge decide today on their own what form the collateral should take. Estimates were that power companies would have had to tie up hundreds of millions of dollars per company in cash collateral.

MR. MARTIN: So that did not happen. Swaps and hedges by end users do not have to be cleared because of the commercial end-user exemption that Tom Emmons mentioned that spares swap parties who are not financial institutions and who use swaps to hedge or mitigate their own commercial risks from having to clear their swaps. But I notice that this was described as an optional exemption. What does that mean?

MR. SHELK: It is optional in the sense that if the end-user party to the transaction wishes to take a particular transaction to the clearing exchange or the central exchange, that can be done at the option of the end user. There is no requirement that an end user clear.

MR. MARTIN: I noticed the bill does not expressly exempt commercial end users from the need to meet margin requirements, but I understand there was a letter from the two key Senators, Dodd and Lincoln, to the two key Congressmen, Frank and Peterson, on June 30 to say that it was not their intention to subject such swap parties to margin requirements. If you are a commercial end user, are you comfortable with that letter? Does it settle the issue?

MR. SHELK: We are comfortable. I would / *continued page 4*

## Financial Sector Reform

*continued from page 3*

not say it settles the issue. I think of the bill as having two potential trapdoors that could adversely affect our ability to use swaps and hedges. The first trapdoor was the one that we just discussed that would have required mandatory clearing. The legislation is clear that if you are a commercial end user, then there is no mandatory clearing, subject to the caveat that anyone who is considered a swap dealer or a major swap participant will have to watch closely for future CFTC rulings.

The second trapdoor is the one just mentioned, which is whether or not the CFTC will require margin and capital requirements on transactions that were exempted from mandatory clearing. While it got a little messy during the sausage making on Capitol Hill, we were relieved to see both Chairman Dodd and Chairman Lincoln write the letter to their counterparts in the House. The view they expressed in the letter was reinforced by statements on the House floor that the intention was not to apply set capital and margin requirements for swaps and hedges to which one of the parties is a commercial end user.

We think that gives us a lot of comfort. I wouldn't say it settles the matter. The CFTC will have the ultimate say. If I were making a list of issues to watch carefully during the rulemaking process, this is one I would put on the short list.

MR. SALANT: Aren't there some who are a little nervous because there was language in the bill at one point that explicitly said that a bank that is a party to a swap with a commercial end user does not need to post margin, but that language was deleted from the final bill? The letters were a substitute for explicit language. People are nervous as to why Congress took the language out in the first place.

MR. SHELK: That's an accurate recitation of what happened at three and four in the morning, when most people were asleep. The letter said the explicit statement was removed from the final bill because it was redundant. Chairman Gensler was in the room at 3 a.m. when the letter was written. To be fair and candid, we would have preferred that the explicit exemption had remained in the bill. We complained to the committee chairmen that even if they thought the language was redundant, removing it at the last minute would create an unfortunate inference. That's when they wrote the letter.

MR. MARTIN: We were just talking about margin requirements. If the end user is exempted, must the bank or other trading company that is the counterparty to the swap clear it through a central exchange? And if the answer is yes, won't this still make swaps and hedges more expensive for power

companies to arrange?

MR. SHELK: I understand the answer is no. So long as one of the parties to the transaction is classified as an end user, then there is no mandatory clearing requirement.

MR. MARTIN: Exempted commercial end users are still subject to reporting requirements. John Shelk, what reporting is required? The reporting could be to the Securities and Exchange Commission or to the Commodity Futures Trading Commission, depending on the type of swap.

MR. SHELK: There are two aspects to reporting. First, every transaction will have to be reported to a central repository, whether or not the swap is subject to clearing. Second, every company entering into a swap or hedge will have to report how it intends to satisfy its financial obligations.

MR. MARTIN: Are the swap provisions in the bill retroactive in the sense that they apply to existing swaps and hedges?

MR. EMMONS: My colleagues interpret the bill to require reporting of existing transactions, so they expect that people in the power sector will be scrambling to collect data on existing transactions and then report those to the regulators.

MR. SHELK: It is clear that existing swaps will not have to be cleared. The language is pretty specific and clear on that point. There is some uncertainty about whether any rules the CFTC adopts on margin, capital and position limits will apply to existing swaps.

MR. MARTIN: The bill has a statement that, unless there was a specific provision on point in an existing swap, no requirement under the bill shall constitute a "termination event, force majeure, illegality, increased cost, regulatory change, or similar event" that would allow one of the parties to walk away from the swap. Have you heard of any problems in this area with people trying to get out of existing swaps?

MR. SHELK: Others may know about specific transactions; I have not heard of any problems.

MR. SALANT: To the extent we are talking about a project that does floating-rate bank debt and fixes it via swaps or is doing interest rate hedges before the deal is launched to protect against interest rate risk, there we see the least impact from these rules. I don't think we have seen a lot of bid-offer impact yet. As you move into commodity swaps or other things that people might be doing — you don't see a whole lot of that in the project finance market right now, but years ago you did — the potential effect is a lot more complicated.

MR. MARTIN: A member of the audience asked: "Wall Street analysts following the power sector contend that many independent power producers are

*/ continued page 5*

## Financial Sector Reform

*continued from page 4*

likely to be considered by the CFTC as swap dealers and swap participants at a minimum. Do you agree, and if not, why not?

MR. SHELK: No, we don't agree. The question said "many." That's not our understanding of the statute, nor is it Chairman Gensler's intention. Not every company has the same business model. For companies that are more active beyond traditional power plant operations and hedging only around those, there may be some risk. There are a few companies with active power marketing operations who will probably have to look at this more closely.

MR. MARTIN: Here's another audience question, but one for which this panel may have no answer: "If a private equity fund hedges at the fund level to mitigate a risk at a portfolio company, will the fund be treated as a commercial end user? For example, if the fund owns only a minority interest in an oil and gas producer, and so is long on oil and gas and the fund wants to hedge its position in the portfolio company." Does anybody have a view?

I guess not.

Stop the press. An audience member just said in an email that it is his understanding that private equity funds are defined as financial entities and cannot be commercial end users. Hence, hedges at the fund level would have to be cleared through a central exchange.

## Capital Adequacy and Trading

MR. MARTIN: Let's move to another topic. There was a Collins amendment — named after Susan Collins, a Republican Senator from Maine. She introduced the amendment at the request of the Federal Deposit Insurance Corporation — that agency pretty much drafted it — and it extends risk-based and leveraged capital standards for FDIC-insured banks to US bank holding companies, including US subsidiaries of foreign banks, and to systemically important non-bank financial companies. Many of these institutions may be required to have more true equity in their capital structures. Jim Metcalfe and Tom Emmons, will this increase the cost of money and, if so, how is it expected to be felt in the project finance market?

MR. METCALFE: I think there is likely to be some increased cost, but it is hard to predict the exact amount yet.

MR. EMMONS: I agree generally with what Jim said. It is one of several factors that will eventually mean less leverage in financial institutions. Less leverage generally means higher costs. We have seen stress tests being applied to banks in

Europe this month with a probable increase in equity fundraising by a number of banks. All of these factors are pushing toward more conservative balance sheets, which could lead to higher costs. Whether it is quantifiable in our particular market, I would say not because there are many other factors in the mix, and there is a long distance between a bank's leverage and the actual pricing in a deal.

MR. MARTIN: Next question: will banks be forced by the financial sector reform bill to shed some types of trading operations? The Financial Times reported a couple weeks ago that one likely outcome from this bill is there will be opportunities for established trading companies in Europe to move into sectors that US banks are having to abandon. Has anyone seen any evidence of this? What are the opportunities?

MR. SALANT: There is a lot of noise in the system over articles published about what Goldman Sachs is or is not doing. This is one of those areas where people really have to wait to see what rules come out.

MR. MARTIN: Then let's turn to a question from the audience: "Will the uncertainty still surrounding interpretation of the legislation — for example, on proprietary trading and private equity investments — translate into higher required yields on debt or tax equity that banks finance?"

MR. EBER: It is too early to tell.

MR. MARTIN: In what direction are tax equity yields moving? Are they holding, or do you expect some further tightening for the rest of the year?

MR. EBER: The yields have been fairly constant, almost going back the past year.

MR. MARTIN: What about the debt markets, Tom Emmons?

MR. EMMONS: They have also been fairly constant. There was some talk of a softening a couple months ago. The actual instances of softening were few and, I think, specialized. The question going forward will be whether the demand starting in 2011 will be robust and whether this will affect the pricing because there could be excess capacity if the wind market, for instance, continues to shrink because of the lack of a national renewable energy standard.

MR. MARTIN: John Shelk, what issues should the trade associations continue to work on, even after the bill has been enacted?

MR. SHELK: We have touched on a lot of them. There are some key terms like "end user" and "major swap participant" and "swap dealer" that will have to be defined in regulations. We need to watch how those regulations are written. We expect it will be at least a year, if not

*/ continued page 6*

## Financial Sector Reform

*continued from page 5*

longer, before all of this is settled.

MR. MARTIN: Are there other ways the bill could affect the market besides what we have covered on this call?

MR. METCALFE: It could have an effect on the rating agencies. I believe the bill imposes potential liability on rating agencies that do not do adequate diligence before issuing ratings.

MR. MARTIN: Let me sum up. If any of you disagrees with this summary, please speak up. We talked about four areas in the bill that have the potential to affect the project finance market.

One is a Volcker rule that bars banks from engaging in short-term proprietary trading and from putting more than 3% of capital into private equity funds. I think we decided that it will not affect the tax equity market in the renewable energy sector, with one caveat. Everyone wants to see how the rules are interpreted by the bank regulators over the next couple years.

Another area is a ban on banks from dealing in swaps and other derivatives. Their access to FDIC insurance for their deposits and their ability to borrow from the Federal Reserve will be taken away if they keep those business lines. I think we concluded it is too early to tell which trading operations US banks will shed, although there has been speculation that some

of the trading operations US banks will have to shed will provide an opportunity for established trading companies in Europe to move into the US market.

Another issue we discussed are swaps and hedges and whether the requirement to run them through central clearing exchanges and post margins will make swaps and hedges more expensive for independent power companies to engage in. I think we concluded that the commercial end-user exemption looks pretty good and should exempt most, if not all, of the swaps that we see in the project finance market — swaps that hedge interest rate, foreign currency, natural gas prices and other types of commodity risk.

The last topic we covered was the increased capital adequacy requirements for banks. They cannot be good news for developers interested in finding cheap money, but the word from this panel was so many things affect the cost of capital in the project finance market that it is hard to see this, certainly in the short term, pushing up yields.

MR. SALANT: One clarification about your third point — I think the bill will have a minimal impact on foreign exchange and interest rate swaps and derivatives, but I would be more cautious about the effect on gas and other physical commodities. You may see more impact on them. ☺

September 2010