

Chapter 1

Overview of project finance

Introduction to project finance

What is 'project finance'? The term features prominently in the press, more specifically with respect to infrastructure, public and private venture capital needs. The press often refers to huge projects, such as building infrastructure projects like highways, Eurotunnel, metro systems, or airports. It is a technique that has been used to raise huge amounts of capital and promises to continue to do so, in both developed and developing countries, for the foreseeable future.

While project finance bears certain similarities to syndicated lending, there are a host of specific issues that mean that it is essentially a specialized discipline unto itself, effectively a discrete subset of syndicated lending.

Project finance is generally used to refer to a non-recourse or limited recourse financing structure in which debt, equity and credit enhancement are combined for the construction and operation, or the refinancing, of a particular facility in a capital-intensive industry.

Credit appraisals and debt terms are typically based on project cash flow forecasts as opposed to the creditworthiness of the sponsors and the actual value of the project assets. Forecasting is therefore at the heart of project financing techniques. Project financing, together with the equity from the project sponsors, must be enough to cover all the costs related to the development of the project as well as working capital needs.

Project finance risks are therefore highly specific and it is essential that participants such as commercial bankers, investment bankers, general contractors, subcontractors, insurance companies, suppliers and customers understand these risks since they will all be participating in an interlocking structure.

These various participants have differing contractual obligations, and the resultant risk and reward varies with the function and performance of these various parties. Ideally, the debt servicing will be supported by the project cash flow dynamics as opposed to the participants, who at best provide limited coverage.

Uses for project finance

Project finance techniques have enabled projects to be built in markets using private capital. These private finance techniques are a key element in scaling back government financing, a central pillar of the current ideological agenda whose goals are well articulated by Grover Norquist, a US Republican ideologue and lobbyist, who says ‘I don’t want to abolish government. I simply want to reduce it to the size where I can drag it into the bathroom and drown it in the bathtub.’ On the basis of such ideological agendas and lobbyists’ machinations are the macroeconomic policies, upon which project finance feeds, made, thus transferring the control of public services from the electorate to private, unaccountable and uncoordinated interests.

Such agendas make project financing a key method of using private capital to achieve private ownership of public services such as energy, transportation and other infrastructure development initiatives. The goal ultimately is to make government irrelevant and achieve a two-tier society where government panders to the marginalized and infrastructure development and exploitation are handed over to private capital, free from the encumbrances of electoral mandates. Some of these sectors include:

- **Energy** Project finance is used to build energy infrastructure in industrialized countries as well as in emerging markets.
- **Oil** Development of new pipelines and refineries are also successful uses of project finance. Large natural gas pipelines and oil refineries

have been financed with this model. Before the use of project finance, such facilities were financed either by the internal cash generation of oil companies, or by governments.

- **Mining** Project finance is used to develop the exploitation of natural resources such as copper, iron ore, or gold mining operations in countries as diverse as Chile, Ghana and Australia.
- **Highways** New roads are often financed with project finance techniques since they lend themselves to the cash flow based model of repayment.
- **Telecommunications** The burgeoning demand for telecommunications and data transfer via the Internet in developed and developing countries necessitates the use of project finance techniques to fund this infrastructure development.
- **Other** Other sectors targeted for a private takeover of public utilities and services via project finance mechanisms include pulp and paper projects, chemical facilities, manufacturing, hospitals, retirement care facilities, prisons, schools, airports and ocean-going vessels.

Why use project financing

Non-recourse/limited recourse

Non-recourse/limited recourse is one of the key distinguishing factors underlying project finance. Classic long term lending typically depends on cash flows but the facilities' ultimate credit rationale resides upon the creditworthiness of the borrower, since the lender will have a claim over the company's assets.

In a project financing, this is rarely the case since the size of the operation may dwarf the size of the participating companies' balance sheets. Moreover, the borrowing entity may be a special purpose vehicle with no credit history.

This is why it is useful to distinguish between non-recourse and limited recourse project financings.

- **Non-recourse project financing** Non-recourse project financing means that there is no recourse to the project sponsor's assets for the debts

or liabilities of an individual project. Non-recourse financing therefore depends purely on the merits of a project rather than the creditworthiness of the project sponsor. Credit appraisal therefore resides on the anticipated cash flows of the project, and is independent of the creditworthiness of the project sponsors. In such a scenario, the project sponsor has no direct legal obligation to repay the project debt or make interest payments.

- **Limited recourse project finance** In most project financings, there are limited obligations and responsibilities of the project sponsor; that is, the financing is limited recourse. Security, for example, may not suffice to fully guarantee a project. The main issue here is not that the guarantees offered fully mitigate the project but rather implicate the sponsor's involvement sufficiently deeply in order to fully incentivize the sponsor to ensure the technical success of the project.

How much recourse is necessary to support a financing is determined based on the unique characteristics of the project. The project risks and the extent of support forthcoming from the sponsors will directly impact the risk profile of the project, as well as the syndication strategy.

For example, if the lenders perceive that a substantial risk exists during the construction phase of a project, they could require that the project sponsor inject additional equity should certain financial ratio covenants be violated. Other mechanisms subject to negotiations between the agent bank and project sponsors are also possible.

Advantages of project finance

- **Non-recourse/limited recourse financing** Non-recourse project financing does not impose any obligation to guarantee the repayment of the project debt on the project sponsor. This is important because capital adequacy requirements and credit ratings mean that assuming financial commitments to a large project may adversely impact the company's financial structure and credit rating (and ability to access funds in the capital markets).
- **Off balance sheet debt treatment** The main reason for choosing project finance is to isolate the risk of the project, taking it off balance

sheet so that project failure does not damage the owner's financial condition. This may be motivated by genuine economic arguments such as maintaining existing financial ratios and credit ratings. Theoretically, therefore, the project sponsor may retain some real financial risk in the project as a motivating factor, however, the off balance sheet treatment *per se* will effectively not affect the company's investment rating by credit rating analysts.

- **Leveraged debt** Debt is advantageous for project finance sponsors in that share issues (and equity dilution) can be avoided. Furthermore, equity requirements for projects in developing countries are influenced by many factors, including the country, the project economics, whether any other project participants invest equity in the project, and the eagerness for banks to win the project finance business.
- **Avoidance of restrictive covenants in other transactions** Because the project financed is separate and distinct from other operations and projects of the sponsor, existing restrictive covenants do not typically apply to the project financing. A project finance structure permits a project sponsor to avoid restrictive covenants, such as debt coverage ratios and provisions that cross-default for a failure to pay debt, in the existing loan agreements and indentures at the project sponsor level.
- **Favourable tax treatment** Project finance is often driven by tax-efficient considerations. Tax allowances and tax breaks for capital investments etc. can stimulate the adoption of project finance. Projects that contract to provide a service to a state entity can use these tax breaks (or subsidies) to inflate the profitability of such ventures.
- **Favourable financing terms** Project financing structures can enhance the credit risk profile and therefore obtain more favourable pricing than that obtained purely from the project sponsor's credit risk profile.
- **Political risk diversification** Establishing SPVs (special purpose vehicles) for projects in specific countries quarantines the project risks and shields the sponsor (or the sponsor's other projects) from adverse developments.
- **Risk sharing** Allocating risks in a project finance structure enables the sponsor to spread risks over all the project participants, including the lender. The diffusion of risk can improve the possibility of project

success since each project participant accepts certain risks; however, the multiplicity of participating entities can result in increased costs which must be borne by the sponsor and passed on to the end consumer – often consumers that would be better served by public services.

- **Collateral limited to project assets** Non-recourse project finance loans are based on the premise that collateral comes only from the project assets. While this is generally the case, limited recourse to the assets of the project sponsor is sometimes required as a way of incentivizing the sponsor.
- **Lenders are more likely to participate in a workout than foreclose** The non-recourse or limited recourse nature of project finance means that collateral (a half-completed factory) has limited value in a liquidation scenario. Therefore, if the project is experiencing difficulties, the best chance of success lies in finding a workout solution rather than foreclosing. Lenders will therefore more likely cooperate in a workout scenario to minimize losses.

Disadvantages of project finance

- **Complexity of risk allocation** Project financings are complex transactions involving many participants with diverse interests. This results in conflicts of interest on risk allocation amongst the participants and protracted negotiations and increased costs to compensate third parties for accepting risks.
- **Increased lender risk** Since banks are not equity risk takers, the means available to enhance the credit risk to acceptable levels are limited, which results in higher prices. This also necessitates expensive processes of due diligence conducted by lawyers, engineers and other specialized consultants.
- **Higher interest rates and fees** Interest rates on project financings may be higher than on direct loans made to the project sponsor since the transaction structure is complex and the loan documentation lengthy. Project finance is generally more expensive than classic lending because of:
 - the time spent by lenders, technical experts and lawyers to evaluate the project and draft complex loan documentation;
 - the increased insurance cover, particularly political risk cover;

- the costs of hiring technical experts to monitor the progress of the project and compliance with loan covenant;
- the charges made by the lenders and other parties for assuming additional risks.
- **Lender supervision** In order to protect themselves, lenders will want to closely supervise the management and operations of the project (whilst at the same time avoiding any liability associated with excessive interference in the project). This supervision includes site visits by lender's engineers and consultants, construction reviews, and monitoring construction progress and technical performance, as well as financial covenants to ensure funds are not diverted from the project. This lender supervision is to ensure that the project proceeds as planned, since the main value of the project is cash flow via successful operation.
- **Lender reporting requirements** Lenders will require that the project company provides a steady stream of financial and technical information to enable them to monitor the project's progress. Such reporting includes financial statements, interim statements, reports on technical progress, delays and the corrective measures adopted, and various notices such as events of default.
- **Increased insurance coverage** The non-recourse nature of project finance means that risks need to be mitigated. Some of this risk can be mitigated via insurance available at commercially acceptable rates. This however can greatly increase costs, which in itself, raises other risk issues such as pricing and successful syndication.
- **Transaction costs may outweigh the benefits** The complexity of the project financing arrangement can result in a transaction whose costs are so great as to offset the advantages of the project financing structure. The time-consuming nature of negotiations amongst various parties and government bodies, restrictive covenants, and limited control of project assets, and burgeoning legal costs may all work together to render the transaction unfeasible.

Common misconceptions about project finance

There are several misconceptions about project finance:

- The assumption that lenders should in all circumstances look to the project as the exclusive source of debt service and repayment is

excessively rigid and can create difficulties when negotiating between the project participants.

- Lenders do not require a high level of equity from the project sponsors. This may be true in absolute terms but should not obscure the fact that an equity participation is an effective measure to ensure that the project sponsors are incentivized for success.
- The assets of the project provide 100% security. Whilst lenders normally look for primary and secondary sources of repayment (cash flow plus security on project assets), the realizable value of such assets (e.g. roads, tunnels and pipelines which cannot be moved) are such that the security is next to meaningless when compared against future anticipated cash flows. Security therefore is primarily taken in order to ensure that participants are committed to the project rather than the intention of providing a realistic method of ensuring repayment.
- The project's technical and economic performance will be measured according to pre-set tests and targets. Lenders will seek flexibility in interpreting the results of such negotiations in order to protect their positions. Borrowers on the other hand will argue for purely objective tests in order to avoid being subjected to subjective value judgements on the part of the lenders.
- Lenders will not want to abandon the project as long as some surplus cash flow is being generated over operating costs, even if this level represents an uneconomic return to the project sponsors.
- Lenders will often seek assurances from the host government about the risks of expropriation and availability of foreign exchange. Often these risks are covered by insurance or export credit guarantee support. The involvement of a multilateral organization such as the World Bank or regional development banks in a project tends to 'validate' a project and reassure lenders' concerns about political risk.

Description of a typical project finance transaction

Project finance transactions are complex transactions that often require numerous players in interdependent relationships. To illustrate, we provide

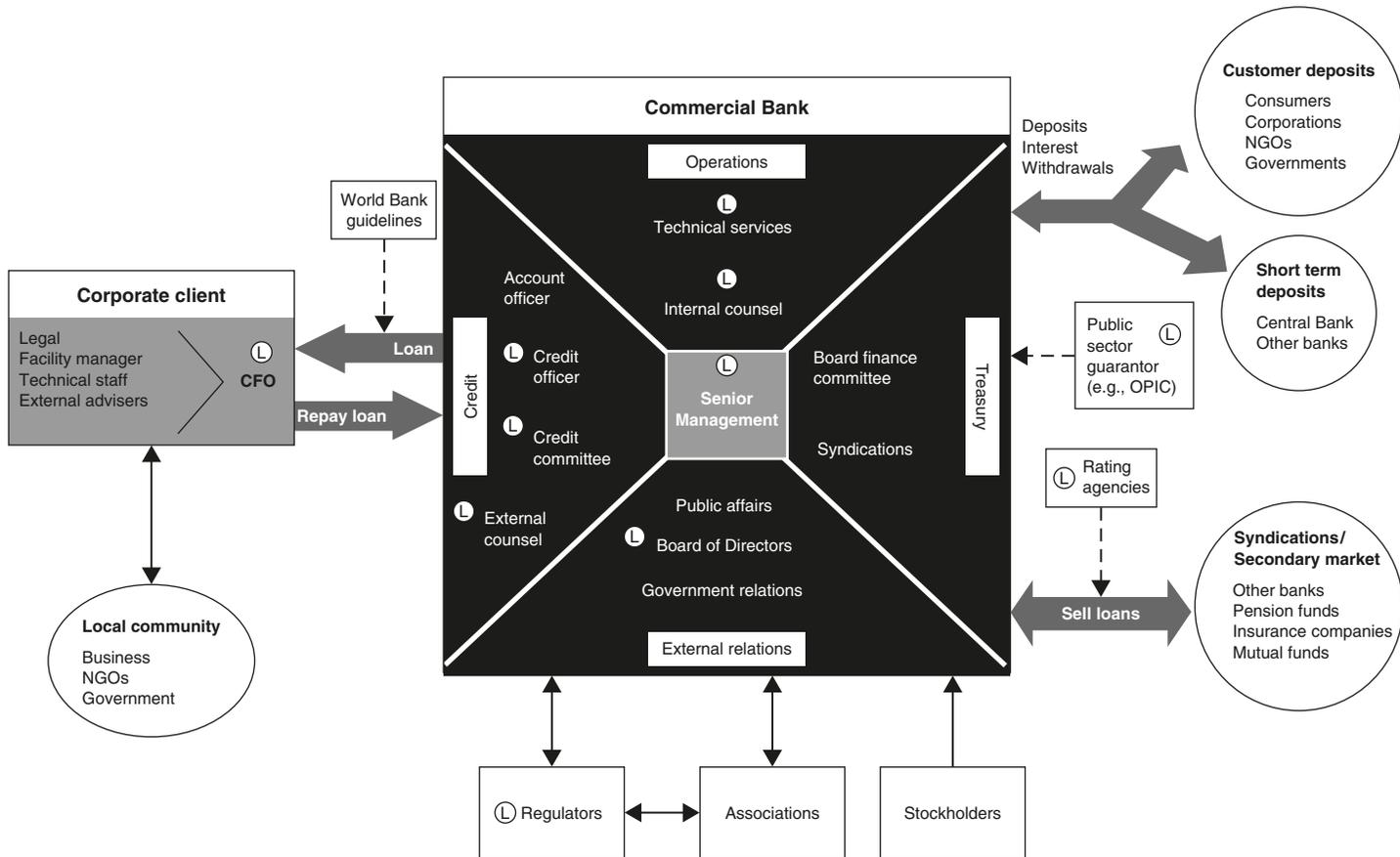


Figure 1.1 Example of a commercial bank

an organization diagram of the various players seen from the viewpoint of an agent bank in a generic project finance transaction:

- The core of a project financing is typically the project company, which is a special purpose vehicle (SPV) that consists of the consortium shareholders (such as contractors or operators who may be investors or have other interests in the project). The SPV is formed specifically to build and operate the project. The SPV can be structured either as a local project company or a joint venture (JV) consortium.
- The SPV is created as an independent legal entity, which enters into contractual agreements with a number of other parties necessary to the project. The contracts form the framework for project viability and control the allocation of risks.
- The project company enters into negotiations with the host government to obtain all requisite permits and authorizations, e.g. an oil or gas production licence, a mining concession, or a permit to build and operate a power plant.
- A syndicate of banks may enter into a financial agreement to finance the project company. There may be several classes of lending banks, e.g.
 - international banks lending foreign currency;
 - local banks lending domestic currency for local costs;
 - export credit agencies lending or guaranteeing credits to finance suppliers to the project of their national equipment; and
 - international agencies lending or guaranteeing development credits (World Bank, Asian Development Bank, African Development Bank, European Bank for Reconstruction and Development).
- The project company enters into various contracts necessary to construct and operate the project: The major types of contracts include:
 - EPC contract (engineering, procurement and construction) – to build and construct the project facility;
 - O&M contract (operation and management) – to manage and operate the facility and project during its operational phase;
 - supply contract (the project company enters into contracts with suppliers to ensure an uninterrupted supply of raw materials necessary for the project);
 - off-take agreements (the project company enters into contracts with purchasers of the project company's product or service).

Project phases

Project financings can be divided into two distinct stages:

- Construction and development phase – here, the loan will be extended and debt service may be postponed, either by rolling-up interest or by allowing further drawdowns to finance interest payments prior to the operation phase. The construction phase is the period of highest risk for lenders since resources are being committed and construction must be completed before cash flow can be generated. Margins might be higher than during other phases of the project to compensate for the higher risks. The risks will be mitigated by taking security over the construction contract and related performance bonds.
- Operation phase – here, the lenders will have further security since the project will begin to generate cash flows. Debt service will normally be tailored to the actual cash flows generated by the project – typically a ‘dedicated percentage’ of net cash flows will, via security structures such as blocked accounts, go to the lenders automatically with the remainder transferred to the project company. The terms of the loan will frequently provide for alternative arrangements should cash flows generate an excess or shortfall due to unanticipated economic or political risks arising.

Parties to a project financing

As we saw in the previous section, there are several parties in a project financing. Here is a list, albeit non-exhaustive, of the most usual ones.

Project company

The project company is the legal entity that will own, develop, construct, operate and maintain the project. The project company is generally an SPV created in the project host country and therefore subject to the laws of that country (unless appropriate ‘commissions’ can be paid so that key government officials can grant ‘exceptions’ to the project). The SPV will be controlled by its equity owners. The control mechanism may be defined in a charter, a joint venture agreement or

partnership agreement and may also be subject to local laws. Its only activity will be to own and operate the project.

Sponsor

The project sponsor is the entity that manages the project. The sponsor generally becomes equity owner of the SPV and will receive any profit either via equity ownership (dividend streams) or management contracts (fees). The project sponsor generally brings management, operational, and technical experience to the project. The project sponsor may be required to provide guarantees to cover certain liabilities or risks of the project. This is not so much for security purposes but rather to ensure that the sponsor is appropriately incentivized as to the project's success.

Borrower

The borrowing entity might or might not be the SPV. This depends on the structure of the financing and of the operation of the project (which will themselves be determined by a host of factors such as tax, exchange controls, the availability of security and the enforceability of claims in the host country). A project may in fact have several 'borrowers', for example, the construction company, the operating company, suppliers of raw materials to the project and purchasers (off-takers) of the project's production.

Financial adviser

The project sponsor may retain the services of a commercial or merchant bank to provide financial advisory services to the sponsor. The financial adviser theoretically will be familiar with the project host country and be able to advise on local legal requirements and transaction structures to ensure that the loan documentation and financial structure are properly assembled.

A financial consultant can also advise on how to arrange the financing of the project, taking into consideration streaming cash flows, creation of shell offshore companies, tax avoidance, currency speculation, desirable

locales for the project and capital required. Consultants can add the imprimatur of legality to the creation of such convoluted structures and provide help with accounting issues relating to the above other issues, such as the expected cost of the project, interest rates, inflation rates, the projected economics of operations and the anticipated cash flow.

The financial adviser finally can assist in the preparation of the information memorandum regarding the proposed project. As the name suggests, the information memorandum provides information on the project, and is presented in glowing positive terms as an inducement for banks to participate in the financing, and achieve a successful syndication (despite disclaimers stating to the contrary that the memorandum is not a recommendation to participate in the facility and no responsibility can be taken for the accuracy of the information provided therein).

The lenders

The large size of projects being financed often requires the syndication of the financing. For example, the Eurotunnel project financing involved some 220 banks. The syndicated loan, which is treated in a separate book in this series, exists because often any one lender individually does not have the balance sheet availability due to capitalization requirements to provide the entire project loan. Other reasons may be that it wishes to limit its risk exposure in the financing or diversify its lending portfolio and avoid risk concentration.

The solution is to arrange a loan where there are several lenders forwarding funds under a single loan agreement. Such a group of lenders is often called a *syndicate*. A syndicate of banks might be chosen from as wide a range of countries as possible to discourage the host government from taking action to expropriate or otherwise interfere with the project and thus jeopardize its economic relations with those countries. The syndicate can also include banks from the host country, especially when there are restrictions on foreign banks taking security in the country. There are various categories of lenders in a loan syndication, typically:

- **The arranger** The bank that arranges the syndication is called the arranging bank or lead manager. The bank typically negotiates the

term sheet with the borrower as well as the credit and security documentation.

- **The managers** The managing bank is typically a title meant to distinguish the bank from mere participants. In other words, the bank may take a large portion of the loan and syndicate it, thus assuming some of the underwriting risk. Managers can therefore broaden the geographic scope of the syndication. This role is reflected in the title which then features in the facility tombstones and any other publicity relating to the facility.
- **The facility agent** exists to administer the administrative details of the loan on behalf of the syndicate. The facility agent is not responsible for the credit decisions of the lenders in entering into the transaction. The agent bank is responsible for mechanistic aspects of the loan such as coordinating drawdowns, repayments, and communications between the parties to the finance documentation, such as serving notices and disseminating information. The Facility Agent also monitors covenant compliance and, when necessary, polls the bank group members in situations where a vote is needed (such as whether to declare a default or perfect security arrangements) and communicates these decisions to the borrower.
- **Technical/engineering bank** as the name implies monitors the technical progress and performance of the project and liaise with the project engineers and independent experts. As such, the bank is responsible for identifying technical (engineering) events of default.
- **Account bank** The account bank is the bank through which all project cash flows pass and are monitored, collected, and disbursed.
- **Insurance bank** The insurance bank undertakes negotiations in connection with project insurances, to ensure that the lender's position is fully covered in terms of project insurance.
- **The security trustee** exists where there are different groups of lenders or other creditors interested in the security and the coordination of their interests will call for the appointment of an independent trust company as security trustee.

The interrelationships of participating banks in a bank syndicate often appears post-syndication in a 'tombstone', which is a form of advertising for the successful syndicating bank.

Technical adviser

Technical experts advise the project sponsor and lenders on technical matters about which the sponsor and lenders have limited knowledge (oil, mining, fuel, environmental). Such experts typically prepare reports, such as feasibility reports, for the project sponsor and lenders, and may monitor the progress of the project, possibly acting as the arbiter in the event of disagreements between the sponsors and the lenders over the satisfaction of the performance covenants and tests stipulated in the finance documents.

Lawyers

The international nature and complexity of project financing necessitates the retention of experienced international law firms. Project finance lawyers provide legal experience with specific experience of project finance structures, experience with the underlying industry and knowledge of project contracts, debt and equity documents, credit enhancement and international transactions.

Project finance lawyers provide advice on all aspects of a project, including laws and regulations; permits; organization of project entities; negotiating and drafting of project construction, operation, sale and supply contracts; negotiating and drafting of debt and equity documents; bankruptcy; tax; and similar matters.

It is advisable to involve the lawyers at an early stage to ensure that the structure of the financing is properly conceived from the outset and is tax-efficient. Local lawyers in the host country of the project are also necessary in opining on various local legal matters in connection with the project financing. They are particularly useful with respect to assessing the enforceability of claims on project assets located in the host country.

Equity investors

These may be lenders or project sponsors who do not expect to have an active management role as the project goes on stream. In the case of

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BANQUE PSA FINANCE HOLDING and PEUGEOT FINANCE INTERNATIONAL N.V. FRF 12,500,000,000 Multicurrency Revolving Loan Facility Incorporating a FRF4, 190,000,000 Swingline Facility		
guaranteed by BANQUE PSA FINANCE HOLDING		
<i>Arrangers</i>		
ABN-Amro Bank NV NatWest Markets		Credit Suisse/CS First Boston Limited Société Générale
<i>Senior lead managers</i>		
Banque Indosuez Banque Paribas Crédit Lyonnais Dresdner Bank Luxembourg SA Morgan Guaranty Trust Company of New York		Banque National de Paris Commerzbank Aktiengesellschaft, Succursale de Paris Deutsche Bank AG, Succursale de Paris Midland Bank Plc, Paris Branch Union Bank of Switzerland
<i>Lead managers</i>		
Argentaria/Banco Exterior de España, Paris Branch Banque Française du Commerce Extérieur Caisse Centrale des Banques Populaires Crédit Commercial de France Den Danske Bank The Fuji Bank Limited Rabobank, Succursale de Paris The Sumitomo Bank Limited, Paris Branch Unicredit/Crédit Agricole Group		Banque Fédérative du Crédit Mutuel Bayerische Vereinsbank AG, Succursale de Paris Caisse des Dépôts et Consignations Crédit Industriel et Commercial de Paris DG Bank, Deutsche Genossenschaftsbank ING Bank, Paris Branch Enskilda The Toronto-Dominion Bank WestLB Group
<i>Managers</i>		
Banca Commerciale Italiana SpA, London Branch Banca Nazionale del Lavoro SpA, Succursale de Paris Banco Bilbao Vizcaya SA, Paris Branch Bank of America NT & SA Banque Bruxelles Lambert France SA Banque Worms Caja de Madrid Crédit du Nord The Dai-Ichi Kangyo Bank Limited, Paris Branch Kredietbank, Succursale Française The Mitsubishi Bank Limited, Succursale de Paris Royal Bank of Canada Group The Royal Bank of Scotland plc Scotiabank (Ireland) Limited Standard Chartered Bank		Banca Monte dei Paschi di Siena SpA, London Branch Banca Popolare di Milano, London Branch Banco Santander SA, Paris Branch The Bank of Tokyo Ltd, Paris Branch Banque Sanpaolo BHF-Bank Aktiengesellschaft The Chase Manhattan Bank NA Credito Italiano SpA, Paris Branch Generale Bank Lyonnaise de Banque NationsBank Republic National Bank of New York The Sanwa Bank, Paris Branch Sogeval, Strasbourg
<i>Facility and swingline agent</i>		
ABN-Amro Bank NV		

Figure 1.2

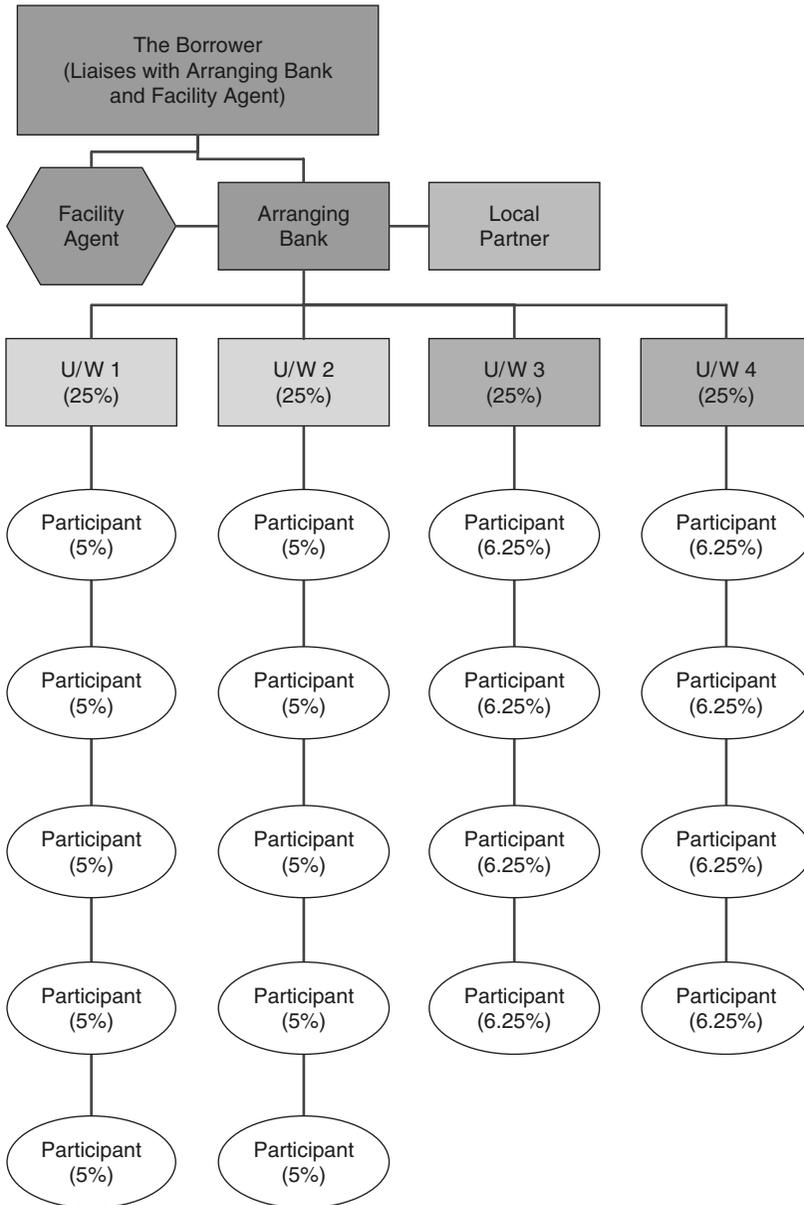


Figure 1.3 Hypothetical loan syndication breakdown

lenders, they are putting equity alongside their debt as a way to obtain an enhanced return if the project is successful. In most cases, the equity investment is combined with agreements that allow the equity investor to sell its equity to the project owner if the equity investor wishes to get

out. Third party investors normally look to invest in a project on a much longer time scale than a contractor who in most cases will want to sell out once the construction has reached completion. Many third party investors are development or equity funds, which diversify their portfolios by investing in a number of projects. They may seek to manage the project by appointing members of their own organizations to the board of the project company.

Construction company

Since most project financings are infrastructural, the contractor is typically one of the key players in the construction period. Construction can be either of the EPC or 'turnkey' variety. EPC, or engineer, procure, and construct, is when the construction company builds the facility as per an already designated specifications. Turnkey, on the other hand, is when the contractor designs, engineers, procures and constructs the facility, assuming all responsibility for on-time completion. In both cases, it is important that the construction company selected has a track record of successful project management and completion. In many large projects, consortia of constructors may become involved either for sheer economies of scale or for political reasons. In such cases, lenders prefer members of the consortia to undertake joint and several liability since the risk of failure of performance is the total responsibility of each member of the consortium.

Most projects are structured on the basis that only one turnkey or EPC contractor will be employed. The various designers, contractors and subcontractors participating in the project will therefore be under the overall control of the project manager. This enables the coordination and streamlining of reporting lines.

Regulatory agencies

Projects naturally are subject to local laws and regulations. These may include environmental, zoning, permits and taxes. Publicly owned projects also will be subject to various procurement and public contract laws. It is important to ensure that a project has received all the requisite permissions and licences before committing financial resources. In many

markets, such ‘roadblocks’ may require extensive and time-consuming preparation for applying for the requisite government permission followed by indeterminate waiting. Another possibility is the lobbying of local political figures or the payment of large ‘commissions’ to persons in the host country’s government which may or may not have the clout to obtain the requisite approval. For example, a Mercedes 600 SLC given to an individual in the host country’s government may accelerate the requisite permission for an oil rig to enter or leave the state’s territorial waters. Then again, it may not. Therefore, ‘caveat emptor’ or in this case, ‘know your prince’.

Export credit agencies

Export credit agencies (ECAs) promote trade or other interests of an organizing country. They are generally nationalistic in purpose and nationalistic and political in operation. Funding of bilateral agencies generally comes from their organizing governments. Government-supported export financing includes pre-export working capital, short term export receivables financing and long term financing.

ECAs play important roles in infrastructure and other projects in emerging markets by stimulating international trade. They normally provide low cost financing arrangements to local manufacturers who wish to transport their technology to foreign lands.

ECAs also provide political risk insurance to projects. This has an effect of ‘validating’ the project as lenders believe that foreign governments are reluctant to curry disfavor by defaulting on facilities granted by a foreign bilateral agency.

United States Export–Import Bank

The Export–Import Bank of the United States (Ex–Im Bank) is the official export credit agency of the United States. Ex–Im Bank’s mission is to assist in financing the export of US goods and services to international markets.

Ex–Im Bank enables US companies – large and small – to turn export opportunities into real sales that help to maintain and create US jobs and contribute to a stronger national economy.

Ex-Im Bank does not compete with private sector lenders but provides export financing products that fill gaps in trade financing. It assumes credit and country risks that the private sector is unable or unwilling to accept. It also helps to level the playing field for US exporters by matching the financing that other governments provide to their exporters.

Ex-Im Bank provides working capital guarantees (pre-export financing), export credit insurance (post-export financing) and loan guarantees and direct loans (buyer financing). No transaction is too large or too small. On average, 85% of its transactions directly benefit US small businesses.

Ministry of Economy Trade and Industry (Japan)

The Export-Import Insurance Division of Japan's Ministry of Economy Trade and Industry ('METI', ex MITI) is an agency of the Government of Japan. It provides insurance coverage to Japanese companies and non-Japanese companies registered in Japan. MITI coverage can be combined with OPIC coverage to cover the entire bank group, depending upon the location of members of the bank group. There is no maximum amount of coverage.

Export-Import Bank of Japan

The Export-Import Bank of Japan provides limited political risk coverage. Eligibility is limited to loans from financial institutions in Japan (including branches of foreign banks), for funding recently privatized businesses and regulated industries in developing countries. Significant is that the coverage is not limited to Japanese export financing. The maximum coverage is generally 95% for a maximum term of 12 years.

Export Credits Guarantee Department

ECGD, the Export Credits Guarantee Department, is the UK's official export credit agency. It works closely with exporters, project sponsors, banks and buyers to help UK exporters of capital equipment and project-related goods and services to win business and invest overseas.

ECGD was originally set up in 1919 to help British exporters re-establish their trading positions following the disruption caused by the Great War.

This assistance largely took the form of providing insurance against the commercial and political risks of not being paid by overseas buyers after goods were exported. In 1991, the arm of ECGD which dealt with exporters who traded on short terms of credit (i.e. up to two years) was sold to NCM Credit Insurance Ltd. Exporters of this type of goods, e.g. consumable items, can now obtain credit insurance from a number of companies in the private market. ECGD still provides exporters of British capital goods and services with finance and insurance packages to help them win valuable overseas orders. It also insures British companies who invest abroad against the political risks of a non-return on their investments.

ECGD is a separate Department of the British Government, reporting to the Secretary of State for Trade and Industry. It derives its powers from the 1991 Export and Investment Guarantees Act.

ECGD operates on a break-even basis, charging exporters premium at levels to match the risk on non-payment. From this, reserves are built up to pay for claims if overseas buyers/borrowers default on payments. ECGD would then seek to make recovery of claims paid through negotiation with overseas buyers/borrowers.

Compagnie Française d'Assurances Commerciale Exterieur

Founded in 1946, Coface is a subsidiary of Natexis Banques Populaires and the Banque Populaire Group, whose regulatory capital (tier 1) amounted to €12.2 billion at 31 December 2003. Coface facilitates global trade by offering companies solutions to manage, finance and protect their customer portfolio and enabling them to outsource all or part of their receivables management, as well as the related risks.

Coface has over 4000 employees serving 85 000 clients, with an organization in each country based on integrated sales forces and four product lines: credit insurance; credit information and corporate ratings; receivables management; and factoring and receivables securitization. Coface also offers three other business lines: guarantee insurance, receivables management training and, in France, public procedures management for export guarantees on behalf of the State.

Coface has subsidiaries or branches in 57 countries and offers local services in 91 countries through its partners in the CreditAlliance network, united by shared credit risk management systems (the Common Risk System).

Export Development Corporation of Canada

The Export Development Corporation of Canada (EDC) provides political risk coverage to projects located in eligible countries. The product or service exported generally must be at least 50% in Canadian content. The maximum coverage is CN\$ 100 million. The maximum term is 15 years.

Other OCED government insurance entities

Each member country of the Organization for Economic Co-operation and Development (OECD) has established political risk insurance programs similar to the United States OPIC program.

Current members are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, the United States and its territories. Some of these are summarized in Table 1.1.

Commercial insurance

Complementary and alternative political risk insurance is offered by a small community of insurers. These include:

- Lloyd's of London
- American International Underwriters
- Unistat Assurance
- Citicorp International Trade Indemnity, Inc.

In general, these coverages are of a limited term of one to three years, and do not typically match the term of the project debt. However, private insurance companies are generally more flexible than OPIC, MIGA or the export–import agencies because they are not constrained by public policy considerations. In addition, they provide benefits of confidentiality and possible cost savings associated with negotiation of complete, single source insurance protection for a project, including casualty, liability

Table 1.1 Major ECAs operating today (listed by country)

Australia	Export Finance and Insurance Corporation (EFIC) provides export financing and commercial and political risk insurance
Austria	Oesterreichische Kontrollbank AG
Belgium	Office National du Decroire (OND) provides export credit insurance as the credit enhancement for commercial bank loans
Canada	Export Development Corporation (EDC) provides export financing and insurance support
Denmark	Eksportkreditaadet – the Danish export finance organization. It provides only guarantees.
Finland	Finish Export Credit Limited – a joint stock company, majority owned by the government. It provides financing to exporters, buyers and bank to bank credit
France	Compagnie Française d'Assurance pour le Commerce Extérieur provides commercial and political risk insurance
Germany	Kreditanstalt fiir Wiederaufbau provides export credits. Also, Hermes Kreditversicherung AG, a private company, provides credit premium of risk insurance, and Ausfuhrkredit Gesellschaft, a private consortium of commercial banks, provides export credits
Italy	Instituto Centrale per il Credito a Medio Termine administers Italy's export credit programme. Export credit commercial and political risk insurance is provided by Sezione Speciale per Assicurazione del Credito all'Esportazione (SACE).
Japan	Export Import Bank of Japan provides credits to purchasing foreign entities for financing Japanese goods and services
Korea	Export Import Bank of Korea provides bilateral loans
Netherlands	In the Netherlands, export financing is provided by commercial banks. The Nederlandsche Credietverzekering Maatschappij provides insurance against credit risks
Norway	Garanti instituttet for Eksportkreditt provides loan guarantees to support export financings. Also, the Norwegian Agency for Development Cooperation, together with Eksportfinans, provides export credit. Eksportfinans is an export credit agency owned by commercial banks and GEIK

(continued)

Table 1.1 (continued)

Sweden	Swedish International Development Authority provides export guarantees which emanate from the Swedish Export Credits Guarantee Board
Spain	Export Credit Insurance Company provides commercial and political risk insurance for export credits. Concessional export credits are provided by the Institute for External Trade
UK	Export Credit Guarantee Department (ECGD) guarantees payment to a UK financial institution to support UK goods and services, guaranteeing exporters against payment risks resulting from commercial and political risks
USA	Export Import Bank operates as an independent US agency
USA	Overseas Private Investment Corporation (OPIC) is an agency of the United States government
Other bilateral support	Bilateral agencies also provide other support to exporting entities and their lenders, particularly for projects in developing countries. Most common is insurance against export commercial and political risks. Guarantees are also available to protect against these risks

and other insurance. On the other hand, commercial insurers rarely offer currency transfer and political violence coverage in developing countries and emerging economies.

Multilateral agencies/development banks

European Bank for Reconstruction and Development (EBRD)

The European Bank for Reconstruction and Development was established in 1991 when communism was crumbling in Central and Eastern Europe and ex-soviet countries needed support to nurture a new private sector in a democratic environment. Today the EBRD uses the tools of investment to help build market economies and democracies in 27 countries from Central Europe to Central Asia.

The EBRD is the largest single investor in the region and mobilizes significant foreign direct investment beyond its own financing. It is owned by 60 countries and two intergovernmental institutions. But despite its

public sector shareholders, it invests mainly in private enterprises, usually together with commercial partners.

It provides project financing for banks, industries and businesses, both new ventures and investments in existing companies. It also works with publicly owned companies, to support privatization, restructuring state-owned firms and improvement of municipal services. The Bank uses its close relationship with governments in the region to promote policies that will bolster the business environment.

The mandate of the EBRD stipulates that it must only work in countries that are committed to democratic principles. Respect for the environment is part of the strong corporate governance attached to all EBRD investments.

Every EBRD investment must:

- help move a country closer to a full market economy: the transition impact;
- take risk that supports private investors and does not crowd them out;
- apply sound banking principles.

Through its investments, the EBRD promotes:

- structural and sectoral reforms;
- competition, privatization and entrepreneurship;
- stronger financial institutions and legal systems;
- infrastructure development needed to support the private sector;
- adoption of strong corporate governance, including environmental sensitivity; and it provides technical assistance.

World Bank

The International Bank for Reconstruction and Development (IBRD), better known as the World Bank, came into existence on 27 December 1945 following international ratification of the agreements reached at the Bretton Woods Conference.

The World Bank was originally operated as a vehicle for member countries to loan money to member countries needing foreign capital. It was structured as a financing intermediary for those countries that lacked the creditworthiness to borrow at attractive rates on their own.

The main objectives of the bank are:

- to assist in the development of member countries by facilitating the investment of capital for productive purposes;
- to promote private foreign investment by means of guarantees or participation in loans and other investments made by private investors;
- to promote the long-range balanced growth of international trade and the maintenance of equilibrium in balance of payments.

Most recently, the World Bank has assumed an ideological dimension by undertaking measures to reduce the prominence of the public sector role and increase that of the private sector. Thus, various factors must be addressed to determine whether a project will be attractive to the World Bank for participation by it. These include improvement of the business environment in accordance with the World Bank's *weltanschauungen*. Its recent track record confirms that this policy objective has taken a front seat to its original objectives of 'reducing poverty and encouraging economic development'.

Though repeatedly relied upon by impoverished governments around the world as a contributor of development finance, the Bank has been criticized by opponents of corporate 'neo-colonial' globalization for undermining the national sovereignty of recipient countries through its pursuit of economic liberalization.

One of the issues arising on repayment policy is that some loans were provided to dictators and military juntas even though the dictators did not have a popular mandate to represent the people, and following the departure or overthrow of the dictators, the hapless inhabitants of the country are then called upon to honour the loans of the despots which tyrannized them. This has the hallmarks of debts being transmitted from generation to generation, a form of slavery. A similar argument could be applied to bilateral loans made in these periods too.

Finally multilateral agencies can threaten governments with various measures should they fail to implement desired policies. The resulting dislocations and hardships borne by the indigenous population re. labour markets and cost of living variations are effectively irrelevant.

International Finance Corporation

The International Finance Corporation (IFC) promotes private sector investment in developing countries. IFC is a member of the World Bank Group and is headquartered in Washington, DC. It shares the primary objective of all World Bank Group institutions: to improve the quality of the lives of people in its developing member countries. Established in 1956, IFC is the largest multilateral source of loan and equity financing for private sector projects in the developing world. It promotes sustainable private sector development primarily by:

- financing private sector projects located in the developing world;
- helping private companies in the developing world mobilize financing in international financial markets;
- providing advice and technical assistance to businesses and governments.

IFC has 176 member countries, which collectively determine its policies and approve investments. To join IFC, a country must first be a member of the IBRD. IFC's corporate powers are vested in its Board of Governors, to which member countries appoint representatives. IFC's share capital, which is paid in, is provided by its member countries, and voting is in proportion to the number of shares held. IFC's authorized capital is \$2.45 billion.

Multilateral Investment Guarantee Agency

The Multilateral Investment Guarantee Agency (MIGA) was created in 1988 as a member of the World Bank Group to promote foreign direct investment into emerging economies to improve people's lives and reduce poverty. MIGA fulfils this mandate and contributes to development by offering political risk insurance (guarantees) to investors and lenders, and by helping developing countries attract and retain private investment.

MIGA is led in its mission by four guiding principles: focusing on clients – serving investors, lenders, and host country governments by supporting private enterprise and promoting foreign investment; engaging in partnerships – working with other insurers, government agencies and international organizations to ensure complementarity of services and approach; promoting developmental impact – striving to improve the lives of people in emerging economies, consistent with the goals of host countries and sound business, environmental, and social principles; ensuring financial soundness – balancing developmental goals and financial objectives through prudent underwriting and sound risk management.

MIGA membership, which currently stands at 163, is open to all World Bank members. The agency began operations in 1988 with a capital base of \$1 billion. In 1999, the MIGA Council of Governors approved a resolution for a capital increase of \$850 million. Members have since contributed \$655 million (or 77%) of this amount; when further pledges are converted, this should rise to \$824 million, or 97%. In addition, the agency received a \$150 million contribution to its recapitalization from the World Bank.

Regional development banks

Regional development banks are organized with goals similar to the World Bank, such as poverty reduction and promotion of economic growth. Rather than a global focus, however, these banks instead focus on a particular geographic region. They are owned and funded by the governments of the region and industrialized nations. These include:

- **African Development Bank** The African Development Bank (AfDB), which began operations in 1963, is a major source of public financing in Africa. The member countries include 51 African states and 25 other countries, most of which are industrialized nations.
- **Arab Fund for Economic and Social Development** Established in 1972, the Arab Fund for Economic and Social Development assists development in the member countries of the Arab League. The fund assists in financing of development projects.
- **Asian Development Bank** The Asian Development Bank is a multilateral development finance institution that engages in mostly public sector lending for development purposes in its developing member

countries in Asia and the Pacific. It pursues this goal by providing loans and technical assistance for a broad range of development activities. ADB raises funds through bond issues on the world's capital markets but also relies on members' contributions. The ADB was established in 1966 and has its headquarters in Manila, Philippines. As of September of 2003, the ADB had 58 member countries. Although ADB historically focused on government-level public agency lending with a governmental guarantee, the significant increase in privatizations in member countries has resulted in a private-sector mandate.

- **European Bank for Reconstruction and Development** The European Bank for Reconstruction and Development (EBRD) began operations in 1991. It was organized to provide assistance to the nations of Central and Eastern Europe for transition to market based economies. There are over 50 member countries. The EBRD raises funds from member countries as well as the capital markets.
- **European Union** The European Union, organized in 1993, is an organization of 25 industrialized European nations. It provides grants to developing countries throughout the world, including Africa, Asia, the Caribbean, central and eastern Europe, Latin America and the former Soviet Union.
- **European Investment Bank** Organized in 1958, the European Investment Bank (EIB) provides financial support for development. The members of the EIB are the members states of the European Union. Funds are raised by the EIB from member countries and also from the capital markets. Loans are generally made within the European Union, but are also made outside of the union.
- **Inter-American Development Bank** The Inter-American Development Bank (IDB) was organized in 1959, and is a major lender to Latin American and Caribbean member countries. It is currently the principal source of external finance for most Latin American countries. The 46 member countries include Latin American countries, the United States and other industrialized nations. Funds for loans are raised by the IDB from member countries as well as from the capital markets. Loans are generally made to public agencies of member countries to finance specific projects. A government guarantee is required. Direct support to the private sector is made available by the bank through its affiliate, the **Inter-American Investment Corporation (IIC)**.

- **Islamic Development Bank** The Islamic Development Bank (IsDB), established in 1974, is a multilateral organization of 45 countries. Its purpose is to promote economic development in member countries and in Muslim communities in non-member countries. The bank, operating within the principles of the Koran, provides interest-free loans for development projects, and also finances lease transactions and instalment sales, and makes equity investments.
- **Nordic Investment Bank** The Nordic Investment Bank (NIB) was formed in 1975 by Denmark, Finland, Iceland, Norway and Sweden. Its purpose is to finance investments in which its member nations are interested, both within the Nordic countries and internationally.
- **Nordic Development Fund** Since 1989, the Nordic Development Fund (NDF) has provided credits to developing countries on concessional terms, primarily in Africa and Asia. It participates in co-financing arrangements with other multilateral agencies and regional banks.
- **OPEC Fund for International Development** The OPEC Fund for International Development, established in 1976, provides financial assistance to developing countries. Its members are the countries that are members of the Organization of Petroleum Exporting Countries.

Host governments

The host government is the government of the country in which the project is located. The host government is typically involved as an issuer of permits, licences, authorizations and concessions. It also might grant foreign exchange availability projections and tax concessions. In some projects, the host government is an owner of the project, whether majority or minority, or will become the owner of the project at the end of a specified period, such as in a build-own-transfer (BOT) structure. It might also be involved as an off-take purchaser or as a supplier of raw materials or fuel.

Construction contractors

These include the engineers and contractors responsible for designing and building the project. Any or all of these parties may be contractually part of the financing. The contractor is the entity responsible for construction of the project; to the extent construction of a facility is a part

of the overall project. It bears the primary responsibility in most projects for the containment of construction-period costs.

Suppliers

Suppliers provide raw materials or other inputs to the project, since supply arrangements are key to project success, project sponsors and lenders are concerned with the underlying economic feasibility of supply arrangements and the supplier's ability to perform the contracts. Closely linked to inputs are the matter of appropriate transportation links and the ability to move the requisite materials or machinery through customs.

Purchasers

In large infrastructure projects, the project company will seek in advance to conclude long term agreements to sell the good or service being produced by the project (e.g. selling coal to electric power plants). This is known as an 'off-take agreement'. *The output purchaser* provide a crucial element of the credit support for the underlying financing by seeking to stabilize the acquisition of the raw materials over time and protect itself from market volatility. Such support can be seen as a credit enhancement (such as guarantees) to make the project more attractive to the financing banks.

Leasing companies

If capital allowances are available for the writing-down of plant and machinery or other assets, the project structure might involve one or more financial leasing companies. Their role will be to lease out assets to the project company in return for a rental stream. In addition to the tax advantages are the financial ones of keeping the assets off the project company's balance sheet.

Insurers

The sheer scale of many projects and the potential for incurring all sorts of liabilities dictates the necessity of arranging appropriate insurance

arrangements. Insurers therefore play a crucial role in most projects. If there is a adverse incident affecting the project then the sponsor and the lenders will look to the insurers to cover them against loss.

Financing sources used in project financing

Just as financial instruments range from debt to equity and hybrids such as mezzanine finance, project finance can raise capital from a range of sources.

Raising financing depends on the nature and structure of the project financing being proposed. Lender and investor interest will vary depending on these goals and risks related to the financing. Commercial lenders seek projects with predictable political and economic risks. Multilateral institutions, on the other hand, will be less concerned with commercial lending criteria and will look towards projects that ostensibly satisfy not only purely commercial criteria.

In assembling a project financing, all available financing sources should be evaluated. This would include equipment suppliers with access to export financing; multilateral agencies; bilateral agencies, which may provide financing or guarantees; the International Finance Corporation or regional development banks that have the ability to mobilize commercial funds; specialized funds; institutional lenders and equity investors; and commercial banks, both domestic and international.

Equity

Equity is often raised in the stock markets and from specialized funds. Equity, as it is well known, is more expensive than debt financing. Domestic capital markets provide access to significant amounts of funds for infrastructure projects, although capital markets in developing countries may lack the depth to fund large transactions. In such cases, the international capital markets can also provide access to significant amounts of funds for infrastructure projects. However, this is generally limited to

transactions whose sponsors are large, multinational companies. Access to international capital markets by companies in developing countries is generally limited, due to their low name visibility in the international financial markets.

Developmental loan

A development loan is debt financing provided during a project's developmental period to a sponsor with insufficient resources to pursue development of a project. The developmental lender is typically a lender with significant project experience. Developmental lenders, who fund the project sponsor at a very risky stage of the project, desire some equity rewards for the risk taken. Hence, it is not unusual for the developmental lender to secure rights to provide permanent financing for the project as part of the development financing arrangement.

Developmental loans are typically advanced to the project sponsor on a periodic basis, based on a budget prepared to cover the development stage of the project. The developmental lender will typically require liens on all project assets including project contracts. Repayment of the loan is typically from proceeds of construction financing. Developmental loans are extremely risky for the lender since there is no assurance that the project can be developed. These loans are also risky because the value of the collateral is totally dependent on the ability to complete the project. That value can reduce to nothing at any point.

Subordinated loans

Subordinated loans, also called mezzanine financing or quasi-equity, are senior to equity capital but junior to senior debt and secured debt. Subordinated debt usually has the advantage of being fixed rate, long term, unsecured and may be considered as equity by senior lenders for purposes of computing debt to equity ratios.

Subordinated debt can sometimes be used advantageously for advances required by investors, sponsors or guarantors to cover construction cost

over-runs or other payments necessary to maintain debt to equity ratios, or other guaranteed payments.

Senior debt

Commercial banks and institutional lenders are an obvious choice for financing needs. Commercial banks tend to limit their commitments to 5–10 with floating interest rates based on LIBOR or US prime rate. Fixed interest rate loans for 5- to 10-year maturities or longer are sometimes available. Commercial bank loans for large projects are typically arranged as syndicated bank loans.

The senior debt of a project financing usually constitutes the largest portion of the financing and is usually the first debt to be placed. Generally the senior debt will be more than 50% of the total financing. Senior debt is debt that is not subordinated to any other liability, in other words, the first to be paid out if the company or project is placed under liquidation.

Senior debt falls into two categories: unsecured and secured loans.

Unsecured loans

Unsecured loans basically depend on the borrower's general credit-worthiness, as opposed to a perfected security arrangement. Unsecured loans will usually contain a negative pledge of assets to prohibit the liquid and valuable assets of the company from being pledged to a third party ahead of the unsecured lender.

The loan agreement may include ratio covenants and provisions calculated to trigger a security agreement, should the borrower's financial condition begin to deteriorate. An unsecured loan agreement may also contain negative covenants which limit investments and other kinds of loans, leases debt obligations of the borrower.

The loan agreement may also include affirmative covenants which are things that the company has to do: e.g. ensure that the business will be

properly managed, proper books and records will be kept, financial information will be furnished, insurance coverage kept in force, and the business operated according to law.

Large unsecured loans are available only to the most creditworthy companies with long histories of commercially successful operation and good relationships with their lenders. Since projects tend to be new enterprises with no operating histories, projects rely upon the reputations of their sponsors, owners, and managers for standing in the financial community.

Secured loans

Secured loans are loans where the assets securing the loan have value as collateral, which means that such assets are marketable and can readily be converted into cash.

In a fully secured loan, the value of the asset securing the debt equals or exceeds the amount borrowed. The reputation and standing of the project managers and sponsors, and the probable success of the project, all enter into the lending decision. The lending, however, also relies on the value of the collateral as a secondary source of repayment. The security interest is regarded by lenders as protection of loan repayment in the unlikely event the loan is not repaid in the ordinary course of business. Because of the security interest, a secured loan is superior since it ranks ahead of unsecured debt. In the event of financial difficulties, the secured creditor in control of key assets of a project is in a position to demand that its debt service, payments of interest and principal continue, even if this means that unsecured creditors may be left with nothing.

The enforceability of security interests requires a practical word of caution. Inexperienced lenders sometimes confuse the right to realize security with the ability to realize it. It is important to distinguish between the two since the ability to enforce a right can come up against technical and practical difficulties of doing so – especially in the case of seizing properties located in countries with underdeveloped legal systems.

Syndicated loans

As we noted, project finance typically occurs in two phases: construction and operation. In some circumstances, the construction and operation phases are governed by separate agreements:

- **The construction phase** begins when the lender disburses funds for the construction of the project (as per the construction agreement, contingent on the submission of appropriate drawdown requests with supporting documentation such as completion certificates). Since there is no operating revenue during this stage, interest is typically capitalized.
- **The operations phase** begins when the construction is complete. The lending banks will advance funds (as per the terms in the loan agreement), typically on the first day of commercial operations. Since the project is now ostensibly generating a cash flow, payments of interest and principle can begin. The loan amortization schedule will have been drafted beforehand based on the cash flow projections, actual payments will of course depend on the actual cash flow generated. To account for minor variations in cash flow generation, the lenders may extend a working capital line of credit. Major shortfalls may lead to the loan facility being restructured.

A syndicated loan is a loan that is provided to the borrower by two or more banks, known as participants, which is governed by a single loan agreement. The loan is arranged and structured by an arranger and managed by an agent. The arranger and the agent may also be participants. Each participant provides a defined percentage of the loan, and receives the same percentage of repayments.

The syndicated lending market is international by nature – that is to say, many of the borrowers and projects being financed are international – taking place in Europe, Eastern Europe, Africa, the Middle East, etc. Furthermore, in order to place these large loans (e.g. up to several hundred million dollars) in the market, sometimes several banks are needed to participate in these loans.

The factors which account for the size and spectacular growth of this market are several:

- The market is international rather than being confined to a particular country, and new debt issues can avoid a great deal of national regulation which may involve onerous registration requirements. This can lead to a significant reduction in the cost of the issue.
- The international syndicated lending market has evolved a very fast, efficient and flexible distribution network which can place deals in large volumes and for the most part can ensure that they are launched successfully and in an orderly fashion.
- This is because syndicated loans are managed, underwritten and sold by syndicates. These syndicates are dominated by the London based Swiss, American, European, and Japanese banks which have access to large client bases.
- The international marketplace gives borrowers access to a greater number and diversity of investors than would be possible within their own marketplace. This ability to tap different sources of finance can reduce overall interest costs.
- The most important European banking markets are based in the UK. The effect of London being the UK's capital (capitol) city should not be overestimated. The large volume of activities, the variety and innovation of banking products, the large number of people employed in the UK banking industry is significantly influenced by the strength of the London trading and capital market activities.

The syndicated loan market was initially developed in London by a relatively small number of merchant banks which had small balance sheets but large and important customers. It would not have been possible for these merchant banks to provide the full amounts of loans needed by their customers and so other banks were asked to provide parts of the loans on the same terms and conditions, with the merchant bank taking a fee to arrange the loan and administer it once it was drawn. In today's terms, the merchant bank was acting as arranger and agent.

During the 1960s many North American and other foreign banks opened branches in London, attracted by the growth of the new Eurodollar market.

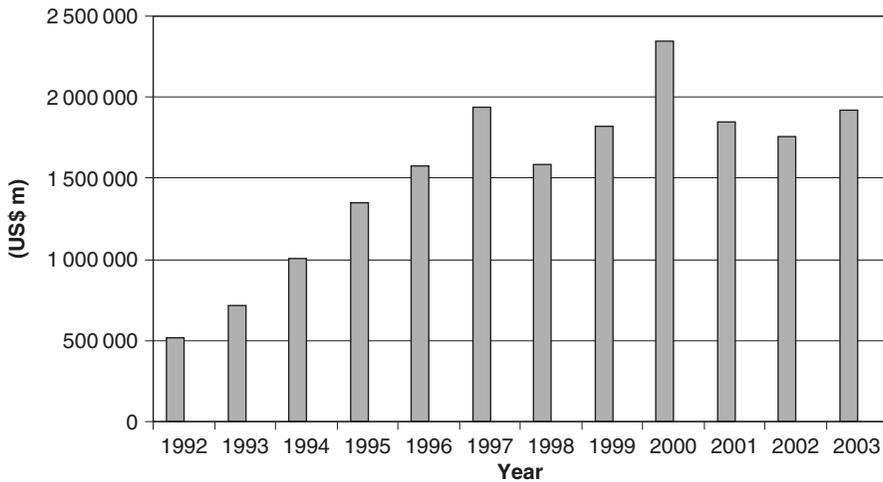


Figure 1.4 Global syndicated loan borrowing

These new branches could gain assets quickly and easily by participating in syndicated loans to borrowers with which they would not otherwise have had a relationship. The American and Japanese banks in particular began targeting large companies with the specific intention of arranging syndicated loans in order to maximize their fee income. In recent years in the London market, the part played by Japanese banks as arrangers has lessened and some of the UK clearing banks have become increasingly active.

Today the syndicated loan market is a major part of the operations of banks throughout the world, with major centres in London, New York and Hong Kong. They are typically used to finance large projects such as the Jorf Lasfar Power Station in Morocco – one of the largest syndicated loans.

World Bank group financing sources

Multilateral institutions such as the World Bank provide funds to infrastructure development projects world wide according to criteria which may change over time. While such financial support is limited, any involvement by these institutions is helpful to a project as it serves to 'validate' it in the eyes of banks which may be invited to participate in a

Table 1.2 Mandated arranger rankings for global syndicated loans, 1 January 2003 to 31 December 2003

<i>Ranking</i>	<i>Bank name</i>	<i>Amt US\$ m</i>	<i>No.</i>	<i>% share</i>
1	Citigroup Inc	198 227	742	10.49
2	JP Morgan	193 678	824	10.24
3	Bank of America Corp	164 455	1048	8.70
4	Deutsche Bank AG	82 513	355	4.36
5	Barclays	80 827	328	4.28
6	Bank One	68 080	540	3.60
7	BNP Paribas	66 660	360	3.53
8	ABN AMRO	60 386	437	3.19
9	HSBC	59 810	284	3.16
10	Wachovia Corp	52 642	587	2.78
11	Royal Bank of Scotland	47 655	244	2.52
12	Mizuho	45 580	281	2.41
13	Credit Agricole – Credit Lyonnais	42 894	259	2.27
14	FleetBoston	40 474	449	2.14
15	Mitsubishi Tokyo Financial Group Inc	38 699	325	2.05
16	Credit Suisse First Boston	37 550	166	1.99
17	Sumitomo Mitsui Banking Corp	35 645	363	1.89
18	Dresdner Kleinwort Wasserstein	32 293	91	1.71
19	SG	30 156	178	1.60
20	UBS	17 927	97	0.95

parallel syndicated loan facility. Some of the World Bank's financing programmes are:

- **Loan Programme** Loans are generally made to member countries to finance specific projects. Eligibility is conditioned on a showing that the borrower is unable to secure a loan for the project from any other source on reasonable terms. It is therefore generally considered as the lender of last resort. Also, a showing must be made that the project is technically and economically feasible, and that the loan can be repaid.
- **Guarantee Programme** The World Bank also provides guarantees. After the debt crisis of the 1980s, and the decrease in commercial loans

in developing countries, guarantee programmes were established to improve access to financing sources. The World Bank Partial Risk Guarantee Program provides private sector lenders with limited protection against risks of sovereign non-performance and against certain force majeure risks.

- **Indirect support** World Bank involvement in a project can be extremely important, even though the financial commitment is small, as it basically confirms that the loan has met the World Bank's lending and financial analysis criteria and therefore validates it in the eyes of commercial banks. A World Bank involvement therefore can affect the availability of funds from other, non-World Bank affiliated sources.

Export credit agencies

Export credit agencies use three methods to provide funds to an importing entity:

- **Direct lending** This is the simplest structure whereby the loan is conditioned upon the purchase of goods or services from businesses in the organizing country.
- **Financial intermediary loans** Here, the export–import bank lends funds to a financial intermediary, such as a commercial bank, that in turn loans the funds to the importing entity.
- **Interest rate equalization** Under an interest rate equalization, a commercial lender provides a loan to the importing entity at below-market interest rates, and in turn receives compensation from the export–import bank for the difference between the below-market rate and the commercial rate.

Bonds

In recent years, the use of the bond market as a vehicle for obtaining debt funds has increased. Bond financings are similar to commercial loan structure, except that the lenders are investors purchasing the borrower's bonds in a private placement or through the public debt market. The bond holders are represented by a trustee that acts as the agent and

representative of the bondholders. Bond purchasers are generally the most conservative source of financing for a project. The main bond markets are in Germany, Japan, the United Kingdom and the United States.

Advantages of bonds

Financing via bonds offers several advantages:

- **Large and liquid market** The public debt market provides project sponsors with access to a large and liquid market. In contrast, limited bank and institutional funds are available for international projects.
- **Longer term of debt** The public debt market tolerates a longer average life for debt than does the private debt market. Commercial banks and some institutional investors have regulatory or internal restrictions on long term lending.
- **Less onerous terms** Terms of public debt deals are less onerous and contain fewer restrictive covenants than do private debt deals.

Disadvantages of bonds

- **Regulatory oversight** Public market deals in the USA require lengthy SEC registration processes.
- **Ratings** Credit ratings are necessary. These are time-consuming to obtain and affect the structuring and risk allocation in project contracts.
- **Consents to changes to underlying project are difficult** Amendments, changes, or restructurings of a project are extremely difficult to negotiate and complete because of the passive nature of the investment.
- **Excess liquidity** Bond issues yield all the proceeds at once, while in a bank deal, funds are only drawn as needed during construction (although commitment fees are typically levied on undrawn funds). The company must therefore manage this excess liquidity to best effect.
- **Expensive transaction costs** Transaction costs are very high for accessing the public debt markets. Consequently, transactions of less than \$100 million cannot generally access this market.

Investment funds

Investment funds mobilize private sector funds for investment in infrastructure projects. These specialized funds may be sponsored by governments or the private sector and include:

- asset funds or income funds;
- investment management companies and venture capital providers;
- money market funds.

Institutional lenders

Institutional lenders include life insurance companies, pension plans, profit-sharing plans and charitable foundations. These entities can be a substantial source of funding, particularly in the United States.

Leasing companies

Leasing companies, which use tax benefits associated with equipment ownership, can offer attractively priced leases for equipment, contributing to the overall pool of financing.

Vendor financing of equipment

Many equipment manufacturers have financing programmes to encourage the sale of their machinery and equipment. Credit terms and criteria may therefore be relatively competitive.

Contractors

Contractors are rarely able to participate significantly in the long term financing of large projects due to the relatively modest size of their balance sheet. However, they can provide support via fixed price contracts (e.g. building a project facility without cost overruns).

Contractors can also assist their clients by providing advice on the financing of projects, since they have had considerable expertise in

dealing with lenders, potential sponsors and various government agencies. They may also be able to suggest structures and methods for project financing based on their previous experience in similar projects.

Sponsors

Sometimes, a direct loan or advance by a sponsor is the only way in which the project can be financed. Such direct loans may also be necessary as a result of cost over-runs or other contingent liabilities that the sponsor has assumed. A loan is preferable to a capital contribution, since it is more easily repaid.

Sponsor loans can be at lower than market rates, moreover, some sponsors prefer to lend directly to a project rather than to guarantee a loan, because they view the credit exposure as being the same, but prefer to earn interest on their exposure.

Supplier financing

A supplier seeking a market for a product or a by-product which it produces is sometimes willing to subsidise construction, or guarantee debt of a facility that will use that product. This might, for example, be a steel plant that would use natural gas in the Middle East. The list of possible suppliers varies with each project.

In such cases, a loan is made to the supplier, and the supplier quotes financing terms to the purchaser. Supplier credits usually require the supplier to assume some of the financing risk, although in practical terms, the supplier's profit margin may exceed the risk assumed.

Host government

The host government can also be a direct or indirect source of financing.

- Direct sources are when the government loans funds to the project company.

- Indirect sources comprise tax relief, tax holidays, waiving customs duties for project equipment, etc.

There are a number of advantages to host country financing assistance in a project. These include reducing the impact of leverage; subordination; foreign exchange burden on the project sponsors. It also implies that the government support decreases political risk, which can help attract private capital.