Structurally Sound? How Development Finance Institutions and Commercial Bank Project Financing Structures Differ

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Haynes Boone Partner Conrad Purcell and Associate Kayley Rousell authored an article for *Clean Energy Pipeline* discussing how development finance institutions and commercial bank project financing structures differ.

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Project finance often involves the provision of finance to facilitate the development and construction of assets within the energy and infrastructure space that are complex and involve considerable amounts of capital investment. Given the scale and capital-intensive nature of such projects the need for lender financing is commonly crucial to their realisation.

Where project finance is used this is traditionally derived from commercial banks in OECD countries. It however is not always the case that debt from commercial banks can be readily obtained, particularly in jurisdictions with limitations on liquidity and depth in the local banking market or where there are considerable local political or market risks. Bridging this financing gap is often facilitated by multilateral or bilateral development banks and other institutions known as Development Finance Institutions ("DFIs").

This article will focus on DFI lending in a project finance context, and the differences between the financing structures used by DFIs versus commercial banks on project finance transactions.

What are DFIs?

DFIs are specialised finance institutions that provide long term financing (by way of loans, equity, guarantees and/or insurance) to facilitate economic, environmental and social development and are also used in emerging markets where the political or credit risk is such that commercial banks are not able to lend.

DFIs are not banks

Project finance typically requires the establishment of a special purpose vehicle that will own the project. This entity is the borrower and its shareholder(s) provide it with a portion of the funds needed to construct its project, either by way of shareholder loans or subscription for shares, this is referred to as equity. The balance of the funds needed to pay for the construction of the project is provided by third party lenders. Although DFIs can provide a project company with the funding needed to develop and build an infrastructure project that is not enough to enable the establishment of a secured project finance lending facility. A typical project finance structure will require that the following roles be occupied by a competent person: i) a facility agent; ii) a security trustee or agent; iii) an account bank; and iv) a hedge provider.

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The facility agent is needed to serve as an administrative agent which acts for the group of lenders on the transaction. Often described as a “post box” between the lenders and the borrower, its day-to-day role involves handling the flow of money and any communication or information passed between the parties, for example receiving and distributing payments or forwarding notices or waiver requests received from the borrower to the lenders The security agent or trustee’s (subject to the applicable jurisdiction and whether the concept of a trust is recognised) role is to hold the security on trust for, or on behalf of, all of the finance parties. The aims of the security agent are to act as a single entity responsible for the administrative aspects of the security and to ensure that if a lender assigns or transfers its interest to another lender, the new lender will benefit from the existing security without the need for security to be re-registered or new security being entered into (which impacts hardening periods).

The account bank provides the borrower with bank accounts that may only be operated in accordance with the terms of an accounts agreement that restricts the borrower’s ability to access its accounts other than in accordance with the agreed purpose for the loans granted to it and the cash waterfalls that determine the destination and use of all funds related to the applicable project.

The hedge provider is needed to provide hedging facilities to the borrower to manage risks relating to interest rates and currency exchange. Where the lender is a DFI, hedge counterparties often have to provide interest rate cover for DFI loans if the DFI is unable to provide interest rate hedging or fixed rate loans.
Whereas it is common for a commercial bank to occupy each of these roles on a deal where it is the Lender or the bank nominated to perform such a role on behalf of a group of lenders, a DFI is generally not able to perform these roles as they are not set up to operate as banks.

As such, on DFI lending transactions third party issuer service providers (which are often designated sections of commercial banks given the strength of their credit rating and global presence) are instead appointed to fulfill these roles. However, in particularly challenging jurisdictions where third-party issuer service providers do not have a presence due to political and/or economic risk, local banks may alternatively be appointed to fulfil these roles. The result being, in a DFI lending context, a greater number of parties and larger suite of documentation in comparison to a considerably more straightforward commercial bank lending structure.

Conclusion

Although the use of DFI lending is often crucial to enable the development of projects in challenging markets there are inevitably practical consequences that arise from having to involve a number of additional entities within the group of finance parties that would not necessarily be required to perform those roles on a transaction with a commercial bank lender in an OECD country.

Each of the facility agent and security agent/trustee (who may be the same person) will require independent legal advice as will the account bank, who may be otherwise unconnected to the transaction, and may take time to develop familiarity with the suite of finance documents that were drafted before they were even considered for the role. The hedge provider will also require independent legal representation and the fact that they are not a lender but are still exposed to the borrower may give rise to intercreditor negotiations between the hedge provider and the senior lenders.

Time needs to be allowed for all of these negotiations to conclude and it is for this reasons that project finance transactions, which are not simple at the best of times, can become very time

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consuming and complex in emerging markets, even leaving aside the challenges of doing business in less developed countries.

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