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Returning for more

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Credit Suisse First Boston is back. Round two of the bank's innovative securitization of a pool of project finance loans is due to take place in April or May and banks are eager to see the form the deal will take.

CSFB's first foray into the project finance collateralized loan obligation market was in March 1998, when it became the first bank to pool $617 million of its project finance loans and issue a bond. The deal, which followed the template set by similar creditcard-backed and mortgage-backed securitizations, sent a ripple of excitement through project finance departments. This was a way for banks to reduce their project finance debt portfolios without loosing control of the loans or as one banker put it ?giving away the crown jewels to the opposition?.

Despite enthusiasm following the first project finance securitization, CSFB remains alone in marketing this product (see Project Finance, August 1998, page 28). The question is whether this will change after the second transaction. And, while phase one set the benchmark for future deals, phase two has various innovations.

Guy Cirincione, director in the global project finance department at CSFB and leader on both of the securitization transactions outlines two of the key differences between the projects. In project one the bank took 41 of its fully amoritizing project finance loans and, with the exception of one Chilean mining project and a US steel plant, all the projects are in the US power sector. According to analysts at rating agency Moody's in New York, CSFB picked the projects which would be easiest to securitize. Institutional investors bought into a blind pool knowing that the loans are denominated in US dollars and are largely US power deals which have completed construction.

It is also important that the portfolio has a diversity of asset classes. Rating agencies Standard & Poor's and Moody's have a statistical approach to the loans in the pool. ?The agencies come up with a ?shadow rating' for the loans rather than carrying out full due diligence on all of the loans,? says Cirincione. ?This is more efficient.?

Waiting for round two

The difference in project two is quite pronounced. ?This time the pool will include assets from two, and possibly even three [as yet, unnamed] European banks,? says Cirincione. CSFB will put some of its own loans into the pool but it will also act as an aggregator for other banks which, presumably, do not have what Cirincione terms as ?the critical mass? of deals to make up their own securitization package ? a successful and cost effective deal requires a minimum of $500 million in project loans. Project number two will initially have $600 million-worth of loans in the pool but as not all the loans in the pool have been drawn there is $900 million in commitments. As a result a second and third issuance will take the pool value up to $900 million.

Around 38% of the loans in the portfolio involve projects still under construction. Cirincione says that the construction risk has been thoroughly evaluated by the rating agencies. Risks are not being buried in the pool. ?There is a significant amount of risk mitigators ? sponsor guarantees, political risk insurance, contractor and liquidator damages requirements,? he adds. ?We've taken a disciplined approach to the credit quality ? we are not trying to hide some assets. So those loans which relate to projects still under construcion are on time, on budget and pose no significant problems.?

But it is the emerging market element which really makes project two stand out from the first transaction. This time 13% of the loans carry true emerging market risk.

Those marketing the new product at CSFB are enthusiastic about the benefits of securitization. According to research produced by the bank over $80 billion-worth of project finance loans have been placed on the books of banks in the past five years. And because these assets are often not traded or rated there is not an active market in which to move loans or an entire portfolio.

Phase one removed 96% of the repayment risk off the CSFB's books. ?It created significant capital relief,? says Cirincione. And with 40% of the institutional investors who bought into project one coming from Europe and the remaining 60% from the US, Cirincione argues that the bank has proved that there are expanding sources of liquidity.

Cirincione says that in 1998 and 1999 project finance groups face three main challenges: diminishing liquidity; syndicating deals; and booking business. ?With rising syndication risks can bankers really go to their credit committee and argue that 20-year debt should stay on their book?? he says.

But there are other compelling reasons to securitize. Banks which have a large amount of debt for a sector which they no longer follow may find it slightly unpaletable to sell those loans off to a competitor bank. Doing so is often seen as undermining the credibility of the bank while also potentially harming relationships with the project sponsors. ?Banks who have now left the mining sector, for example, will want to get rid of their mining portfolios and would rather transfer the repayment risk to a third party,? says Cirincione.

Securitization is also another way of freeing up bank balance sheets following a merger. As Christopher Beale, global head of project finance at Citicorp in New York says ?1+1 does not equal two? in deals where a merged bank is working. Merged banks are not likely to do twice as much or even as much as they did as separate institutions. As organizations combine there is a greater need to redeploy their portfolios.

The challenges

As CSFB embarks on its fact-explaining mission, what is the response from other financial institutions and the sponsors?

Cirincione emphasizes that the bank remains the lender of record in all transactions so that project sponsors have been cooperative in the securitization process. Unnecessary changes of personnel will not occur.

Despite this, bankers are greeting the next transaction with a mixture of caution and excitement. The derth of participation banks and the decline in the Rule 144A bond market has hit project finance hard and securitization is not seen as a panacea for the slow down of business.

Some banks argue that their own project finance portfolios are still not large enough to allow securitization. Others feel that the costs of going through securing the assets do not out weigh the benefits. CSFB for example has a dedicated team working on the product and has exhausted considerable resources. Inevitably the first bank in the market is likely to spend more time and money developing the concept but there have also been legal and tax hurdles to overcome.

In the first securitization, the bank had to make sure that the regulatory authorities were confident about where the deals were booked. In this transaction the New York state bank authority had to be comfortable with the loans.

But because of the international flavour of project two, CSFB has, among others, had to approach authorities in the US, Australia, the UK and Germany. Each country has different tax withholding legislation. Because this is a multijurisdictional deal, the bank has to establish that the sale has transferred the economic risk in each case. ?You have to examine the true sale law in each country,? says Cirincione. ?In the UK, for example, we created a UK trust structure. In Australia the withholding tax laws are very complicated so that you have to adjust the forms of transfer or you can move the asset to a US branch if they are willing.?

Credit Suisse First Boston claims that by testing the water twice, once on its own and this time with other European banks, it hopes to prove that securitizing a pool of project finance loans is a repeatable process. Certainly a number of European banks which Project Finance has spoken to in the past few months, have expressed an interest in the process, with one French bank deploying a person full-time to liase with the central bank. But others remain more sceptical, seeing the process as too costly and laborious. Perhaps the rating agencies have the last word. Rather than a flurry of deals in 1999, a representative of one of the agencies says he is predicting a few more deals but not a flood.

A few facts about the 1999 securitization
Project two includes:

- Projects in 18 different countries
- 56% are investment grade
- 44% are non-investment grade
- 20% of the project loans have political risk insurance
- 11% of the loans have pierced the sovereign ceiling
- Only 13% of the loans carry true emerging market risk
- 12 of the 26 in the pool have fixed contracts
- 11 of the 26 have exports related to the project which are sold in US dollars
- Only 38% of the projects carry pure construction risk but of those the longest time required before completion is two-and-half years.