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Project Finance Transactions – Managing Interest Rate Risk

Adam Lapidus [*]

In this article, the author summarizes the building blocks of effective interest rate hedging in project finance transactions and considers the varying perspectives of multiple creditors that have recourse to the same pool of collateral.

Coordinated drafting of the ISDA Master Agreement and other financing documents is critical to addressing the disparate perspectives of lenders, bondholders, and hedge providers that have recourse to the same collateral. This article discusses project finance structure, interest rate risk arising from loans, and drafting agreements for competing creditors of shared collateral.

PROJECT FINANCE STRUCTURE

The borrower and/or bond issuer in a "typical" project finance transaction (the "Company") may be organized as a newly formed special purpose vehicle or as a subsidiary within an existing corporate structure.[1] In either case, the Company's project will be financed on the expectation that the project's future cash flows will cover expenses including principal amortization and interest payments.

A project usually has two distinct phases: (1) construction, and (2) operational. Loans are typically structured to finance both phases, with the interest rate swap matching the loan's tenor. Bonds traditionally may be part of the second, operational phase, but bond investors have increasingly been willing to bear some risk during the construction phase. The type of infrastructure asset (whether power generating equipment, toll roads, or a new hospital) affects important details of managing the project but not the management of interest rate risk.

When the Company enters into the project loan, it may also issue project bonds with different tenors and rates than the loan. Project financing (whether

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[1] This "typical" project finance transaction structure is stylized. In practice, transactions can take many shapes and forms. Interest rate risk management is not contingent on any particular structure, or on whether the project is brownfield or greenfield.

in the form of bank loans or project bonds) can take decades to mature. The Company and its creditors must therefore take the long view with respect to interest rate risk of the loan and see beyond the current very low market interest rates.

INTEREST RATE RISK ARISING FROM THE LOAN

While operational, logistical, governmental, environmental, and completion risk (among others) are relevant to a project's success, interest rate risk is an important – and manageable – element of the overall risk profile. Future revenues, which may be fixed under the project's offtake or similar agreement, will determine whether the Company can repay its loan and meet its other expenses. Unanticipated financing expenses over the long life of the project could threaten the project's viability (and its appeal to investors).

The project loan is typically floating rate.[2] Entering into an interest rate swap to obtain fixed interest rate expense for the life of the project is valuable, especially when current market interest rates are so low. Even though interest rates are at historically low levels now, variable rate loans expose the Company (and its lenders) to default risk in an environment of rising interest rates.[3]

Lenders' credit departments and the Company's CFO alike can take comfort in the fixed interest rate expense that results from an interest rate swap that hedges the loan's payment profile. The Company may enter into an interest rate swap with a financial institution meeting certain criteria, such as being a lender or its affiliate, or having some minimum credit rating, (the "Swap Provider").[4]

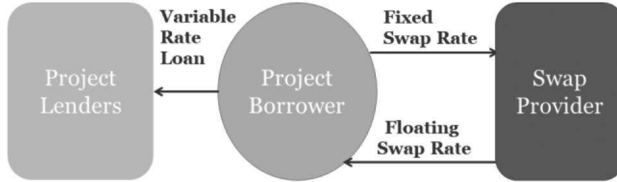
[2] Project bonds, by contrast, are typically fixed rate.

[3] Rates, however, could fall and become negative. Parties may decide to include a zero interest rate floor in the loan agreement and, if they do, may also add a floor to the interest rate swap.

[4] There are often multiple Swap Providers in any one project. The credit facility usually requires the Company to hedge some portion of loan principal while the bond documents will similarly provide for the Company to hedge interest rate risk within negotiated parameters.

The cash flows under the swap and variable rate loan, resulting in a fixed interest expense, are shown in the figure below.

Achieving a Fixed Interest Rate Expense



Assuming that the Company swaps fixed for floating, the Company obtains a fixed interest rate expense because it always owes to the Swap Provider a fixed rate interest payment. The Swap Provider owes a floating rate payment to the Company. Fixed and floating swap payments are netted – meaning only a single payment is made – and they are payable on the same day as loan payments. (Parties should ensure that the calculation periods in the loan and swap documents match, and that payments under both are due on the same day.) The Company will make a payment to the Swap Provider if the fixed rate is higher than the floating rate. The Company will receive a payment from the Swap Provider when the floating rate is higher than the fixed rate. The Swap Provider's floating rate payment to the Company would offset the Company's variable loan payment expense.

In addition to evaluating the economics of an interest rate swap – simplified here – parties need contracts that delineate the rights, remedies, and competing interests of lenders, bond investors, and Swap Providers.

DRAFTING AGREEMENTS FOR COMPETING CREDITORS OF SHARED COLLATERAL

Regardless of whether the lender and Swap Provider are the same legal entity, the documentation must be drafted to account for their different perspectives in their different capacities. For example, the lender and Swap Provider may have divergent interests with respect to exercising termination rights.[5] Lenders may be inclined to support a distressed borrower and work to refinance the loan

[5] Further complicating matters, bond investors' interests may also diverge in distressed circumstances.

while Swap Providers may prefer to crystallize their exposure as soon as possible.[6]

Even where the lender and Swap Provider are the same entity, they may belong to different business units with different mandates, management, or restrictions. Thus, the financing and swap documentation must account for these potentially divergent views rather than expect a financial institution to have a single view when it is a creditor in more than one capacity.

The Company may similarly have different considerations with respect to its various creditors. For example, the Company may resist giving voting or consent rights to Swap Providers if such Swap Providers or their affiliates already have consent rights as lenders, as doing so would amount to giving such Swap Providers an additional opportunity to block an action that the Company and its other creditors favor, such as refinancing. Moreover, the interest rate swap is usually a small percentage of outstanding exposure compared to the loan and/or bond. The Company will be reluctant to give Swap Providers decision-making power that dwarfs their financial stake in the project.

When drafting deal documentation to accommodate an interest rate swap, counsel should harmonize the ISDA Master Agreement, the loan documents, the security agreement, and the intercreditor agreement.[7]

The ISDA Master Agreement

Parties typically document their interest rate hedges using the industry-standard ISDA Master Agreement (both the 1992 and 2002 versions). The ISDA Master Agreement is a pre-printed form, and the parties customize their rights and remedies by making certain elections in the ISDA Schedule. Parties also have the option to use a long-form confirmation (which focuses on economic terms and non-economic terms such as choice of law and termination currency) instead of the Schedule. But long-form confirmations are not frequently used for project swaps because they:

(i) Are ill-suited to address the Swap Provider's need for detailed credit terms;

(ii) May not be permitted under the terms of the loan facility; and

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[6] In many jurisdictions, including in the U.S. under the Bankruptcy Code, swap creditors can terminate swaps immediately upon the debtor's filing of a bankruptcy petition. Swaps are exempt from the automatic stay provisions of the U.S. Bankruptcy Code that are applicable to other forms of debt such as loan obligations. *See* 11 U.S.C. 362(b)(17).

[7] There may be additional financing documents as well, as documentation architecture can vary by transaction. Parties should also ensure that the covenants and permitted liens in the bond documentation allow the Company to enter into the secured interest rate hedges.

(iii) Are likely incompatible with the Swap Provider's credit risk policies for swaps with long tenors.

Negotiation of the ISDA Schedule often takes place in the shadow of the other financing arrangements – the proverbial canoe next to the cruise ship. The teams negotiating the financing arrangements may differ from the groups that have responsibility for the ISDA. Moreover, the ISDA may be executed after the credit agreement, security agreement, and intercreditor agreement have already been signed.

An inadequately drafted ISDA Schedule could undermine the provisions of the loan agreement by, for example, enabling the swap providers to terminate their swaps before the lenders accelerate the loan. This could trigger a cross-default in the credit agreement or frustrate the borrower's ability to refinance. Conversely, a credit agreement that does not adequately contemplate interest rate hedges may curtail Swap Providers' ability to protect their own interests if the project becomes distressed. Fortunately, the ISDA Schedule can be drafted to address these concerns.

One approach is for parties to tailor the ISDA Master Agreement's standard Events of Default to be consistent with the credit agreement's terms.[8] For example, the grace period for Failure to Pay or Deliver in the ISDA can be adjusted to match the grace period under the loan.[9] In addition, the ISDA's Cross-Default provision can be changed to cross-acceleration, preventing Swap Providers from terminating the swaps when there is a default under the credit agreement but the loan has not yet become due and payable.

Another approach is to make the ISDA Master Agreement's Events of Default not applicable and specify that any "Event of Default," as defined in the loan agreement, will be an Event of Default under the ISDA. Importing the loan agreement's events of default into the ISDA creates uniform definitions for key events of default, such as bankruptcy. This approach also imports the representations, warranties, and covenants from the credit agreement into the ISDA Master Agreement (i.e., breach of a credit agreement covenant would be a breach under the ISDA). Exact replication of the loan's events of default is not always desirable, however, for either the Swap Providers or the Company.

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[8] The eight standard "Events of Default" in Section 5(a) of the ISDA Master Agreement are: (i) Failure to Pay or Deliver; (ii) Breach of Agreement; Repudiation of Agreement; (iii) Credit Support Default; (iv) Misrepresentation; (v) Default Under Specified Transaction; (vi) Cross-Default; (vii) Bankruptcy; and (vii) Merger Without Assumption.

[9] The grace period is one Local Business Day in the 2002 ISDA and three Local Business Days in the 1992 ISDA, in each case after notice of the default is provided.

Certain provisions in the loan agreement (i.e., if there is a long grace period for failure to pay) would be unpalatable to Swap Providers. From the Company's perspective, it may be undesirable to give Swap Providers and lenders the same (i) representations, warranties, and covenants, and (ii) consent or termination rights. For example, if the Company agrees to replicate the loan's events of default in the ISDA Schedule, then Swap Providers may be able to terminate their swaps for the Company's breach of the credit agreement, even if the lenders have not accelerated the loan or have agreed to waive such breach.[10] Whether or not the events of default in the credit agreement and ISDA are identical, it is important to consider the interplay between them.

In addition to negotiating Events of Default, the parties usually specify Additional Termination Events ("ATEs") relating to events under the credit agreement and concerns regarding relative status of creditors. Commonly negotiated ATEs include:

- Swap Provider's failure to maintain pari passu status and ranking with lenders in respect of collateral and payment waterfalls;
- Swap Provider or its affiliate ceasing to be a lender in the Company's project credit facility (often with exclusions for borrower's exercise of yank-a-bank rights);
- Full prepayment, repayment, or refinancing of the Company's project credit facility;
- Partial loan repayment (with optional partial swap termination for voluntary loan prepayments, assuming the Company continues to satisfy its hedging requirements under the credit agreement);
- Release of collateral without the Swap Provider's consent (but see discussion of voting and consent rights above); and
- Ratings downgrade of the Swap Provider.

These ATEs should be the same with each of the Company's Swap Providers. Any substantial discrepancies among the Swap Providers' ISDA Schedules – especially disparities among their termination rights – will complicate matters during the life of the swap, upon refinancing, and if the Company defaults.

It is important to point out that while a Swap Provider will often (rightfully) insist on ATEs addressing its status as secured creditor, the security agreement

[10] To avoid this outcome, the ISDA Schedule should specify that only an "Event of Default" under the loan agreement that *results in the loan becoming due and payable prior to its maturity date* shall be an Event of Default under the ISDA. In any event, the Company will want to be careful to avoid giving Swap Providers rights that influence or interfere with lenders' ability to act or forebear under the loan.

and/or intercreditor agreement – not the ISDA Schedule – confer secured creditor status, as discussed more fully below. The occurrence of an ATE for failure to be secured pari passu would merely give rise to an unsecured claim unless the security agreement and/or intercreditor agreement provide that the Swap Provider is secured pari passu with other secured creditors.

Lastly, parties should focus on the assignment provisions of both the credit agreement and ISDA Master Agreement to understand whether a lender but not a Swap Provider, or vice versa, may assign the loan or swap, respectively.

The Credit Agreement

As it relates to the interest rate swap, the credit agreement, among other things, will typically establish (a) eligibility criteria for a lender or its affiliate to enter into a secured hedge, (b) the Company's hedging requirements, and (c) the payment waterfalls.

The defined term for interest rate hedge provider should state clearly whether any eligibility criteria applies only at the time of the swap transaction or on an ongoing basis. Swap Providers that do not have a credit rating will want to ensure that a guarantee by a rated affiliate would satisfy any such ratings requirement.

The minimum and maximum percentage of loan principal that the Company must hedge is subject to negotiation. For example, lenders may agree to permit the Company some discretion to hedge a percentage of outstanding loan principal within an agreed upon range, allow the Company to hedge more than 100 percent of outstanding loan principal, or require the Company to maintain a perfect hedge throughout the life of the loan. The amount that the Company must hedge becomes important upon partial repayment of loan principal as it could require the Company to terminate a portion of its swap with one or more Swap Providers.

To ensure ratable treatment of the Swap Providers, the post-default waterfalls should state that (i) regularly scheduled swap payments are pro rata with regularly occurring payments of amortizing loan principal and interest, and (ii) swap termination payments are ratable with repayment of loan principal. The payment waterfalls in the credit agreement should be consistent with any similar provisions in the intercreditor agreement.

Finally, in a cross-border transaction with payments and revenues in different currencies, the Company may also be permitted to enter into a foreign exchange transaction to hedge its currency risk. Parties should discuss whether to afford the currency hedge providers identical rights and recourse to collateral as the secured interest rate hedge providers (whether or not the currency hedge providers are the same dealers as the secured interest rate hedge providers). This

issue can be addressed by having a separate defined term for foreign exchange hedge providers, or alternatively including both types of hedge providers in the same defined term.

The Security Agreement and Intercreditor Agreement

No matter what the ISDA Master Agreement states or how the credit agreement addresses interest rate hedging, Swap Providers will only be secured ratably with lenders and bondholders to the extent that the security agreement and intercreditor agreement make them so.[11]

The granting language in the security agreement should state that the collateral is pledged for the ratable benefit of lenders, bondholders, and Swap Providers. There may be some discrepancies in the credit support – i.e., guarantors that are not "eligible contract participants" can guarantee the loan but not the swap,[12] the Debt Service Reserve Account may benefit only the lenders and bondholders, and non-U.S. collateral may not be pledged to certain creditors – but these minor discrepancies are commonly accepted among secured creditors. Subject to these minor discrepancies, the project's lenders, bondholders, and Swap Providers all have recourse to the same pool of collateral – the Company's assets – if the project fails.

The intercreditor agreement serves several functions. It enables the differently situated creditors to agree to finance the project, prescribes dispute resolution mechanics, and accommodates subsequent creditors that enter the deal during the life of the project. As between these creditors, the intercreditor agreement allocates payments, governs voting, and facilitates the orderly exercise of remedies. The intercreditor agreement usually specifies that it supersedes or limits the exercise of remedies provided for in the other financing agreements. Swap Providers cannot therefore rely on the ISDA Schedule alone to determine their termination rights, nor can they address issues of relative creditor status solely though ISDA negotiations.

There are several items for creditors to consider:

- Are Swap Providers included in the bundle of definitions necessary to be secured creditors?
- How are the Swap Providers treated relative to the other secured

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[11] Although the ISDA documentation suite includes a Credit Support Annex under which the Company could post financial collateral to the Swap Provider, the Company will likely lack the necessary liquidity to do so (unless the sponsors are providing additional credit support).

[12] *See* Section 1a(18) of the Commodity Exchange Act for the definition of "eligible contract participant" and CFTC Letter No. 12-17 regarding swap guarantors.

creditors?

- Is there a cap on secured swap amounts – and if so, who calculates the cap and how?
- Is there an accession agreement that allows subsequent lenders, Swap Providers or bondholders to become secured parties?
- Does the intercreditor agreement override or conflict with any of the termination rights specified in the ISDA Schedule or bond documentation?

These considerations should be top of mind when drafting or reviewing the intercreditor agreement.

CONCLUSION

Parties should calibrate the interest rate swap to sufficiently hedge the interest rate risk arising from the variable rate loan. Counsel should scrutinize the ISDA Schedule, credit agreement, security documents, intercreditor agreement, and any other relevant financing documents to ensure that they form a cohesive and consistent whole. Drafting gaps may prove costly, either in an adverse scenario or by making the deal less attractive to investors. Agreements that clearly define the permitted hedging activities and the relative status and rights of lenders, Swap Providers, and bondholders are crucial to managing interest rate risk in a project finance transaction.