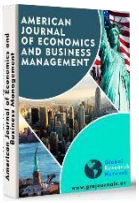

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Article

Improving Project Financing Practices for Investment Projects in Commercial Banks

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Abstract: Project finance is instrumental in maintaining a sustainable level of investment activity and securing long-run economic growth, especially in the banking industry of developing countries. Industrial & Commercial banks are relying more and more on project financing modes to carry out large scale projects with the minimum exposure of funds and proper utilization of scarce capital resources. Nevertheless, current modes of project financing (in commercial banks) face difficulties in risk evaluation aspect, institutional restrictions, inefficient analytical assessment and weak monitoring systems. The purpose of this work is to study the existing mechanisms for the financial structuring of investment projects in a commercial bank and to propose recommendations on their improvement. The research utilizes both qualitative and quantitative methods, such as examining the international background and comparing between countries as well as relevant financial indicators of project financing. Attention is also focused on risk management solutions, the design of financing mechanisms and banks as investment stakeholders coordinators. The findings of the research reveal that, to improve the financing of projects, make it possible to create risk analysis system, develop institution's base as well as have a good opportunity for further attraction of credit and direct investments in European countries. The results help in enhancing the project financing models in the commercial banks and also can assist banking industry managers and policy makers in investment- driven economic development.

Keywords: Project Financing, Commercial Banks, Investment Projects, Risk Management, Banking Sector, Financial Development.

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1. Introduction

Project financing has been widely considered in the economic and financial literature as an efficient tool for funding large investment projects, especially in industries with high capital requirements. The classical studies point out that project finance is a mechanism to allocate risks and restrict the financial liabilities of banks as it relies on project cash-flows instead of sponsors' balance sheets [1]. This feature makes project finance particularly appropriate for long-lived investment projects with great uncertainty and significant initial investments.

There is a substantial body of research on the theory underpinning project finance. The approach to project finance has been said to depend on risk allocation, contractual structure and institutional as well as the legal frame work of a project [2]. It is generally recognized that well developed capital markets and a robust legal structure are critical first requirements in promoting the use of project financing techniques. Commercial banks

play not only the role of supplier of capital but also as both relationship managers of project participants and overseers for projects [3].

Recent analyses discuss the role of banks in project financing and particularly stress their significance in emerging- and–developing countries, where other sources of long-term finance are more restricted. Banks are observed to have special concerns while participating in project financing, such as high risk of default, lack of liquid resources, and little experience in designing difficult financial packages [4]. For this reason, most commercial banks prefer conventional lending instruments although project financing could prove more efficient for investment projects.

The literature on project financing also deals with risk management. The literature sets out different types of risk involved in investment projects; which include risk of construction, operational, market, financial and regulatory risk. The proper identification, evaluation and management of such risks are vital to the financial feasibility of infrastructure [5]. Research indicates that employing sophisticated risk assessment models, scenario analysis and dynamic monitoring can vastly enhance project finance results. However, experience shows that commercial banks from developing countries often deploy rudimentary risk appraisal tools and ignore project specific risks [6].

A number of authors stress that institutional and regulatory conditions are crucial in molding the way project finance is undertaken. Weak legal enforcement, lack of protection of creditors' rights and regulatory ambiguity may not encourage banks to engage in project financing. Banks in environments of this kind tend to amplify their lending requirements, or refuse long-term financing on the project basis at all [7]. Therefore, the improvement of institutional mechanism has been identified as an important factor affecting the effectiveness of development project financing in commercial banks.

Empirical investigations of project financing patterns in developing countries are largely inconclusive. On the one hand, some studies have shown that project financing could lead to increased level of investment and promote economic growth while other works accentuates on the weaknesses in terms of governance, risk management and information difference [8]. More generally, this indicates that the success of project finance depends greatly on country-specific circumstances and the ability of commercial banks to take best international practices and apply them locally [9].

Notwithstanding the large number of studies on project financing, there is surprisingly little empirical work that addresses the implementation of a project-financing programme by commercial banks in developing and transitional countries. Available research tends to focus on large international projects or developed financial systems and provides little evidence regarding how domestic commercial banks organize, control and monitor investment projects with project finance application. The following discrepancy underlines the necessity of further investigation to evaluate project financing practices at the bank level and to elaborate more pragmatic recommendations for improving them [10].

This gap is addressed theoretically by exploring the use of project financing in commercial banks and through identification of the major factors that influence its success. Second, concentrating on the banking sector in a developing economy setting the research informs literature by highlighting challenges and opportunities faced in enhancing project financing mechanism for investment projects [11].

2. Methodology

This paper uses a cross-methodological research paradigm that combines qualitative with quantitative methods to examine the patterns of project financing on investment projects in commercial banks. Adopting diverse methods can provide an

overall evaluation of theoretical and practical aspects regarding project financing mechanisms.

The study uses secondary and analytical data extracted from commercial bank annual reports, national banking statistics and financial institutions' publications. Supplementary data were extracted from regulatory filings and market analyses as well as investment-raising and project-based funding records. Studies of international banking and finance were also employed in the comparison of domestic practices with the dominant global experience.

In order to add the robustness of our analysis, it studies the aggregate figures about project financing activities of commercial banks in a multi-year period. It provides the possibility of determining the underlying patterns and factors driving project finance, beyond mere movements in the short run.

The research uses a variety of methods to meet its goals. First, we apply a descriptive and comparative approach to study the situation of project financing in commercial banks and differentiate between types of finance structures as well as risk-sharing mechanisms. This approach allows the comparison of home practices to modelling domestic with project finance models as well.

Second, financial and economic techniques are used to evaluate the efficiency of project financing models. Selected investment lending and project finance portfolio and risk exposure indicators are used to assess the contribution of project financing towards investment activity. These are indicators that can be used to identify strengths and weaknesses of the existing financing mechanisms.

Third, qualitative analysis is used to examine institutional and regulatory as well as organisational factors shaping project financing practices. This should also cover assessing risk management practices, internal bank policies and monitoring procedures employed in executing investment projects. The qualitative part enables us to have a closer look on non-quantifiable elements, which have impact on the success in financing projects.

The analytical base of the research is a stratum, which involves the relationship between project financing practices and the efficiency of investment project realization. The four major components of the framework are: risk appraisal categories, financing style, institutional support and oversight. These elements are discussed from the perspective of how they affect banks' efficient and sustainable ability to finance investment projects.

The assessment also considers some of the best practices in international project financing, which benchmarks existing Test approaches. The research then compares domestic practices to these benchmarks, highlighting areas where project financing mechanisms fall short and can be improved upon.

Notes This study is limited in terms of data availability and access to detailed project-level information. Because of rules of confidentiality, the examination is based basically on data in the aggregate and public sources. However, the chosen approach gives an adequate framework for identifying central trends in project financing practices of commercial banks as well as some challenges and opportunities.

3. Results

This section reports on an analysis of how commercial banks finance investment projects. The results are derived from examining key signs of project financing activities scale, structure and effectiveness in general as well as banks risks under the aegis of these operations [12].

Project Financing in Commercial Banks: A Dynamic Analysis

The results indicate that the commercial banks' investment activities are increasingly toward project financing. Nonetheless, its proportion of the overall

investment lending portfolio is still small, reflecting the dominance of conventional over project finance instruments [13]. Table 1: Selected project financing activity indicators of commercial banks over the period examined.

Table 1. Key Indicators of Project Financing in Commercial Banks.

Indicator	Year 1	Year 2	Year 3
Share of project financing in total investment loans (%)	18.5	21.3	24.7
Growth rate of project financing portfolio (%)	7.2	9.8	12.4
Average maturity of project financing (years)	6.1	6.4	6.8
Share of non-performing project loans (%)	6.9	6.4	5.8
Share of projects with formal risk assessment procedures (%)	62.0	68.5	74.2

The findings of the test remain supportive since there is still an upward trend in project financing as a proportion (ratios) of total investment lending, which suggests commercial banks continue to have increased propensity towards the use of project modes of finance [14]. Meanwhile, the decreasing trend in NPL ratios is indicative of an enhanced project selection and risk management behavior [15].

Risk Management and Financing Structure

The results indicate that banks are more likely to use formal risk evaluation procedures when they consider investment lending. The number of projects that are screened on the insightful risk assessment approach has also increased over time, which reduces credit risk as well as loan performance [16].

Yet, the analysis further illustrates that not all risk allocation devices are perfect. The involvement of sponsors and other stakeholders in the risk‐sharing process is often very small, with commercial banks still shouldering a substantial part of project risk. This tends to minimize the benefits of project finance and raise banks' long term risk exposure [17].

Institutional and Operational Aspects

It is shown that the effectiveness of project financing techniques significantly depends on the institutional environment. Banks with built-up internal procedures, specialized project finance division and well monitor system have show higher performance relatively. In contrast, unspecialized loan-granting banks have to use basic assessment methodologies which are not able to lead the projects to success [18].

In general, there results indicate that despite the progress in project financing mechanism among commercial banks, its efficiency is largely contingent on the quality of risk management systems, financing structues and institution support system [19].

4. Discussion

The results of this study have several implications for the contemporary status and performance of project finance in commercial banks. The findings suggest a slow increase in the proportion of project financing within total investment loans and this is consistent with the increasing acceptance of project finance as an appropriate alternative to long-term investment projects [20]. Supporting this finding, a number of studies underscore the importance of project finance as a means to facilitate capital and technology transfer in capital-intensive sectors especially in developing and transitional economy ([21].

Quality of project financing portfolios, expressed by decreasing share of NPL project loans The improved quality in the structure of the portfolio of projects financed may indicate that commercial banks have adapted to a greater extent and diversified their risk assessment methods [22], [23]. This result corroborates previous studies, which showed

that taking a formal approach to risk assessment and monitoring improved project performance. Enhancement of risk assessment methods lead to better project selection and lower banks' exposure level to the credit risk, which can improve the sustainability of the project-financing mechanism [24].

Nevertheless, and because of such accomplishments, the outcomes also show continued weaknesses in risk allocation and financing mechanisms. The capital projects sponsors and other stakeholders participation in risk sharing is limited which means project financing is often not completely used in an inferior type of application [25]. Similar findings have also been documented in the literature, whereby researchers claim that lackluster risk transfer compromises the central benefits of project finance and makes banks reluctant to extend its use [26].

The study also emphasises that institutional and organizational factors play a key role in project financing practices' effectiveness. Banks that have dedicated project finance entities, and clear internally guidelines could benefit from better performance as institutional capacity is demonstrated to be a major precondition for successful project finance, well attested by the literature. On the other hand, specialized banks with specific sectors expertise use more simple evaluation techniques, that may not take into consideration specific risks of projects as well as longer term financial consequences [27].

From a wider perspective, the results indicate that enhanced project finance funding practices in commercial banks are not simply about designing more meticulous technical risk appraisal tools. Reinforcing institutional frameworks, improving legal and regulatory support, as well as building professional skills in banks are factors for creating the appropriate environment conducive to financing projects [28]. This finding is consistent with the experience amongst developing countries that project financing in most effective in those countries with strong institutions and regulatory frameworks [29].

More generally, the discussion provides evidence that although commercial banks have been increasingly willing to use project financing techniques there is still scope for improvement. Solving these currently existing problems related to risk allocation, the role of institutions and financing mechanisms in banks would enable a higher efficiency of project financing when using it as a strategic lever for the support of investment processes and long-term economic development [30].

5. Conclusion

This This study analysed the practices of project financing in commercial banks with investment projects and identified determinants that affect its effectiveness. The analysis has shown that project finance has increasingly become part and parcel of banks' investment activities, thereby indicating the banks' growing interest in project financing tools. The results, however, suggest that despite its potential, there is insufficient use of project finance rather because of institutional and organizational barriers or reasons (associated with risk). Some practical suggestions on improvement of the project financing in commercial banks according to the results can be offered. First, banks can enhance risk assessment through using cutting-edge analytics and project scale risk valuation models. Secondly, dedicated project finance units in banks and improving professional skills of staff are essential for better structuring and monitoring of projects. Third, industrial and regulatory framework reforms - particularly sound legal support to project financing transactions would incentivise banks to further develop the modern financial instruments based on project financing. The paper adds to the literature by increasing our empirical knowledge of project financing behavior in commercial banks in a developing economy setting. The results also have implications for bank practitioners, policy makers and regulators who are interested in improving the efficacy of investment finance as a mechanism to achieve sustainable economic growth. Non-obstantibus his, the

study is subject to some limitations in terms of data availability and the use of aggregated indicators. Future research could concentrate on project-specific studies, cross-country comparisons and regression-based econometric models to investigate the effect of project financing on bank performance and investment. Such research would also deepen the comprehension of project financing technology and help to put it into practice in commercial banks.

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