

# PPPbulletin

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## Vital signs

NHS LIFT and Scotland's HUB show signs of life



**PLUS** OBAMA'S RESCUE PLANS REJUVENATES PPP MARKET  
CANADA WELCOMES OVERSEAS GUESTS  
JOHN LAING STANDS FIRM IN THE UK MARKET



**John Ryan**  
Managing director  
Greengate

“Infrastructure development, relief for strapped state governments (where PPP can be useful) and green energy are all part of the current US fiscal stimulus bill – and traditional areas for project financing”



## Filling the gap

**JOHN RYAN, MANAGING DIRECTOR FROM GREENGATE IN WASHINGTON, DESCRIBES A POSSIBLE SOLUTION FOR PROJECT FINANCE LOANS**

Project finance seems like a way to avoid past mistakes. This type of structured finance is by definition centered on large, no-nonsense assets that have a clear economic or social purpose. The legal framework allows disparate parties to define their interests and obligations in the asset with precision over a long time period, which makes it ideal for such naturally wary partners as government and the private-sector, and decreases the chance of resource misallocation. Success or failure (for the deal itself anyway) is clear-cut, since it is determined by cash flow that either is or isn't there. There is little scope to hide in complex corporate balance sheet or accounting games.

Post-crisis, such transparency and economic efficiency count for a lot. Government and private-sector companies that commit to use project assets can demonstrate the cost-effectiveness of these obligations and generally conserve their own balance-sheets. For investors, particularly insurance companies and pension funds that need to invest conservatively on a long-term basis to match liabilities, project equity offers tangible security, a potential inflation-hedge, and a relatively low risk profile.

Committed users and project equity investors are not enough, however. Project finance relies heavily on leverage. In theory, debt should be the easy part – if end-users and equity investors think the project asset is a good bet, why wouldn't lenders agree for all the same reasons with even less risk? But the reality may be quite different. A lack of project finance debt may well become an industry-wide bottleneck, possibly severe.

The causes of this potential debt bottleneck are two-fold. The first, most obvious, reason is that lenders are balking at everything right now. It is possible that the general lending freeze begins to thaw before many planned projects are at the debt-raising stage, so this aspect of the bottleneck may lead to delay but not cancellation. But there is a second reason for a potential bottleneck that might be more persistent, since it

arises from the intrinsic characteristics of project lending.

### A Problem of Phases

Project finance really requires two quite different types of lending: a complex and somewhat risky 'Development Phase' that includes a multi-year construction loan commitment (during which the bank needs to work closely with the end-user and project equity to get all the operational details rights), followed by a lower risk 'Amortisation Phase' loan (which is fully funded, very long-term and mostly passive if all goes according to plan). The two phases are not really suitable for the same type of financial institution.

The Development Phase is ideal for commercial banks to use their balance sheet liquidity in a medium-term way that requires active expertise and earns fees. The Amortisation Phase is more suited to a coupon-clipping institutional investor that can match fund the long-term hold. In theory, project finance banks should always sell or transfer the Amortisation Phase to institutional investors once the project is finished and operational, which would optimise capital and liquidity resources between the two. But in practice, such transfers haven't happened nearly as often as the theory would suggest.

Project loans are usually unrated, idiosyncratic and complex, so they take some effort to sell individually. When bank capital was abundant and bank liquidity was assumed to be almost infinite, some project banks simply held onto the Amortisation Phase as part of the price to get the more lucrative Development Phase business. Others that managed their resources more aggressively tackled the problem of Amortisation Phase transfer on a customised basis that involved some sort of repackaging. For larger projects, one approach was to have a monoline wrap the debt and sell it as a highly-rated bond. Another approach, designed for portfolios of smaller PPP deals, used synthetic CLOs structure (often also wrapped by a monoline) to achieve a regulatory capital benefit.

Along with everything else, the credit crisis has changed these dynamics. Bank capital and liquidity, as well as monoline wraps, are now exceptionally scarce resources, and may be so for a long time. Development Phase lending opportunities may become relatively attractive to thawing lenders, but the Amortisation Phase will be much more of a problem with few easy solutions. While institutional investors may be willing to put more effort into considering individual project loans than in pre-crisis times, the complexity and idiosyncratic qualities of the debt remain, making placement uncertain and potentially expensive.

### A Model Solution

As before, the solution for more certainty in Amortisation Phase transfer might lie in some sort of re-packaging. Unlike before, synthetic or structured solutions won't do – the transfer needs to be a full cash sale, freeing up the originating bank's liquidity and capital, without hidden promises of future support. A model exists – ironically developed as a solution to a previous banking crisis. The commercial mortgage-backed securities (CMBS) market takes chunky commercial real estate mortgages originated by banks into conduits and issues rated securities, using a combination of standard ABS techniques and private ratings (in lieu of statistical data). Jump-started by the US Resolution Trust Company to clear out the real estate loans of failed S&Ls, the CMBS market grew quickly over the last decade (to \$300bn in pre-crisis 2007) in large part because it addressed issues of capital management and liquidity faced by banks that finance commercial real estate development – the same issues that bedevil project lenders. CMBS has plenty of its own problems now, but these are due to the irrational exuberance of recent underwriting standards, not to fault in the underlying mechanics. The relevant point is that complex and idiosyncratic debt can be successfully packaged on a wholesale basis using true-sale securitisation techniques that are eminently adaptable to many project finance loans, particularly those (like PPP) with a high real estate component. Even the CMBS investor base may overlap to some extent, if only because those buyers that are still

in business might want diversification from pure commercial real estate. If not, at least the high returns on the lower, riskier tranches will intrigue institutional investors interested in project equity-type risk but wanting a more capital markets-oriented form of investment.

There is a major missing piece, however. The low risk profile of most project finance loans means that the AAA-rated tranche will be a large percentage of a pool's capitalisation, 80% or more, and this tranche drives the overall economics of the securitisation. Pre-crisis, that would have been a positive factor. Now, structured finance AAA paper is almost unsalable – to the extent that the US Treasury finds it necessary to offer a program, the Term Asset Liquidity Facility (TALF), to buy AAA tranches of vanilla ABS conduits in order to keep consumer credit flowing. The TALF is likely to be extended to CMBS for a different policy objective – to ensure that an upcoming slew of commercial mortgage refinancings don't lead to widespread defaults. The UK government is apparently considering similar programmes. Governments clearly recognise that, like it or not, securitisation is an integral part of systemic liquidity and an appropriate focus of policy.

### Policy and Projects

Obviously, a market that does not yet exist has no ramifications for systemic liquidity, so that is not a policy reason to backstop project finance loans securitisations. But project finance is squarely in the middle of other policy objectives, particularly in the US. Infrastructure development, relief for strapped state governments (where PPP can be useful) and green energy are all part of the current US fiscal stimulus bill – and traditional areas for project financing. Why not encourage these types of projects to be developed and financed in the private sector by offering a TALF-like programme for the AAA tranches of project loan securitisations?

Criteria for inclusion would be based primarily on how the underlying projects furthered specific policy objectives – certain kinds of infrastructure development, support for local PPP, renewable-based energy production, etc. Such criteria can be defined clearly, often simply as a technical specification or

description of the project asset, and would drive decisions by project developers (and their banks) in the planning stage. Since the program would only support the project's debt, the project would need to have fundamental economic viability to attract equity from the private sector – a factor which should exclude 'bridges-to-nowhere'.

If the program is limited to backstopping the AAA tranche of pool composed of Amortisation Phase loans on completed and operational projects, the risk to the taxpayer should be low. The lower tranches from the private sector would do the heavy lifting of risk bearing and analysis, increasing efficiency of allocation and speed of processing. The details don't need to be designed in a hurry, but the program can have an immediate effect. Were the program and the specific inclusion criteria to be announced, project developers and banks would be prompted to begin the Development Phase in light of some certainty of an Amortisation Phase take-out a few years later.

Like other stimulus measures, the program can be limited in duration, until credit markets have normalised. If the early history of CMBS is any guide, a few years should be enough – once the basic mechanics and participants are in place, the private sector can take over completely when AAA structured paper becomes salable. Of course, when that happens, project policy limitations will not be binding on new deals – so the current bottleneck might represent something of a unique opportunity to influence project development at little cost. It shouldn't be overlooked. ■