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## Project Finance and Securitization: A Natural Hybrid

*James J. Croke, Jr.\**

The current climate of the project finance funding markets underscores the global need to pursue the benefits associated with securitization as an alternative to traditional bank lending. Despite the rating agency scrutiny and legal expenses that often accompany securitization transactions, the capital markets offer a cheaper source of funds and a means to fill the funding gap that exists between the growing demand for financing projects globally and the static limits of available bank loan financing to this market. Different securitization techniques, including collateralized debt obligations (“CDOs”) and asset-backed commercial paper (“ABCP”) conduits, offer innovative financing solutions and could spark significant project finance market growth.

Historically, established methods of financing offered a workable means for obtaining funds for projects throughout the world, as lenders such as commercial banks and government bodies extended credit to project sponsors through various loan arrangements. Under a traditional bank-funded project finance transaction, a bank and a special purpose vehicle (“SPV”) enter into a loan agreement. The SPV then offers equity to the project owner which provides the owner with some limited control over the project as well as certain rights in respect of payments derived from the project cash flow. These project cash flow payments are principally applied by the SPV to make payments to the bank under the loan agreement. Alternatively, project sponsors may seek funding through the private placement of “project bonds” with institutional investors. In both schemes, revenues generated by the project are expected to cover debt servicing costs and to provide some level of return to the equity holders.

Traditional mechanisms for project finance funding, due to a myriad of factors, are no longer able to adequately meet the needs of the project finance community. As demand for funding these types of infrastructures has grown worldwide, the level of financing available to them remains static. In addition, the Revised Basel Capital Accord, released in June of 2004, sets forth new risk capital standards that will require banks to increase the amount of risk capital they hold for certain project debt. Rules requiring banks to hold more risk capital against project debt will raise the price of project finance borrowing. Given current circumstances, the door is wide open for alternative financing forms and activity in recent years demonstrates that securitization is the funding mechanism capable of meeting market demand.

Securitization involves the collection of a pool of assets and a financing, on a bankruptcy-remote basis, through the issuance of securities in the capital markets. With respect to project finance, rather than enter into a loan agreement

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with a bank, the SPV issues notes either directly to investors or to a separate SPV securitization issuer, who then refinances through a securities offering. The income received from the sale of notes is used to finance the project, and the future flow of income from the project provides the means to make payments on the notes. Assets that comprise the securitization pool include existing project finance loans, project bonds, or possibly receivables from other projects. The preponderance of securitization deals to date have taken the form of either (i) the SPV project company issuing notes directly to sophisticated investors, or (ii) one or more SPV project companies depositing one or more project notes into a separate SPV securitization issuer which then issues securities into the commercial paper or longer-term bond markets.

In deciding exactly how to structure a project finance securitization, project sponsors take into account numerous legal issues and rating agency criteria. Deals are structured to reach optimum positions with respect to tax and solvency laws. Project sponsors arrange bankruptcy remote transactions to limit the likelihood that issuing entities will enter insolvency proceedings that would jeopardize the timely and full payment of obligations. In addition, there is an entire overlay of regulations and rules relating to securities laws that need to be satisfied in connection with the offering of securities through securitization structures. Securities law considerations include identifying the type of securitization vehicle to be used, the type of investors intended to be targeted, and the most favorable jurisdiction in which to locate the securitization vehicle. Project sponsors must contemplate the extent to which securities are being offered globally since each jurisdiction maintains different rules relating to the types of protection that securities laws are designed to offer.

Project sponsors must consider rating agency perspectives when structuring a securitization deal. Rating agencies analyze the rights of those providing the debt financing to the project, since provider rights directly or indirectly form the basis of the rights of note purchasers. The rating agencies focus on what phase a project is in, whether there is a suitable ratings basis for conducting an analysis and assigning a rating, whether there is a need for an insurance wrap, and whether the issuer and/or project SPV is sufficiently bankruptcy-remote. Rating agencies will also take into account the type of program through which the project is being financed and the parties involved. Rating agencies provide a critical securitization function by assessing deal risk and providing information about that risk to the public markets. The confidence instilled by rating agencies and the information they provide essentially drives the capital markets.

Two types of securitization structures currently available to finance project debt are CDOs and ABCP conduits. CDO transactions are a form of financing into term asset-backed and commercial mortgage-backed markets. In a CDO program, assets and their accompanying risks are pooled in an SPV securitization issuer, allowing the project to offer diversified risk through a longer-term offering. CDOs may be issued in tranches, which contractually ensures that the most subordinate tranche will be the first to absorb loss in the deal. As a result, a

deal that lacks high grade collateral may nonetheless issue AAA-rated indebtedness at the higher-rated tranches. This financing technique permits the deal to be structured so that different tranches of debt (and sometimes equity) may be tailored to satisfy the specific demands of individual investor interests. A CDO issuer must also be established and each securities law addressed, including applicable exemptions and offering mechanics.

In an ABCP conduit, project bonds or notes are sold to established securitization vehicles referred to as “asset-backed commercial paper conduits” or “structured investment vehicles.” Hundreds of these vehicles exist in the market today and continuously offer asset-backed securities, typically in the form of short-term *pari passu* commercial paper notes or longer-term *pari passu* medium-term notes. *Pari passu* status means that all notes are paid equally and without preference, in comparison to the seniority tranche structure of a CDO. Under this financing scheme, the asset-backed commercial paper conduit or structured investment vehicle must only be established once. Going forward, the issuer has the ability, within certain rating agency constraints, to invest and engage in various financings with a limited level of additional review. Once formed, the asset-backed commercial paper conduit or structured investment vehicle will have established securities exemptions and offering mechanics in place. These will not need to be modified to permit additional securities offerings to acquire additional project finance debt or other permitted assets. Typically, these entities will have access to (i) liquidity that may absorb a variety of non-credit issues, and (ii) some program-level credit enhancement. These liquidity and credit support devices enhance the ability of these issuers to issue rated securities.

Structuring and completing a stand-alone project finance CDO transaction is typically more time-intensive and costly than financing project bonds through an ABCP conduit. Because CDOs often lack accompanying liquidity and credit support devices, disclosure with respect to CDO programs is much more rigorous as compared to ABCP program disclosure requirements. For example, a CDO offering document may be hundreds of pages long, whereas an offering document for an ABCP program may be merely ten pages long. The increased disclosure provided in CDO transactions reflects the fact that all of the risks associated with the assets will be passed through to the holders of the CDO securities.

Project sponsors utilize the securitization structure to finance assets on terms more favorable than bank-funded project debt. Securitization structures offer the ability to tap into additional funding sources, to access better and potentially cheaper funding, to enhance the diversity of funding sources, and to transfer credit and other risks from the project sponsor and other members of the project team to third parties better equipped to evaluate and handle the risk. Securitization structures may also provide certain risk capital advantages to banks, and these risk capital benefits will likely be even greater when the Revised Basel Accord is fully implemented. Securitization also offers the potential to

obtain longer-term financing and the ability to diversify risk through the pooling of risks of various projects. The deals can also provide project sponsors with increased flexibility, in addition to providing investors with both increased flexibility as to their investment decision and increased liquidity, through their ownership of a transferable security. Finally, securitization allows banks that manage risk to move perceived “high credit risk” that may be associated with certain project deals away from banking institutions, replacing it with cash collateralized risk or the lower credit risk associated with highly rated securities.

Securitization brings new considerations to the project finance context. Given that each project is unique, it is very difficult to estimate relevant legal issues, economic concerns and the credit quality of the borrower in a particular transaction. As a result, pricing securities and predicting project risk becomes difficult. Moreover, securitizing a project in the middle of construction raises a multitude of questions. To ameliorate this risk, parties may delay securitization until after construction is complete. The delay would leave the construction risk with the project sponsor or the contractor, and the contractor is best positioned to minimize cost overruns and delays. Other solutions to securitization concerns exist and can be addressed through warranties, credit enhancement, tranching of risks, and other tools.

A new structure that has emerged over the past decade in the context of project finance is the synthetic securitization. Synthetic securitizations involve the transfer of all or part of the economics and/or credit risk associated with assets, without actually transferring the assets. In this type of transaction, a SPV issues commercial paper, medium-term notes or other indebtedness and makes certain permitted investments. Income produced by these investments pays the principal and all or a portion of the interest on the debt securities. At the same time, the SPV enters into a credit default swap with a holder of project finance debt (for example, a bank), which provides the holder with cash-collateralized credit protection with respect to such project finance debt. The synthetic securitization concept emerged roughly ten years ago, yet in the last five years it has accounted for a high percentage of securitization financing, particularly in jurisdictions in which local commercial law gives effect to anti-assignment clauses and other contractual restrictions of asset transfers that effectively preclude the possibility of transferring assets into a funded securitization.

The benefits of synthetic securitization are likely to fuel an increase of securitization funding in project finance. In synthetic deals, assets may be included in the reference portfolio without actually being transferred. Avoiding asset transfers is helpful in the face of anti-assignment clauses, transfer restrictions under laws of jurisdictions where assets are located, securities law registration issues, legal investment restrictions, withholding taxes, and stamp taxes. In addition, through synthetic securitization, commercial banks may reduce risk capital allocations to project debt through the purchase of cash collateralized credit protection. However, synthetic securitizations raise additional issues, including the fact that SPVs selling risk-linked securities may be subject to

regulation as insurers or reinsurers. Also, purchasers of risk-linked securities may be subject to regulation as providers of insurance or reinsurance. These risks can generally be addressed through careful structuring of the particular transaction and through disclosure to investors and, sometimes, through mechanics that limit or prevent the offer and sale of risk-linked securities in certain jurisdictions.

The project finance landscape is prepared for the growth of securitization mechanisms as a means to raise funds. CDOs, ABCP conduits, structured investment vehicles, and synthetic securitizations offer a multitude of benefits to project sponsors and investors. Despite rating agency scrutiny and securities law considerations, securitization should continue to serve as a valuable alternative to bank-lending into the future. The tremendous need for additional financing of projects globally should encourage governments, regulators and other policymakers to coordinate their efforts so as to facilitate market participants' ability to securitize project debt.

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