Security in Project Finance

Jan-Hendrik Röver

Overview

- What is project finance?
- Project finance after the financial crisis
- Functions of security in project finance
- What is „security“ in project finance?
- Security structures in project finance
- How secure is security in project finance?

What is project finance? A general definition

Project financing is characterised by **five criteria** and thus clearly differentiated from traditional corporate lending:

1 Purpose of financing
Financing of a clearly defined (green or brown field) project

2 Borrower
Legally and economically independent project company

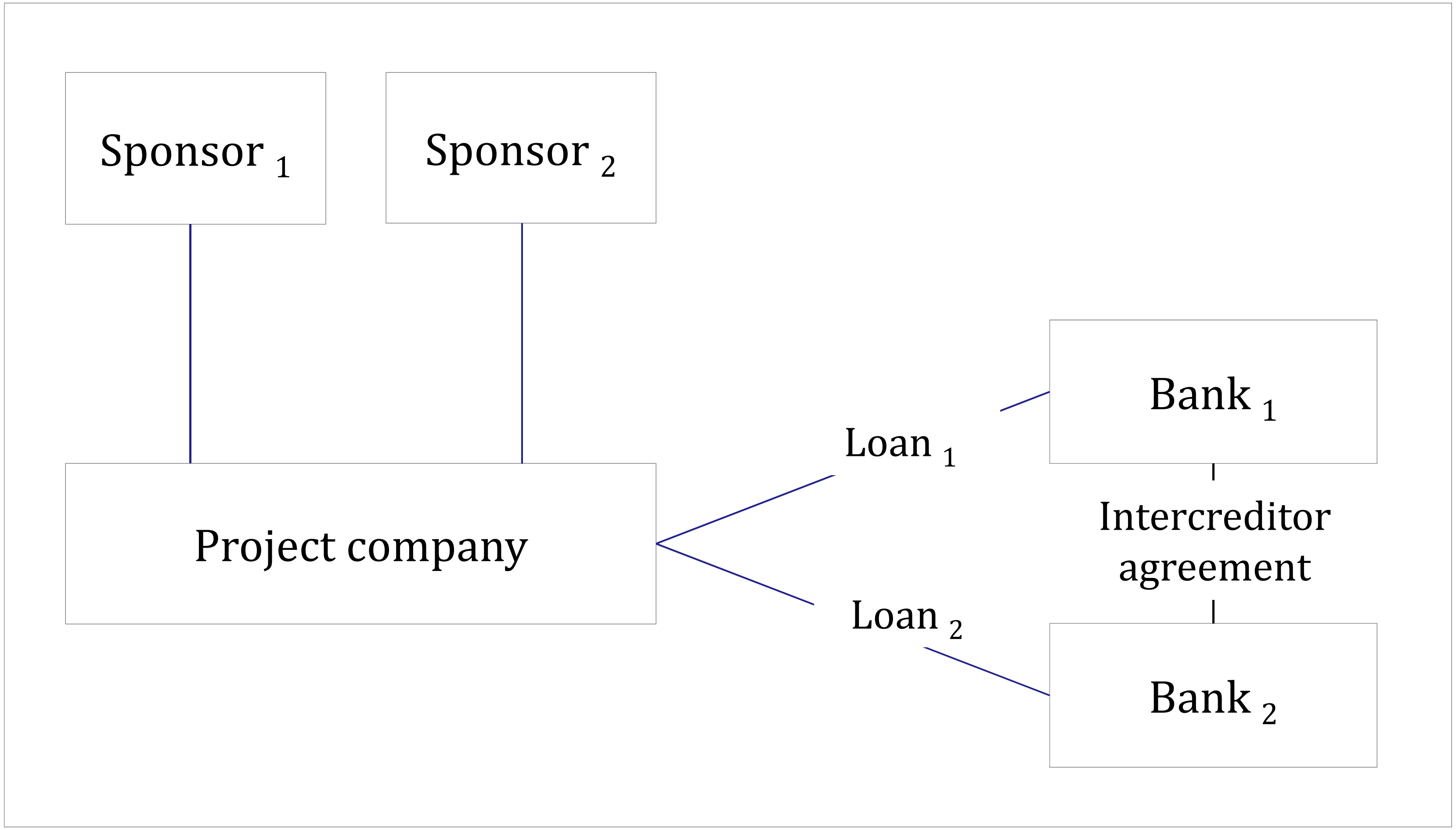
3 Service of project loan (repayment and interest)
from future cash flows of project company

4 Liability of sponsors

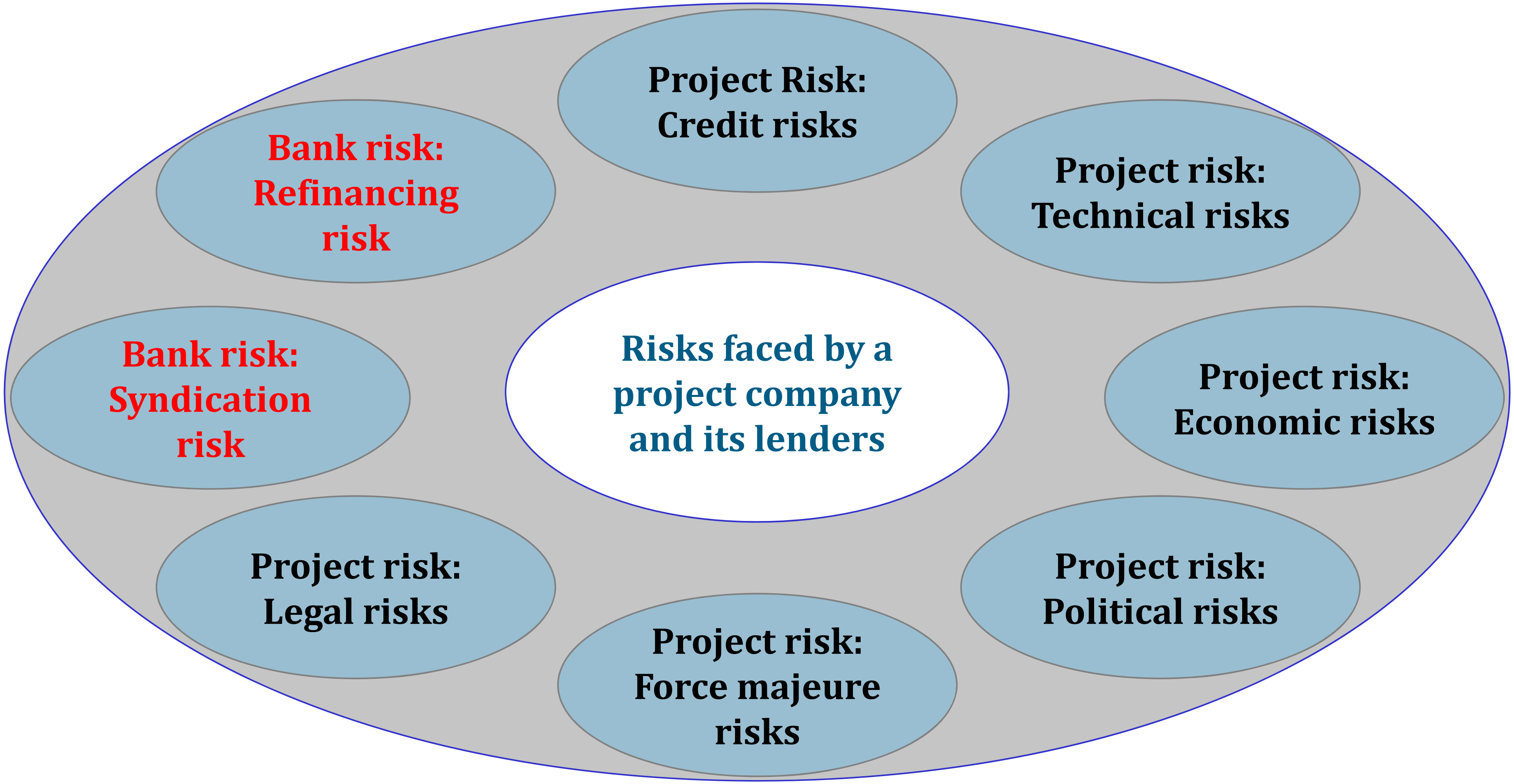
No or only limited recourse to sponsors
- security interests of project company
- (limited) security interests of sponsors

5 Risk structuring

What is project finance? The Parties

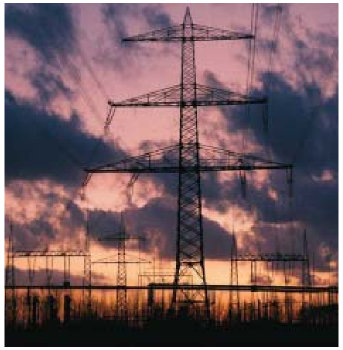


What is project finance? The Risks



For project risks see also summary of risks in Basel II Principles, appendix 4 table 1 (supervisory slotting criteria for specialised lending) issued by Basel Committee on Banking Regulation (in this respect not superseded by Basel III); see also Article 87 § 5 of Directive 2006/48/EC

What is project finance? The types of projects



Power / energy (incl. renewable energy)

35%

Transportation / infrastructure & public private partnerships

25%

Oil & gas

12.5%

Mining

4.5%

Other sectors

- Leisure & Property
- Telecommunications
- Petrochemicals
- Industry
- Water & Sewerage
- Waste & Recycling
- Agriculture & Forestry

23%

Percentages represent 2010 share of sector in total volume of project finance transactions
Source: Thomson Reuters Project Finance International

Project finance after the financial crisis (i)

- Banking world in turmoil since insolvency of **Lehman Brothers** (2008)
- Changes in the general framework
  - **Accounting changes** (IFRS 10*)
    - If sponsor holds majority of shares in project company he must show debt financing of project company on its group balance sheet (no off-balance sheet financing by sponsors)
  - **Banking regulation**
    - Higher equity requirements for „specialised lendings"**
      - Five types of specialized lending of which project finance is one
    - Banks typically use „Internal Ratings-based (IRB) Approach" to credit risk and allocate risk weightings of up to 250%
      - Supervisory slotting criteria for specialised lending

* Applicable since 1 January 2013; incorporated by Regulation (EU) No. 313/2013 of 4 April 2013

** See Basel Committee on Banking Regulation, Basel III: A global regulatory framework for more resilient banks and banking systems, revision June 2011

Project finance after the financial crisis (ii)

- Change in environment for **PPP/PFI projects**
  - Coming to an end of privatisation wave
  - Change in perception of **creditworthiness of public entities** (in particular PIIGS countries [Portugal, Italy, Ireland, Greece and Spain])
- Change in **risk realisations**: long-term assumptions in cash flow models were falsified by reality
  - Renewable energy: wind forecasts
  - Transportation: traffic forecasts
  - Oil and gas: gas price development
  - General: tax assumptions

Project finance after the financial crisis (iii)

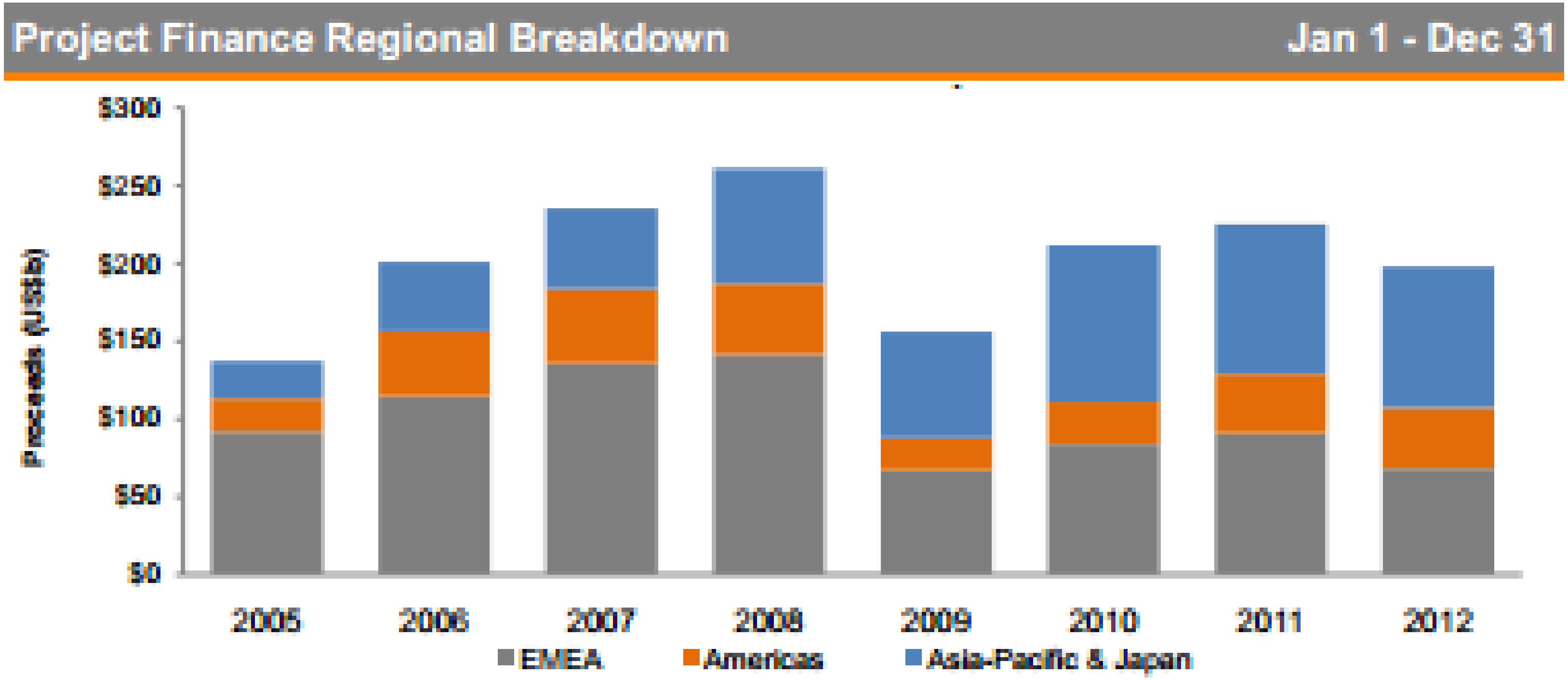
- Changes in project finance structures
  - Generally further increase in risk awareness and risk mitigation leading to **more complex financing structures**
  - Increase of **sponsor support** (transformation of limited recourse financing)
  - Lower **debt/equity ratios** (i.e. higher equity element)
  - More comfortable **financial covenants**
  - Shorter **loan tenors** / incentives for early repayment or refinancing such as margin increases over time
    - Leading to a renaissance of quasi „mini-/medium-perm financings“

Project finance after the financial crisis (iv)

- **Risk mitigation instruments**
  - International financial institutions (A/B loan structure)
  - European Investment Bank (EIB) initiative: Loan Guarantee Instrument for Trans-European Transport Network Projects, LGTT (networks in the transportation, power and telecommunication sector), launched in 2008
- Generally reduced availability of bank financing
  - Increased interest in **project bonds** as replacement of bank financing
  - EIB: Europe 2020 Project Bond Initiative, launched in 2012
    - First project: Natural gas storage „Castor" in 2013

Project finance after the financial crisis (v)

- Bank world for project finance has contracted from its peak in 2008



Source: Thomson Reuters, Project Finance Review, Full Year 2012

Functions of security in project finance

- „Security is a shield, not a sword“ (Philip R. Wood*)
- Limited market value of project company‘s fixed assets
- **Negative** or defensive function of security (exclusion of third party creditors); security provides power to enforce and/or priority in enforcement; enables restructuring
  - Not: assignment of insurance contracts
  - Not: security assignments of other receivables
- **Management** function of floating charge
- **Positive** function: enforcement of security
- **Priority** function of security in insolvency

* Project Finance. Subordinated Debt and State Loans, 1995, p. 30

What is security in project finance? (i)

- „By way of security a creditor ensures for himself a privileged status, either
  - by establishing real rights over one, some or all of the debtor‘s assets (**real security**) or
  - by having recourse to a third party who has undertaken responsibility to the lender for payment if the debtor defaults (**personal security**)“*

* Sir Roy Goode and Ewan McKendrick, Commercial Law, 4th ed. (London 2010)

What is security in project finance? (ii)

- Part of the definition of project finance is risk structuring with a view to risk mitigation
  - Security in a functional sense in a project finance context is **broader than personal and proprietary security**
  - Comprises any contractual tool that secures debt service
    - Includes financial covenants
    - Includes further other coventants
    - Debt service reserve account
    - Control of cash flow
  - Broad view on security confirmed by Basel II „supervisory slotting criteria for specialised lending“ (see category „security“)

Security structures in project finance (i)

- Security in a narrow sense („two layer model“)
  - On the level of **sponsors**
  - On the level of **project company**
    - Includes security on the level of the **general construction contractor (EPC)**; (performance-)guarantee of the general construction contractor
      - Provided to the project company
      - Hence, additional security assignment of any (future) right under the guarantee to lender
- Furthermore, so-called „**direct agreements / step-in rights**“ (para. 6 of Schedule 2A Insolvency Act 1986) with main contractual partners (operators, suppliers or offtakers)

Security structures in project finance (ii)

Level	Asset	Type of security
Level of sponsors	Sponsors‘ shares in project company	Pledge of shares
	Sponsor‘s assets	Completion guarantee
Level of project company *(continued on next slide)*	Project company‘s rights to payment of account deposits	Pledge for the benefit of bank
	Real estate	Security interest in real estate
	Equipment and machinery	Fixed charge (UK) / Security transfer of ownerhip (GER)
	Rights under insurance contracts	Security assignment of receivables
	Rights under general construction contracts	Security assignment of receivables
	Rights under supply contracts	Security assignment of receivables
	Rights under offtake contracts	Security assignment of receivables

Security structures in project finance (iii)

	Asset	Type of security
Level of project company *(beginning on the previous slide)*	**Payment rights under shareholder loans** ***Shareholder loans instead of capital contribution may be efficient form of financing, since interest can be deducted from tax base***	**Security assignment of receivables**
		(Proprietary or quasi-proprietary) security in pool of assets like floating charge of English law or nantissement de fonds de commerce of French law
		Negative „pledge“ clause (covenant not to create security rights for the benefit of third parties) ***No security interest; only obligation***

Security structures in project finance (iv): floating charge

- Floating charges were convenient tool for project financings in the past; they allowed appointing an **administrative receiver** and thus managing project company in default
  - Role in international financings has always been somewhat limited due to the fact that continental legal systems were not able to recognise English law floating charge

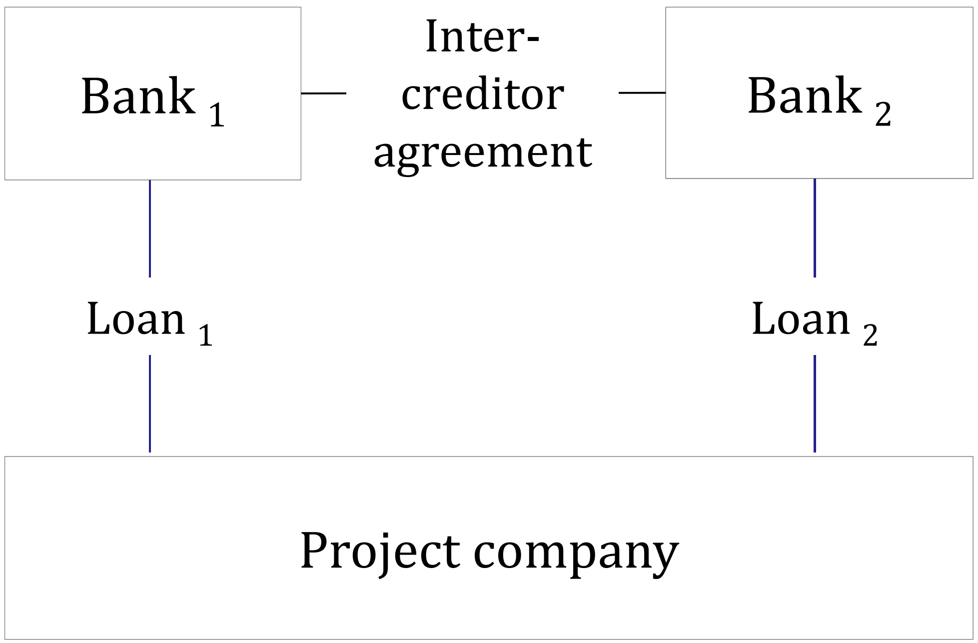
Security structures in project finance (v): floating charge

• Since the reform of the English Enterprise Act an administrative receiver can be appointed only in **exceptional cases**

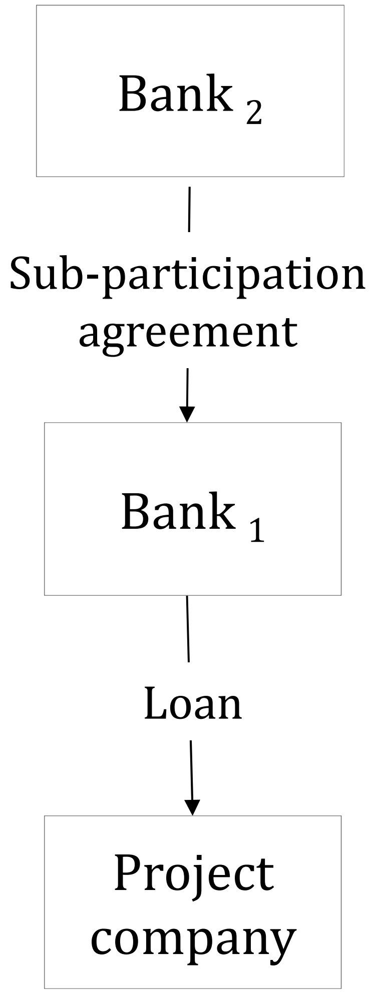
- Pursuant to sec. 250 Enterprise Act 2002 and sec. 72B Insolvency Act 1986 only exceptions for so-called „qualifying floating charges“, e.g. for
  - (2) public-private partnership project,
  - (3) utility project,
  - (5) a financed project (project financing) with a total debt amount of at least £ 50 million
    - Scope of “project” unclear

Security structures in project finance (vi): security trustee

Syndicated loan



Sub-participation (e.g. EBRD A/B loan)



Security structures in project finance (vii): security trustee

- Relevant for syndicated loans
- Security trustee under English law for proprietary security interests
- More complex trust structure under German law
  - Non-accessory (non-ancillary) security rights*
    - Creation for (German law) **trustee**
  - Accessory (ancillary) security rights**
    - Creation for **each bank** in order to secure loan obligation
      - Securityholder must also be creditor of the secured debt
    - Creation of security for the benefit of a (German law) **trustee** to secure a parallel secured debt (debt acceptance [Schuldanerkenntnis])

* I.e. non-accessory real estate mortgage for security purposes, security transfer of ownership, security assignment of receivables

** Pledge of accounts, pledge of shares, accessory real estate mortgage (the latter is not often used in practice)

How secure is security in project finance? (i)

- There is no difference in the **legal efficiency** of security in a narrow sense in project finance compared to other types of financing
- However, the **economic efficiency** is quite different
  - At least at the early stages of a project if project works (and thererfore security is not needed)
- Therefore, security in a narrow sense in project finance has mainly a **defensive role**
  - At least at the early stages of a project if project works (and thererfore security is not needed)

How secure is security in project finance? (ii)

- However, in understanding project finance security structures one should not focus on security in a narrow sense only
  - There are **functional security instruments** used in project finance structures which supplement personal and proprietary security
  - Leads to high financial stability of projects (provided that assumptions are correct)

Bibliography (i)

German secured transactions law

- *Jan-Hendrik Röver,* Realsicherheiten und Direktvereinbarungen, in: Ulf R. Siebel, Jan-Hendrik Röver and Christian Knütel (eds.), Rechtshandbuch Projektfinanzierung und PPP, 2nd ed. (Cologne, Munich 2008)
- *Hansjörg and Jörg-Andreas Weber*, Kreditsicherungsrecht, 9th ed. (Munich 2012)

English secured transactions law

- *Hugh Beale, Michael G. Bridge, Louise Gullifer and Eva Lomnicka*, The Law of Security and Title-Based Financing, 2nd ed. (Oxford 2012)
- *Michael Bridge,* Personal Property Law, 3rd ed. (Oxford 2002)
- *Michael Bridge, Louise Gullifer, Gerard McMeel and Sarah Worthington*, The Law of Personal Property (London 2013)
- *Sir Roy Goode and Ewan McKendrick*, Commercial Law, 4th ed. (London 2010)

US-american secured transactions law

- *James J. White and Robert S. Summers*, Uniform Commercial Code, 6th ed. (St. Paul, Minn. 2010)
- *James J. White and Robert S. Summers*, Principles of Secured Transactions (St. Paul, Minn. 2007)

Bibliography (ii)

Eastern European secured transactions laws

- *Jan-Hendrik Röver*, Secured Lending in Eastern Europe. Comparative Law of Secured Transactions and the EBRD Model Law (Oxford 2007)

Western secured transactions law (in particular European Union secured transactions laws)

- *Eva-Maria Kieninger (ed.)*, Security Rights in Movable Property in European Private Law (Cambridge 2004)
- *Harry C. Sigman and Eva-Maria Kieninger (eds.)*, Cross-Border Security over Tangibles (Berlin 2007)
- *Harry C. Sigman and Eva-Maria Kieninger (eds.)*, Cross-Border Security over Receivables (Berlin 2009)
- *Horst Eidenmüller and Eva-Maria Kieninger (eds.),* The Future of Secured Credit in Europe (Berlin 2008)