

**EXH. CJP-5
DOCKETS UE-240004/UG-240005
2024 PSE GENERAL RATE CASE
WITNESS: CRAIG J. POSPISIL**

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY,

Respondent.

**Docket UE-240004
Docket UG-240005**

**FOURTH EXHIBIT (NONCONFIDENTIAL) TO THE
PREFILED DIRECT TESTIMONY OF**

CRAIG J. POSPISIL

ON BEHALF OF PUGET SOUND ENERGY

FEBRUARY 15, 2024

Proposed Basel III Rules could be catastrophic for the traditional tax equity market

Posted in [Blog article Renewable energy](#)

On July 27, 2023, the Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System; and the Federal Deposit Insurance Corporation (the “U.S. Banking Authorities”) jointly released a Notice of Proposed Rulemaking (“NPR”) for the finalization of Basel III rules.^[1] The proposed rules, which would take effect in 2025, substantially revise the capital requirements applicable to large banking organizations (and their depository subsidiaries) and to banking organizations with significant trading activity. Among other things, the proposed rules change the risk weighting of the types of investments that include clean energy tax equity investments. The expanded simple risk-weight approach (“ESRWA”) in the proposed rules could have dire consequences for future traditional tax equity financings because ESRWA would quadruple the capital requirement for banks holding tax equity investments, rendering traditional tax equity prohibitively costly for banks subject to ESRWA.

Basel III background

The Basel Committee for Banking Supervision (“BCBS”) is a committee of banking authorities and central banks, with 45 members from 28 jurisdictions.^[2] BCBS is the primary global standard setter for the regulation of banks. It has a mandate to strengthen the regulation, supervision and practices of banks worldwide for the purpose of enhancing financial stability. BCBS furthers that mandate by releasing standards for internationally active banks known as the “Basel Framework.”

The most recent addition to the Basel Framework is “Basel III,” which was released in response to the 2007-2009 global financial crisis.^[3] The final round of Basel III capital framework reforms, which was published by the BCBS in 2017, is referred to as the “Basel III Endgame” due to the breadth of its reforms. The implementation of the Basel III Endgame was deferred until January 2023, and the U.S. had not proposed implementing rules until July 2023 when the U.S. Banking Authorities issued the NPR.

The Basel III Endgame reforms apply to banks with \$100 billion or more in total assets, which are known as “large banks.” A portion of the reforms related to market risk also apply to smaller banks with significant trading activities (i.e., \$5 billion or more in trading assets plus trading liabilities or trading assets plus trading liabilities equal to or more than 10% of total assets).

Non-Publicly traded equity

While the NPR is almost 1,100 pages, the proposed rule relevant to covered banks with tax equity investments is found on page 640776 of the NPR. That rule, the ESRWA, expands risk weights applicable to equity exposures. Banks are required to maintain certain amounts of capital based on the risk associated with their investments. Holding capital is costly for banks. Investments deemed riskier under the proposed rules carry higher capital requirements.

Table 2 of the NPR assigns a 400% risk weighting to non-publicly traded equity, which would apply to tax equity investments. Under existing rules, tax equity investments have a 100% risk weighting. Quadrupling the risk weighting would quadruple the capital requirements large banks making tax equity investments, which industry sources suggest would lead to banks increasing tax equity investment pricing to levels that developers would find uneconomic. Even though the proposed rule would not take effect until 2025, some tax equity investors are pausing new investments, while others are seeking to add sections (i.e., funding outs) to new deals and to existing deals that have not been fully funded yet.



Risk weighting rules

In contrast, residential mortgages only require 50% capital weighting^[4], which means the U.S. Banking Authorities are implying that tax equity is 8x more risky than a residential mortgage. The capital weighting for public equity is 250%, so the U.S. Banking Authorities are implying that tax equity is 60% more risky than publicly traded stocks.^[5] That would mean holding Sunrun's common stock is 60% less risky than a tax equity investment in a Sunrun sponsored tax equity fund. Anyone who has followed a tax equity portfolio knows this is not the case. In round numbers, the 52-week high of Sunrun's publicly traded stock is \$39 a share and the 52-week low is \$13 a share (i.e., there has been a 300% change in price in the past year). No tax equity investment has that type of volatility; much less 60% more volatility than that.

Typically, when one thinks of non-publicly traded capital one thinks of venture capital, hedge funds or private equity. A well-structured tax equity partnership has little in common with the risk profile of any of those investments.

The Basel rules require banks' (i) "tier 1" capital to not be less than 4% of total risk weighted exposures and (ii) total capital to be not less than 8% of total risk weighted exposures. ^[6] Tier 1 capital is the bank's common equity and retained earnings. Other capital is preferred equity and debt issued by the bank.^[7] Here's an example:

Bank A has \$1 billion of tier 1 capital and \$3 billion of total capital.^[8]

Bank A holds:

\$0.5 billion of short-term government bonds that are zero capital weighting

\$1 billion of long-term government bonds that are 10% capital weighting

\$5 billion of loans to other banks that are 20% capital weighting

\$1 billion of residential mortgages that are 50% capital weighting

\$1.6 billion invested in publicly traded stock that are 250% capital weighting

\$1 billion of non-publicly traded equity that are 400% capital weighting

The numerator of Bank A's capital adequacy ratio would be:

$$\$0 + \$1 + \$1 + \$5 + \$4 + \$4 = \$15 \text{ billion}$$

$$\text{Bank A needs to have } 4\% \text{ tier 1 capital. Then } \$15 \text{ billion} * .04 = \$600 \text{ million}$$

Therefore, Bank A would need \$600 million of tier 1 capital (4%) and \$1.2 billion of total capital (at 8%). Bank A has \$1 billion of tier 1 capital and \$3 billion of total capital. Therefore, tier 1 capital is its constraining factor: Bank A could invest \$2.5 billion more in tax equity and other non-publicly traded equity without running afoul of the tier 1 capital requirement (i.e., $\$15 + (2.5 \times 4) = \25 billion).

(However, Bank A would not want to only invest its remaining tier 1 capital capacity in tax equity and other non-publicly traded equities as that would mean not growing its other business lines and would raise potential risk management issues about diversification of investment risk.)

Alternative tax credit monetization strategies

If the Basel III rules when finalized apply to tax equity as the NPR would appear to, sponsors of clean energy projects could pursue five alternatives to tax equity from large banks. However, all of them combined are unlikely to be able to fill the hole left by the largest banks exiting the tax equity market.

The first strategy is to raise tax equity from providers other than large banks. Banks with less than \$100 billion in assets would not be not subject to Basel III. Further, “corporate” investors (e.g., Patagonia^[9]) are not subject to financial regulation at all. Sponsors will likely turn to both types of investors to fill any gaps caused by Basel III’s effect on the big banks. Both small banks and corporates are important and growing segments of the tax equity market but cannot come close to filling the gap if the big banks were to exit the market.

Another strategy would be to try to structure tax equity investments to qualify as *community development* investments under section 24 (11th) of the National Bank Act.^[10] Such investments only require 100% capital weighting, as opposed to 400%. New market tax credit and qualified opportunity zone transactions qualify under this provision.^[11] The challenge of this approach for renewable energy tax equity is that the typical tax equity transaction does not provide a sufficient direct financial benefit to low-income communities to qualify.^[12]

A third possible strategy is that the financial regulators may not apply 400% capital weighting to tax equity investments that qualify for “proportional amortization” under Generally Accepted Accounting Principles (GAAP). Although, the FASB wrote that proportional amortization is not available for debt instruments, proportional amortization is similar to principal amortization for a loan. Further, the factors required by the FASB to qualify for proportional amortization would also apply to a loan, other than the references to tax benefits. That means that GAAP views the investment as similar to debt, and the Basel III rules key off of the GAAP balance sheet treatment of the investment. The challenge is that the proportional amortization standard promulgated by the Financial Accounting Standards Board is narrow and written without any consideration of the IRS’s safe harbors for tax equity partnerships.^[13] Further, the Basel III guidance does not currently expressly provide guidance on the capital weighting for investments eligible for proportional amortization.

A fourth strategy is a market shift towards sale-leaseback transactions. GAAP’s ASC 840, generally provides, that a lease has to be bifurcated into a financing receivable and a right of use. The portion of the lease exposure classified as a financing receivable could potentially be categorized as debt for risk weighting purposes and qualify for an approximately 50% risk weighting (i.e., analogous to a debt facility with a term of more than a year).^[14]

Finally, it is not an ideal or full solution,^[15] but the transferability rules in section 6418 of the Internal Revenue Code allow sponsors to monetize tax credits without the requirement of an equity investment.^[16] Under the transferability rules, banks (and others) can purchase tax credits for cash from owners of clean energy projects. Many banks find the transferability rules appealing because any capital weighting impact is eliminated once the bank gets the benefit of the tax credits it purchased.

What should be done?

Ideally, the U.S. Banking Authorities would recognize that given how well the tax equity portfolios of the major banks have performed that a tax equity partnership transaction structured in a manner consistent with IRS Revenue Procedure 2007-65 should receive 100% risk weighting (i.e., the same risk weighting as before Basel III). That way the market can continue to operate as it has.

An alternative would be for a regulatory determination that investments that combat climate change, whether or not the project is sited in a low income community or provides a direct financial benefit to low income residents, benefit low income communities (and all communities globally) and can be classified as a community development investment under section 24 (11th) of the National Bank Act and weighted at 100%.

In the last sixteen years, financial institutions from AIG to Silicon Valley Bank have run into capital adequacy problems. Like many financial institutions, many of those with capital adequacy problems made tax-motivated investments in clean energy, but in none of the cases did those investments do anything but add to after-tax profitability. Given the financial performance of tax equity investments historically, it would be unfortunate if the nation's climate change goals are thwarted by the application of Basel III to them.

[1] <https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf>

[2] <https://www.bis.org/bcbs/membership.htm>.

[3] <https://www.bis.org/bcbs/bsel3.htm>.

[4] See https://www.fdic.gov/resources/regulations/federal-register-publications/2012-ad-95-96-97/2012-ad-97_c_05-suppl.pdf (p. 8). Note, mortgages associated with federal programs require less risk-weighting. For instance, a Veteran's Administration mortgage requires zero risk-weighting and a Fannie Mae mortgage requires 20%.

[5] <https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf> (p. 64077).

[6] See https://pages.stern.nyu.edu/~igiddy/articles/capital_adequacy_calculation.pdf (a Reserve Bank of New Zealand example).

[7] See <https://www.investopedia.com/terms/r/riskweightedassets.asp>.

[8] In the interest of simplicity, these example is presented using billions and millions; however, as noted above Basel III would only apply to banks with over \$100 billion in assets. Therefore, the numbers would actually be several magnitudes larger.

[9] See <https://www.greenbiz.com/article/why-patagonia-backing-residential-solar-projects>.

[10] See <https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf> (p. 64077).

[11] See [*New Markets Tax Credits*](#).

[12] See, e.g., <https://www.occ.gov/publications-and-resources/publications/community-affairs/community-developments-investments/jan-2021/index-cdi-jan-2021.html>.

[13] See <https://www.projectfinance.law/tax-equity-news/2023/march/fasb-s-proportional-amortization-method-for-tax-equity-deals-ain-t-all-it-s-cracked-up-to-be/>.

[14] The application of Basel III to lease transactions is an area beyond the expertise of the authors who invite feedback from readers.

[15] See <https://www.projectfinance.law/tax-equity-news/2021/november/direct-pay-ain-t-all-it-s-cracked-up-to-be/>.

[16] See <https://www.projectfinance.law/publications/2023/june/irs-transferability-guidance/>.

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