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The Role of Sydnicated Loan in Project Financing

The Article discusses the mechanism of project financing - loan syndication that has very often been applied during the last decades despite the different needs of lenders. The loan syndication is a means of financing when two or more commercial banks issue loan together and accordingly share risks to finance a project.

The loan syndication is a very commonly applied to finance a project especially such projects which require a big amount of funds. As a rule these are energy sector and infrastructure related projects.

Key Words*: syndicat\ed loan, hydropower plant construction project, agent bank, project financing, risk diversification.*

1. Introduction

The importance of syndicated loan in the project finance increases every day. In the 19th century, banks started syndicating loans to share risks. In addition, most project finance loans were huge and one bank could not manage financing the project without affecting other portfolios.

Loan syndication as a project financing mechanism has been increasing over the last decade. The incentive for lenders to join the syndicate is obscured, though many international project deals are financed through loan syndication. The objective of the paper is to investigate the role of loan syndication in project financing. The motivation for this research paper stems from the importance of credit in the project financing structure and the growing importance of syndicated loans in project financing. The findings indicate that the role of syndication is diverse however, mobilisation of funds and risk diversification prevail over others.

Loan syndication is a funding mechanism where two or more banks come together contribute a portion of the loan to finance the project. Loan syndication is the most common form used for funding project finance deals, especially when it involves large sums. This is especially true for energy and infrastructure projects.

The implementation of the planned project depends on the availability of funds to finance it from start to completion. Equity contribution is usually limited and the project is usually financed by debt for a large proportion of its finance structure, sponsors therefore must ensure that funds are available before the project starts.[1]

Therefore banks need assurance to the effect that the project will be able to generate revenue and pay the loan back. This is done by ensuring that the project has an off-taker, commitment by sponsors through supply contract, construction contract, government support and etc.

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1 *Sein R.,* Financing Energy Projects in Emerging Economies, Pennwell Publishing, USA, 1996, 15.

The provisions of syndicated loan agreement, as a type of bank credit are very important too. In the process of issuance of syndicated loan several commercial banks and/or credit institutions accumulate financial sources and then one unified loan is issued. The number of lenders create some difficulties and, therefore, syndicated loan agreement shall include the relations between the lenders.

The main objective of this paper is to examine the role of loan syndication in project financing. The motivation for this research paper stems from the importance of credit in the project finance structure and the growing importance of syndicated loan structures in project financing and one of the purpose of this paper is to determine the benefits syndicated loans offer to both lenders and borrowers.

2. The Concept of Syndicated Loan

Syndicated loan institution is initially used by the London, Swiss, American, European and Japanese commercial banks which generally provide a service financially powerful, stable and large clients. Syndicated loan agreement are mostly spread in the London market. [2] London commercial banks and other financial institutions use syndicated loan for different purposes. [3] However, historically syndicated loan is mostly spread in the United States of America and Canada.[4] Syndicated loan institute is very famous on the abovementioned countries' market and is widely used to finance and implement different projects.[5]

Syndicated loan agreement is such agreement, where banks (often non-bank credit institutions) accumulate their financial resources to issue one general loan to the borrower. Syndicated loan is considered as a hybrid institution, which is used by the commercial banks and other credit institutions. [6] Despite the fact that the parties of this syndicated loan agreement are bank and non-bank institutions and the number of the lenders is quite high, the main provisions which regulate loan related relations are envisaged in a one, general loan agreement, which is a complex document. [7] As mentioned above, the existence of the documentation related to bank credit agreement is necessary to finance the international projects. Commercial banks are the main financial resources in the process of construction of hydropower plants. [8] The projects differ from each other with the form of the activity, concept and capacity.

Funding of a hydropower plant construction project is included in the list of the projects for which the mobilization of financial resources to the maximum is required. Therefore, banks and other credit institutions mostly accumulate their financial resources on the basis of the capacity of hydropower plant construction project to issue one general syndicated loan to the lender-project company which is one of the widespread types of bank credit. Syndicated loan agreements are considered as a general form to finance large-scale projects. However, the syndicated loan agreements differ from each other. Despite the quite big difference, the meaning, concept and general provisions of the syndicated loan issued to finance any types of projects are common and similar. [9]

To achieve the set goals, syndicated loan combines all stakeholders' opinions. The process is started by a formal offer of the borrower to the bank. The borrower gives the bank an authority to be a leading bank and the manager of the process. Alternatively, the borrower announce a competitive auction where several

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2 *Fight A.,* Syndicated Lending, Linacre House, UK, 2004, 2.
3 Ibid.
4 *Iannotta G.,* Investment Banking, Springer-Verlag Berlin Heidelberg, Germany, 2010, 107.
5 *Armstrong J.*, The Syndicated Loan Market: Developments in the North American Context, Canada, 2003, 1-2.
6 *Iannotta G.,* Investment Banking, Springer-Verlag Berlin Heidelberg, Germany, 2010, 109.
7 *Niehuss J.,* International Project Finance, West Academic Publishing, USA, 2010, 147-148.
8 *Clifford C.,* An Introduction to Loan Finance (Capital Markets and Funding), Clifford Publishing, London, 2003, 52-53.
9 *Niehuss J.,* International Project Finance, West Academic Publishing, USA, 2010, 147.

bank with favorable conditions/offers are chosen to lead this process. In this case banks appoint bank as a leading bank.[10] At a certain stage of the process of concluding a syndicated loan agreement and fundraising for hydropower plant construction, sponsors and their financial advisors choose a bank, which will be an agent bank in the process of concluding syndicated loan agreement.[11] There are negotiations between the sponsor and main, agent bank related to the: 1. notification about the opening a credit line and letter of credit, which together with other issues is a consent about the appointment of leading manager and determines its obligation regarding loan management and 2. agreement on the main conditions of the offered loan and also agreement which is the initial stage of the negotiation on the final loan agreement.[12]

With regard to the agent bank, it should be noted that there are different requirements for them according to the legislation of every country. The specific requirements of the law is derived from the functions of the agent bank itself – it ensures the implementation of syndicated loan issuance and return procedures and actions in accordance with the interests of the parties.[13] It is required to fulfill the obligations in a good faith and diligently. In addition according to the English legislation it is obliged to keep the information confidentially.[14] On the existing markets in the Unites States of America and Europe functions of the agent bank is delegated to any other bank. [15]

Information Memorandum signed between the agent bank and the borrower is also a part of the syndicated loan, containing the list of the banks that will be the participants of syndicated loan agreement and will undertake to issue the loan. Notification on the opening of credit line with the provisions which are the ground of syndicated loan agreement, also comprise the conditions regarding the capacity building to achieve success. [16] Given the fact that using the syndicated loan is becoming more actual, British Bankers' Association with the help of legal companies developed recommended forms of syndicated loan agreement, which provides guidelines necessary for creditors and lenders and the interests of any parties are envisaged to the maximum through these abovementioned forms. [17]

3. The Obligations of Parties to Conclude A Syndicated Loan

Out of legal issues connected with the syndicated loan the prepcontractual relationship between agent bank, lender and borrower shall be mentioned. Together with precontractual relations the legal standing of agent bank is very interesting, what are its obligations in connection to syndicated loan parties and lastly, it very much important to discuss the relations existing among the parties to the syndicated loan. [18] The syndicated loan agreement envisages and regulates the mentioned conditions.

3.1. The Obligations of Lenders

The loan agreement provisions are datailed and comprise both, the obligations of loan receiver as well as bank's. The lenders agree that financial resources will be available at its maximum amount when the letter is required by the lender. [19]

10 *Gatti S.,* Project Finance in Theory and Practice: Designing, Structuring, and Financing Private and Public Projects, Elsevier Inc., California, 2008, 275-277.
11 *Iannotta G.,* Investment Banking, Springer-Verlag Berlin Heidelberg, Germany, 2010, 109.
12 *Niehuss J.,* International Project Finance, West Academic Publishing, USA, 2010, 150.
13 *Fight A.,* Syndicated Lending, Linacre House, UK, 2004,169.
14 *Roberts G.,* Law Relating to International Banking, Woodhead Publishing, England, 2003, 86-87.
15 *Price A.,* Financing International Projects, International Labour Organization Publishing, Geneva, 1995, 31.
16 *Niehuss J.,* International Project Finance, West Academic Publishing, USA, 2010, 151.
17 *Wood P.,* International Loans, Bonds, Guarantees, Legal Opinions, 2nd ed., Sweet & Maxwell Limited, London, 2007, 35.
18 *Graham R.,* Law Relating to International Banking, Sweet and Maxwell Limited, London, 2003, 79.
19 *Graham D. V.,* Project Finance, 2nd ed., Sweet and Maxwell Limited, London, 1998, 62-63.

It is the responsibility of the individual bank to ensure that their respective portion of the loan is paid according to the financial plan. Banks have rights to get their portion of loan repayment in accordance with the provisions of the agreement. In fact all the monies obtained from the borrower, is shared equitably based on the proportions of their loan contributions. They are also obligated to decide whether to continue lending during the subsistence in the event of a default (EoD) [20].

3.2. Obligations of the Borrower

The borrower is responsible for all project activities starting from construction phase in liaison with the contractor and ensuring that the project is going on as planned. It receives draw downs from the agent as provided for in the credit agreement. It is the responsibility of the borrower to ensure that the project passes the completion test and performs as per the agreed performance levels. In the operation phase, the borrower makes payments to the agent as provided for under the repayment schedule. The borrower must ensure adherence to all provisions. Failure to adhere would constitute an event of default which leads to termination of the loan, acceleration or reducing the tenure of the loan.

The borrower does not take any direct risk as to whether the syndication is successful or not. By the time a syndicate loan agreement is signed, the loan agreement should have been signed and thus underwritten by the lead managers.

3.3. Obligations of the Agent

The loan is exclusively granted for a specific purpose specified in the credit agreement. It cannot therefore be used for any other purpose without the approval of the syndicate banks. It is the responsibility of the agent to ensure this. In case the agent detects that the loan has been diverted, this amounts to a default. Therefore banks can terminate the loan or may force the borrower to make early repayments[21], if there is evidence to the effect that the borrower will not be able to repay the loan. It is the duty of the agent to monitor and inform the participating banks the status of the performance of the loan. The agent however, has limited discretion to take minor decisions as spelt out in the credit agreement. Major decisions are taken with the approval of the syndicate. The agent is expected to act in the best interest of the syndicate and performs his duties with skill, care and due diligence.

During construction, the agent organises site visits for the syndicate to keep breast of the progress of the project and obtain formal presentations from the borrower. The agent ensures compliance with all the provisions of the loan agreement for both the SPV and the syndicate banks. In case of detection of non-compliance behaviour, organises impromptu meetings between the parties. Depending on the gravity of the default, the parties may agree to terminate the loan or allow the borrower to accelerate loan repayments. All payments from the project company are received by the agent and remit them to the individual syndicate banks. In case of default, the agent with agreement from syndicate banks takes enforcement action against the borrower.

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[20] *Graham D. V.,* Project Finance, 2[nd] ed., Sweet and Maxwell Limited, London, 1998, 64.

[21] Ibid, 64-65.

4. The Role of Loan Syndication

4.1. Risk Diversification

Completion risk, market risk, political, technological and force-majeure risks need to be analyzed on initial stage in order to persuade each party that project will be profitable. All agreements which concern risk sharing and allocation is cross checked by bank representatives who participate in the process in order to guarantee the compliance with the project financial criteria. Project expanses and financial plan requested by the Parties, technical descriptions of project construction and operation are very essential and useful. When an agreement is reached, each participant agrees that they will proportionally contribute to the loan and sign the syndicated loan agreement. The mentioned confirms that sums will be available in accordance with the financial plan of the project.

The standard theory of why banks join a syndicate is risk diversification. Since mid 1980s, loan syndication has been at the centre stage of financing large projects. . In most cases, these projects require high credit facility that may not be mobilised by one bank. Financing of energy, infrastructural project – bridges, roads, tunnels, railways and public services like hospitals, prisons, and universities require several billions of dollars which may not be available in one bank. In addition, banks have lending exposure limits to specific sectors.

As long as the project is bankable, banks with surplus funds are always happy to join the syndicate and enjoy its benefits. To participate in debt financing, banks employ advisors to ensure that all risks are allocated and the borrower has experience to implement the project in accordance with the provisions of the loan agreement.

4.2. Risk Sharing

Although the risks in project finance structure are transferred to parties competent to bear them, there is uncertainty that the project may not perform according to the financing plans[22] and the loan agreement. The residual risk is also borne by all the participating banks. With many banks involved in the syndicate, the risks are shared according the proportions of their contributions to the loan. In case of default, each bank bears a proportion of the risk, which is offset by returns from successful projects.

4.3. Information Sharing and Competitive Prices

Information sharing between many participating banks reduces risk. Information exchange is paramount for the success of a loan syndicate. However, information gaps between the members of the syndicate, can cause the problems.[23] To the borrower, a harmonized channel of communication reduces costs and time that would otherwise been spent communicating to individual participating banks.

Competitive pricing and more flexible funding structure benefits borrowers and the final consumers. In cases where the process of loan syndication is through competitive bidding, banks that offer the best terms of the loan are awarded the tender[24]. This eases the repayment schedule of the borrower. In case of power

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[22] *Nevitt P., Fabozzi F.,* Project Financing, 7th ed., Euromoney Books, London, 2000, 106.

[23] *Godlewski C.,* Banking Environment, Agency Costs, and Loan Syndication. A Cross-Country Analysis, Louis Pasteur University, France, 2008, 14.

[24] Ibid, 15-16.

projects where the tariff is a function of debt service among others, any reduction in interest rate benefits the power consumer.

5. Measures to Ensure Successful Loan Syndication

The credit agreement clearly specifies the remedies in case of default. Default arises from non-payment of the loan, bankruptcy or insolvency, non-compliance with covenants, and non-payment by the sponsor of any other loan when due. However, all events of default must pass the materiality test in order to be considered as an event of default. The remedies include loan cancellation, right to accelerate the loan, limitation of distributions to sponsors and step-in-rights[25]. All participating banks have the same rights to enforce these provisions, however some credit agreements provide right of enforcement to some banks.

A sharing clause is intended to balance the interests of participating banks. The clause is aimed at protecting the minority banks from the majority participating ones and ensures fair distribution of benefits to all participating banks.

The credit agreement contains provisions for decision making by the participating banks. In this regard, the voting clauses are included to ensure that the syndicate obtains majority consensus before making a decision. This power to exercise the syndicate voting rights must be exercised in the interest of the syndicate, but not to the detriment of the voter.

This should normally be at the centre stage. All provisions of the credit agreement and other financing documents are subject to a comprehensive negotiation. In this regard, participating banks appoint advisors from different disciplines to negotiate and ensure that the terms of the agreements are favourable. If the bank finds that the terms are not in its favour, it has the liberty to leave the syndicate. Appending the signature on the loan syndication agreement implies that all participating banks agree to the terms of the agreement and will comply accordingly.

6. Conclusion

Loan syndication plays a significant role in financing projects. Most projects that require large sums of funds are easily financed through syndication mechanism, otherwise it would be difficult for a single bank to mobilize the funds.

To conclude, it has to be noted that syndicated loan plays significant role in the hydropower plant project execution process. In order to ensure the construction of hydropower plant and enable it to sell the produced electricity in the market the financing is needed. The execution of hydropower plant project is a large-scale project which need big financial resources during each phase of project execution.

The issuance of syndicated loan and its repayment process has a very complex character and in order to better understand it, it is needed to discuss the phases in details. As a result of a research it was proved, that before the issuance of the syndicated loan the commercial banks choose an agent bank (leading bank) and its main function is to organize the issuance of syndicated loan and following phases.

Except an agent, as it was noted, special attention is paid to the parties – the lender and the borrower, risk allocation is always associated with each project especially with hydropower plant projects financed with syndicated loan. Importantly, risk sharing reduces risk exposure to individual lenders and this reduces the cost of debt. However for loan syndication to succeed, the credit agreement should be designed to clearly deal with the respective needs of the counterparties to the syndicate.

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[25] *Gatti S.,* Project Finance in Theory and Practice: Designing, Structuring, and Financing Private and Public Projects, Elsevier Inc., London, 2008, 274.