Executive Summary

February 2020

Natural Resource Governance Institute

Resource-Backed Loans: Pitfalls and Potential

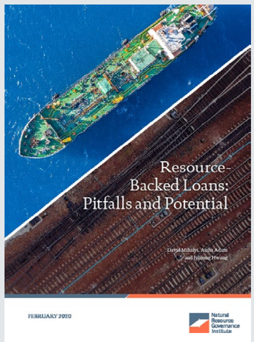
David Mihalyi, Aisha Adam
and Jyhjong Hwang

Key messages

- Resource-backed loans (RBLs) are all loans provided to a government or a state-owned company, where:
  - repayment is either made directly in natural resources (in kind) such as oil or minerals, or from a resource-related future income stream; or
  - repayment is guaranteed by a resource-related income stream, or where a natural resource asset serves as collateral.
- This research identifies 52 RBLs in 14 different countries across sub-Saharan Africa and Latin America, with a total value of $164 billion, made from 2004 to 2018. Two thirds of these RBLs went to countries with a poor or failing score on NRGI's Resource Governance Index.
- RBLs are opaque. In only a single case is the key contract document public. Even basic information such as the loan's interest rate was identifiable in just 19 out of 52 cases surveyed.
- RBLs have been a major public finance risk. Of the 14 RBL recipient countries, ten experienced serious debt problems after the commodity price crash of 2014, with RBLs often an important contributor.
- Two Chinese policy banks were the lenders in the majority of studied RBLs. The next most common lenders were commodity traders. The large majority of the loans studied were backed by oil. A smaller number were backed by minerals.
- This policy brief highlights five key risks and four key opportunities associated with RBLs. There is now an important momentum to change how RBLs are undertaken by learning from past mistakes and finding more sustainable ways forward. The report provides nine guidelines for more responsible use of RBLs going forward.

ABOUT THIS DOCUMENT

This is a summary of a longer report available at: resourcegovernance.org/resourcebackedloans



RESOURCE-BACKED LOANS: RISKS AND OPPORTUNITIES

Risks	Opportunities
Loan landscape	
Risk 1. Weak resource governance can jeopardize a loan	**Opportunity 1.** Resource-backed loans are primarily designated for infrastructure development
Risk 2. The market for loans is not competitive	
Terms	
Risk 3. The terms of resource-backed loans are often hidden	**Opportunity 2.** Resource-backed loans may offer cheaper financing
	Opportunity 3. Resource-backed loans can be structured to mitigate volatility
Public financial impact	
Risk 4. Large resource-backed loans can undermine debt sustainability	**Opportunity 4.** Resource-backed loans can be renegotiated in difficult time
Risk 5. Resource-backed loans can exacerbate financial distress	

INTRODUCTION

To finance their progress, developing countries must inevitably find ways to overcome challenges. One major issue that these countries face is that investors often perceive developing countries as carrying a high financial risk, which limits their ability to access to international capital markets. In the natural resource boom that started at the turn of the millennium, a new financing model has become a popular way to circumvent these risks. In this financing model—called "resource-backed loans" (RBLs)—countries access finance in exchange for, or collateralized by, future streams of income from their natural resource wealth.

In our definition, RBLs are all loans provided to a government or a state-owned company, where:

- repayment is either made directly in natural resources, that is, in kind, or from a natural resource-related future income stream, or
- repayment is guaranteed by a natural resource-related income stream, or a natural resource asset serves as collateral.

We review countries' past experiences with RBLs across sub-Saharan Africa and Latin America from 2004 to 2018. We aim to identify risks and opportunities RBLs pose and to provide recommendations for countries considering taking RBLs in the future. Our analysis relies on data collected by NRGI as well as Boston University Global Development Policy Center and the Johns Hopkins SAIS China-Africa Research Initiative (CARI) and the Inter-American Dialogue.

Our dataset is by no means comprehensive. The RBL landscape remains largely opaque, with limited information available about the terms, and at times even the existence, of RBLs. The dataset, and therefore our analysis, is limited by the information that is publicly available.

FINDINGS

We identified 52 RBLs, 30 of which were taken by countries in in sub-Saharan Africa and 22 in Latin America. They are distributed across 14 countries in the two regions. Thirty-eight were lent by Chinese policy banks, seven are from commodity traders, four are from other Chinese state-owned enterprises, one is from Korea Exim, one is from Nigeria and one is from Rosneft. Forty-three of the loans are backed by oil, six by various minerals, two by cocoa, and one by tobacco. The total loan amount represented in our dataset is $164 billion, of which $66 billion went to Africa and $98 billion to Latin America.

Our review of country experiences, which we discuss in detail in the policy brief, highlights five key risks and four key opportunities associated with RBLs. We also discuss the overall RBL landscape, the terms of RBLs and their public finance impact.

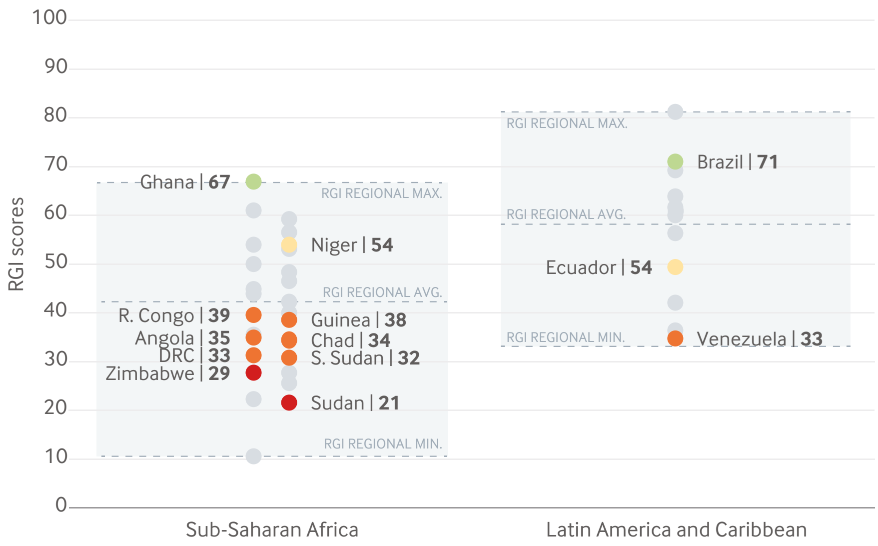
THE RESOURCE-BACKED LOAN LANDSCAPE

In this first section, we discuss which countries and which entities within them tend to enter into RBLs. We next review the main lending entities and finally, we identify how countries are spending funds received through RBLs. We highlight two important risks: first, that the borrowers generally have weak governance and second, that there is little competition between the lenders. We also show that most RBLs within our dataset are earmarked for investments, rather than directed towards consumption.

! Risk 1. Weak resource governance can jeopardize a loan

Sub-Saharan African and Latin American countries that receive loans generally exhibit weak resource governance. Two-thirds of the RBLs in our dataset are going to countries with poor or failing scores on the Resource Governance Index. In forty percent of cases, the borrowing entity within the country is a state-owned enterprise, which is often a source of opacity and off-budget spending.

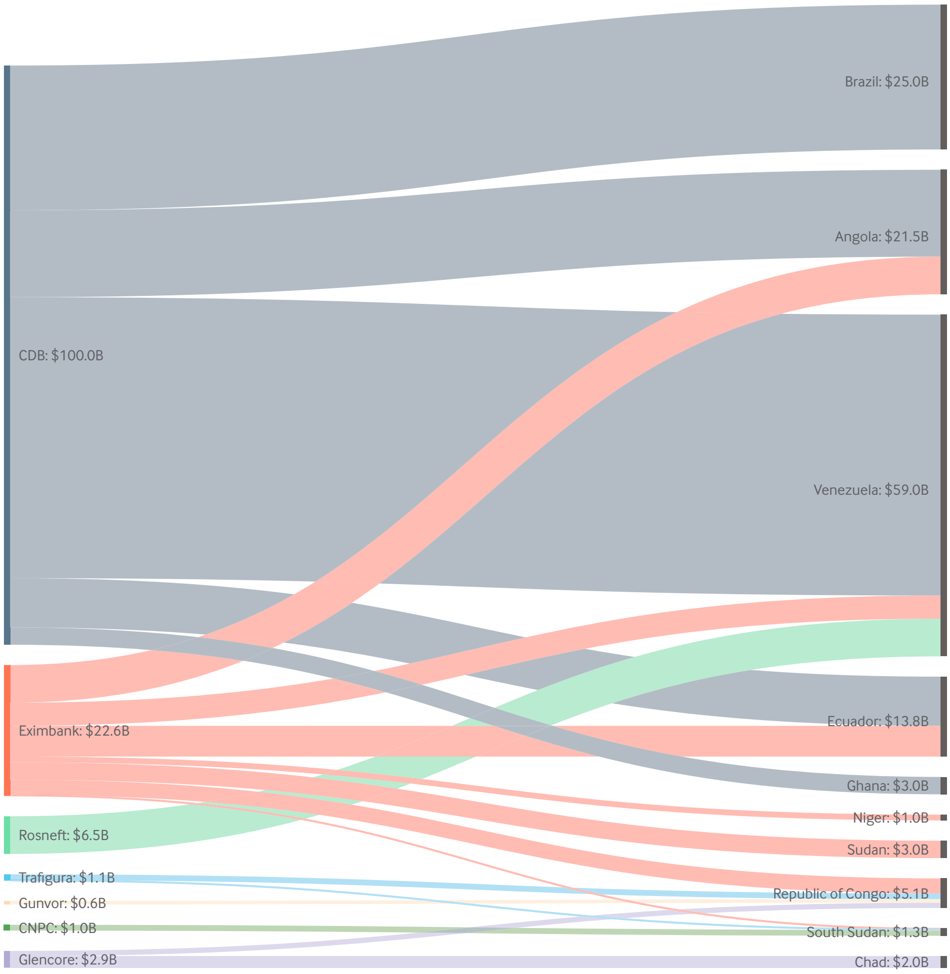
Resource Governance Index scores of resource-backed loan borrowers



Risk 2. The market for loans is not competitive

There are very few entities offering RBLs. The main lenders are two Chinese policy banks (CDB and Eximbank) and, to a lesser extent, commercial commodity trading companies. We document how interconnected their lending is with their other involvement in a country's resource sector, and that we found no evidence of countries using competitive processes to acquire RBLs.

Resource-backed loan flow between lenders and recipient governments (oil sector only)



Opportunity 1. RBLs are primarily designated for infrastructure investment

Across our dataset, more than 85 percent of RBLs (and over 90 percent in RBL value) were earmarked towards capital spending, which includes roads, the oil sector, energy and housing projects. Accordingly, RBLs can be an opportunity to get governments to commit proceeds derived from natural resources to productive investment rather than recurrent expenditures. That said, some of the loans, especially from commodity traders, are either not earmarked (e.g., are used for general budget support) or we were not able to ascertain what they were meant for.

TERMS OF RESOURCE-BACKED LOANS

In this section, we review what is known about the terms of individual deals. First, we discuss the lack of transparency surrounding the deals and how it limits our understanding. Next, we present a short analysis of observable terms, highlighting the rather favorable (at least at face value) lending terms of RBLs from China to sub-Saharan Africa. Finally, we draw attention to some distinct and potentially beneficial features of certain types of RBLs.

! Risk 3. The terms of RBLs are often hidden

There is a severe lack of transparency surrounding RBLs. In only a single case is the main contract document public and key contractual terms are seldom available. We could only identify basic information, such as the interest rate, for 19 of the 52 cases that we surveyed. Information on loan collateral arrangements and the mode and schedule of repayment are rarely made public. Often information is only revealed once repayment problems emerge.

! Opportunity 2. RBLs may offer cheaper financing

Based on the terms that we could observe, rates are relatively favorable for RBLs from China, as compared to other sovereign debt. The rates for shorter-term loans from commercial commodity traders are seldom available, but limited evidence suggest they are not favorable. A comparison based on headline lending terms would have serious limitations because of the lack of data and because RBLs are often part of multi-faceted deals that impact various parts of a country's economy.

! Opportunity 3. RBLs can be structured to mitigate volatility

Some RBLs have a repayment structure that effectively enables the government to pay less in monetary terms when commodity prices (or production levels or profits) are low, and repay the loan quicker when conditions are favorable.

THE PUBLIC FINANCE IMPACT OF RESOURCE-BACKED LOANS

! Risk 4. Large RBLs can undermine debt sustainability

RBL are often very large in proportion to the recipient country's economy. Across the fourteen countries with RBLs in our dataset, ten countries experienced serious debt problems after the commodity price crash, with RBLs often being an important contributor.

! Risk 5. RBLs can exacerbate financial distress

Because RBLs are often repaid in-kind and may have collateral attached. This can complicate debt restructuring and leave traditional lenders at a disadvantage, which may make them reluctant to lend to RBL countries, potentially exacerbating the debt distress.

! Opportunity 4. RBLs can be renegotiated in difficult times

The mutual interdependence between RBL borrowers and lenders and the difficulty lenders can have enforcing RBL collateral has led to many RBLs being successfully renegotiated. This shows that countries are not always trapped in unfavorable loan terms until their debts are fully repaid.

POLICY RECOMMENDATIONS

There is now momentum to assess this experience with RBLs to assist countries in determining if and how they should enter into RBLs in the future. Several countries' recent repayment challenges revealed important parts of largely hidden deals. These disclosures and renegotiations can be important inputs in forging new approaches on process and substance. There is also a renewed interest in this mode of financing, with new deals signed in Brazil and Guinea in 2017, Ghana in 2018 and probably many more under discussion. Borrowing governments, lending institutions, civil society actors and international financial institutions all share a common interest in avoiding bad loans, learning from past mistakes and finding more sustainable ways forward.

Based on the above, we recommend that governments take a cautious approach in taking RBLs. Governments should first determine whether an RBL is the right financing tool to consider in the country's financial and governance context. The recent experience of other countries shows that RBLs have not proven an ideal tool for several countries. This evaluation should involve a cost-benefit analysis, including, in the case of bundled deals, economic modeling of the loan and repayment terms offered, the value of the extractive rights granted and the value of the infrastructure to be provided.

If a government looks to consider RBLs further, they should only do so if they can ensure the following safeguards are in place.

Borrow transparently

Recent steps taken by the EITI, IMF and others have improved the transparency norms applicable to RBLs. Practice should follow so all key terms of each loan contract are promptly made public. Where loan contracts are bundled with contracts for extractive rights or trading, the government should also publish contract terms for those elements. As encouraged by EITI, the criteria for company selection with regards to trading rights should be made public. Both companies and governments should disclose payment flows for RBLs in detail, as they are already have done across several EITI reports.

Bring loans on budget

Given their complex nature and importance, the loans and their associated spending cannot be executed by state-owned enterprises with a limited borrowing remit. Rather, the loans and their associated spending should be brought on budget, be vetted by countries' ministries of finance and subject to parliamentary scrutiny (where applicable).

Invest productively

Loans come at an oftentimes significant cost. Money accrued from borrowing should not be consumed, but spent in productive investments that can generate returns over the long term that exceed their financing costs. Governments should base project selection on their national development plan. The spending plans for RBLs should also be made public and updated periodically. Given the costs involved, the use of RBLs as a form of short-term advance should be avoided.

Make borrowing more competitive

Governments should encourage competition amongst potential RBL providers on loan terms and financed projects. This will help governments secure the best possible deals when presented with alternative options. Even when loan contracts are tied to specific projects, there could still be clauses to increase competition in selecting the contractors and executing the subcontracts to the project. Detailed project evaluations and scrutiny of infrastructure companies' cost declarations are also key. This will help ensure reasonable loan terms and value for projects funded by RBLs.

Use counter-cyclical loans

RBLs allow for more flexibility in structuring the repayment schedule than regular loans. Governments of resource-rich countries should insist that the monetary burden of repayment be less when commodity prices are low, and that loans are repaid quicker when prices are high.

Respect prudent borrowing limits

Countries' ministries of finance need to scrutinize any RBL and ensure that the additional loan fits in its overall debt management strategy and that total debt levels stay within prudent levels. One way to learn this is to include detailed evaluation of RBLs under various price scenarios as part of the IMF and World Bank led debt sustainability analysis.

Avoid using resource rights as collateral

Rights to subsoil wealth make for poor collateral. They are very hard to value appropriately, are likely to be politically and legally contested and likely worth much less to a lender who will have difficulties utilizing it without government's support. If the lenders need guarantees, these can take the form of sovereign guarantees, money kept in escrow or securitizing additional revenue streams.

Bring experts to the negotiation

Governments need robust institutions with the capacity to negotiate such complex deals as RBLs. This includes legal expertise in contracting, economic modeling of the loan conditions, valuation of resources used for repayments and unbiased technical assessments of the projects. These are all critical to ensure that governments can make informed decisions on whether the proposals it received are worthwhile. Once an RBL deal is agreed upon, it should be set out in legal instruments that fit within the country's binding legal framework and are subject to legally required oversight, as opposed to vague protocols that can create excessive ambiguity and discretion.

Lend responsibly

While the primary responsibility for a country's public finances lie with the borrowing country, lenders should also ensure RBLs are only used responsibly. They should disclose key terms of contracts in line with the proposal by the IIF, encourage more competitive allocation processes and ensure debt sustainability.

ABOUT THE AUTHORS

David Mihalyi is a senior economic analyst at NRGI and a research fellow at the Central European University.

Aisha Adam is NRGI's former Africa economic analyst and a doctoral student in economics at Kansas State University.

Jyhjong Hwang is a doctoral student in international relations at Ohio State University and a consultant with NRGI.

The Natural Resource Governance Institute, an independent, non-profit organization, helps people to realize the benefits of their countries' oil, gas and mineral wealth through applied research, and innovative approaches to capacity development, technical advice and advocacy.
Learn more at www.resourcegovernance.org

Natural Resource Governance Institute
Oil, gas and mining for development