Emerging analysis

The evolution of China's lending practices on the Belt and Road

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1 Introduction

Since the announcement of China's 'Going Out' policy in 1999, Chinese capital has poured overseas, via trade, private investment and, increasingly, official finance in the form of concessional and non-concessional lending. As a result, China has become one of the largest sources of bilateral lending to low-income countries (LICs). As debt challenges in LICs have intensified with the Covid-19 pandemic, however, China's role in lending and debt restructuring has come under more scrutiny.

In practice and in substance, China's lending remains opaque. Academic and research institutions have made efforts to track China's overseas lending by volume (Horn, Reinhart and Trebesch, 2019; CARI, 2020; Ray et al., no date), but less is known about the modalities and practices by which Chinese financial institutions lend. It has been estimated that Chinese lenders have entered into over 2,000 loan agreements with LICs (Horn, Reinhart and Trebesch, 2019). As with most official Organisation for Economic Co-operation and Development (OECD) and non-OECD lenders, Chinese lenders do not disclose their loan documentation unless required by law, making a comprehensive review of all Chinese loan agreements impossible. However, pioneering research by Gulper et al. (2021), looking at around 100 Chinese loan agreements, identified distinct characteristics in Chinese lending, and documentation practices considered unusual and somewhat alarming for official lenders, including the mixing of official and commercial terms, the use of confidentiality clauses, the use of special reserve accounts for collateral, and clauses around defaults and debt restructuring.

Gelpern et al. conclude that China is a 'muscular and commercially-savvy lender' that seeks to gain commercial leverage and secure repayment as a creditor. The authors highlight distinct and unusual provisions in Chinese contracts: the use of special reserve accounts, for example, entails the risk that portions of expected government revenue are effectively controlled by a foreign creditor. The use of collaterals is also highlighted by Malik et al. (2021) as part of a 'high-risk, high-reward credit allocation strategy' from Chinese lenders in extending credit to borrowers in high-risk, high-corruption countries (Malik et al., 2021). Chinese contracts were noted to also contain provisions around confidentiality, 'no Paris Club' clauses, which exclude lenders from collective restructuring initiatives (and which potentially stand in tension with current G20 debt restructuring

frameworks), and an expansive use of cross-default clauses, which the authors suggest can allow for greater coordination and collective bargaining power by Chinese lenders. Some of these practices may raise concerns in light of their use by a sovereign creditor, though the paper does not tackle the issue of how such contractual provisions may be enforced.

This brief responds to the work of Gelpern et al. and interrogates *why contracts take the form they do*, the conditions in which they emerged, and the origins behind some of the practices the authors identify and problematise. Rather than reflecting nefarious intention, we suggest that China's contractual practices can be viewed as *emergent properties* of a lending system under a process of improvisation and adaptation, with actors responding to domestic constraints and institutional pressures. These serve the commercial interests of Chinese lenders but entail significant challenges for borrowers under pressure.

The brief sheds light on how China's economic statecraft in the early phase of its globalisation influenced lending practices, and how these processes and institutional constraints for Chinese lenders have shaped contract design. The brief also draws out implications for how contracts are implemented and enforced, with an emphasis on the institutional and relational context in which these contracts exist. Popular interpretations of Chinese loan contracts have given rise to fears around asset seizures in Chinese project loans – particularly in the endemic narrative around 'debt-trap diplomacy'. However, much of this comes from a misrepresentation of contract clauses (Brautigam, 2020; Brautigam and Kidane, n.d.) and neglects the relational and political context in which these contracts are embedded. Finally, the brief draws out the implications for debt renegotiation and restructuring between Chinese lenders and borrowers.

We make three arguments:

1 First, China's overseas infrastructure lending and its lending and contractual practices derive from a history of trade-oriented cross-border lending. This is reflected in the often mixed and commercial characteristics of these loans, and the use of particular instruments such as special reserve accounts.
2 Second, China's legal frameworks around lending reflect an adaptive, path-dependent model of development. Lending practices have emerged from processes of bottom-up experimentation and trial-and-error, adapted to different geographies and contexts, which have then evolved and become standardised over time.
3 Third, the interpretation of legal contracts should not be divorced from a broader relational context and long-term political

relationships. The role and salience of contractual provisions should be evaluated in this light.

In the context of Covid-19 and growing issues of debt distress in many sovereign borrowers, better understanding of Chinese creditors' approach to debt – and how it is evolving – is more important than ever. For borrowers, as Gelpern et al. point out, there is a clear and pressing need for greater transparency, which can empower domestic legislators and civil society to hold leaders accountable regarding external borrowing and the risk entailed in these projects. Legal and regulatory constraints make it unlikely that transparency is going to come from the creditor side anytime soon. Increasing transparency and pushing back against terms of non-disclosure is key to bolster the credibility and leverage of borrowers: Chinese loan contracts have the same potential for flexibility and negotiation as contracts with any other creditor.

For creditors, our analysis also highlights a further structural challenge for China in its approach to lending contracts and negotiations. We show an emergent and evolutionary process, rather than coordination, in how China's lending and contracting has developed – but China is increasingly called upon to provide systemic responses in debt relief initiatives. While China has joined high-level G20 multilateral debt initiatives, absent of political decisions at the top level, prospects for broad-based debt relief will be hugely challenging to reconcile with the institutional constraints in which Chinese banks operate.

2 The development of Chinese lending practices

In its overseas lending activities, as with aspects of its political and economic governance, China is not a monolithic entity acting in perfect coordination. While China's governance structure is often characterised as a strong state directing domestic companies and actors, the reality is much more uneven. China's domestic economic growth, and its overseas ventures, reflect an approach that is pragmatic, adaptive and often experimental. Trial-and-error experiments from local policy-makers were encouraged and replicated when successful in a system that Ang (2016) calls 'directed improvisation', where policy declarations issued from the top are left deliberately broad and vague, allowing interpretation and innovation from local actors and policy-makers.

This 'directed improvisation' approach is evident in China's Belt and Road Initiative (BRI). Famously difficult to pin down as a concept, the BRI serves as a declaration of policy intent, but what is and isn't part of the BRI is intentionally nebulous, and how companies implement projects has been much more adaptive to local conditions (Corkin, 2011). Implementation on the ground reflects a fragmented picture, rather than a coherent strategy on the part of the Chinese state.

While often compared to the Marshall Plan, the BRI represents a much more decentralised initiative that does not benefit from the same type of strategic coordination that the US employed in the post-war era (Greer, 2018). Unlike the Marshall Plan, the BRI does not have a permanent government agency equivalent to the Economic Cooperation Administration (ECA) that can impose uniform practices, coordinate documentation or leverage resources to influence domestic economic and political decisions. Nor does it require the supply of strategic resources (Grünbacher, 2012). Instead, BRI lending practices and loan documentation developed organically, with two particular characteristics: a strong focus on the commercial viability of the underlying project; and the long-term relationship of the stakeholders.

2.1 Pre-export finance in China's lending model

China's overseas capital flows reflect domestic economic cycles. The initial phase of Chinese foreign direct investment (FDI), following the announcement of the 'Going Out' strategy in 1999, focused on securing energy, resources, food security needs and diversification of supply for growing domestic demand (Meidan, 2016). In part, this can be attributed to friction with the US over Taiwan in 1995–1996, which highlighted China's vulnerabilities and reliance on imports. This phase of Chinese FDI saw the development of 'oil-for-money', 'minerals-for-money', 'cocoa-for-money' (Hensengerth, 2011; Brautigam, Huang and Acker, 2020) and other types of long-term pre-export finance structures targeting greenfield projects in Australia and across many emerging economies in Central Asia, Latin America and Africa (AMIQ, 2020).

The global financial crisis in 2008 saw Chinese lenders quickly expand their operations domestically to fill the vacuum left by traditional international lenders, and also marked a turning-point for lenders like the China Development Bank (CDB) in overseas lending. The experience of Chinese lenders with pre-export finance (PXF) over the early 2000s is believed to have had a significant impact on the development of later cross-border lending practices, and contributed to the mixing of commercial and sovereign lending terms.

Often referred to by trade finance practitioners as 'resource-based finance' or '(PXF)' (IMF, 2003; Halland et al., 2014), PXF differs from traditional corporate lending in that it aims to provide a potential producer of goods or commodities a way to borrow the capital needed to build production facilities, using the expected future income as security.1 This is a widely used financing structure and is not unique to Chinese lenders. Nevertheless, it has become strongly associated with Chinese lending to LICs, often labelled the 'Angola model', where resource-backed finance has supported large-scale infrastructure investment (see Box 1) (Corkin, 2011; Bräutigam and Gallagher, 2014). It has also become commonplace in the BRI, where Chinese banks and investors have responded to top-down political directives to invest in the BRI to promote economic connectivity, which entails channelling significant volumes of capital to countries and regions considered commercially risky.

Box 1 Pre-export finance (PXF) in China's overseas lending

Chinese regulatory requirements and lending practices have made Chinese PXF different in many respects. This includes:

[1] Single accepted universal definition of 'pre-export finance' currently exists, but the general nature of the facility, its intended purpose and key elements are generally accepted. See for example www.tradefinanceglobal.com/posts/pre-export-finance-used/.

1. a reliance on expected future income from one or more lynchpin ‘take-or-pay’ sale and purchase contract(s) entered into with a Chinese state-owned buyer;
2. contractual requirements on, among other things, the timely construction of production facilities, and shipped volume and price of the goods/commodities in question;
3. a requirement for the borrower to self-fund at least 15% of the project;
4. disbursement of loan proceeds directly to the Chinese contractor responsible for the construction of the production facilities under an engineering-procurement-construction (EPC) contract.

This challenge has been partly resolved through the participation of Chinese state-owned buyers and contractors, which facilitates bankability and credit assessment by Chinese lenders. The inclusion of a buyer well known to the lender increases the lender’s confidence in the robustness of the project’s primary source of revenue, and the inclusion of a proven Chinese EPC contractor helps lenders assess the risks of construction – though it entails for the borrower a form of economic conditionality, limiting competition in procurement to solely Chinese suppliers, which may provide the best cost or quality option. To further mitigate credit risks and enhance bankability, the China Export and Credit Insurance Corporation (SINOSURE) may be brought in to provide political and commercial risk insurance. All these elements are intended to lower risk and ensure bankability from the perspective of Chinese lenders. In this respect, securing resource exports to China is a secondary consideration, rather than the primary objective.

PXF projects tend to focus on expected revenues from cash-generating resources, which are often monopolised by the state or dependent on income from a state monopoly. As a result, Chinese lenders became accustomed to the provision of sovereign support for loans extended on commercial terms. However, after 2008, and culminating in the BRI, the focus of Chinese FDI and lending shifted from energy security and import substitution to infrastructure projects, as domestic markets became saturated with excess capacity (Dave and Kobayashi, 2018). Chinese contractors and manufacturers increasingly sought overseas markets for infrastructure construction, and PXF lending practices were adapted to support them. Many of these projects, including transport, port and telecoms infrastructure, shared similar traits to PXF projects, in terms of their national strategic importance, the availability of sovereign support from governments and dependence on expected future income (ECN, 2020). At the same time, however, this was a process of improvisation, as banks took existing, familiar tools and adapted them to serve new and different purposes.

As the focus shifts from resources to infrastructure, there is still an evident influence of Chinese lenders’ experience with PXF, as loans

still focus on reliable future cashflow. The ThalNova Thar Coal Power Project in Pakistan, a coal-fired power project falling within the China–Pakistan Economic Corridor financed by the CDB, which accepted future cashflow under a power-purchase agreement supported by Pakistan's Central Power Purchasing Agency Guarantee Limited as being bankable, is one of numerous examples of this (NEPRA, 2017). Prior to the pandemic, there were signs for Chinese lenders that such projects may be heavily exposed to market risk. However, this has not yet changed the PXF model of finance: being able to demonstrate a reliable future cashflow remains the preferred method to prove bankability.

3 Evolution of BRI loan documentation

Gelpern et al. note a large degree of standardisation in loan documentation and the tendency for Chinese lending documents to contain concepts and terms from both sovereign and commercial lending, for example the inclusion of confidentiality clauses which bind both parties, requirements to maintain special reserve accounts, waivers of sovereign immunity and the inclusion of ‘no Paris club’ and/or cross-default clauses (Gelpern et al., 2021). The authors suggest this may be a strategy by Chinese lenders to maximise commercial leverage over the borrower and ensure repayment. The first observation on standardisation of loan documentation is consistent with empirical evidence and the experience of BRI practitioners. However, the second does not reflect a complete perspective of how international and Chinese lending practices have developed.

This section addresses two issues: first, how BRI lending practices have evolved over time to exhibit this kind of standardisation; and second, how and why they developed to differ significantly from US or European creditors in the features they display. We also highlight some problems in viewing Chinese lending practices through the lens of the latter. Our analysis emphasises a trial-and-error process in how contractual practices emerged.

We focus on three specific clauses in Chinese overseas lending: reciprocal confidentiality clauses; project-specific cross-default clauses; and special reserve accounts. We highlight institutional and legal constraints that contribute to their emergence: legal constraints on debt forgiveness from Chinese banking institutions; and institutional constraints that mandate personal accountability on bank staff. While these features serve to ensure commercial advantage for lenders, it is important to recognise that this is an emergent product in a system of multiple actors, institutional constraints and incentives, rather than a result of deliberate strategic design.

3.1 The evolution of contract forms

For zero-interest loans (ZILs) and concessional loans, which are issued through a government-to-government agreement, these contracts operate mostly on documentation governed by Chinese law, reflecting their status as foreign aid loans. ZILs are only available from China’s Ministry of Commerce, while concessional

loans are exclusively provided by the Export-Import Bank of China (Lui, 2020). These loan contracts are customarily governed by Chinese law and are subject to dispute resolution in China, though they may occasionally be documented in English or another language (Lui, 2020). After 1 October 2021, the China International Development Cooperation Agency (CIDCA) has formally been given overall policy and budgetary responsibility for China's foreign aid programme, which is intended to increase coordination between the previously fragmented stakeholders (Lui, 2021).

When it comes to commercial lending, however, Chinese lenders and stakeholders have taken a much more trial-and-error approach, in line with the Deng Xiaoping era slogan of 'crossing the river by feeling the stones', where stakeholders first experiment, and then proven practices become standardised and adopted more widely (BBC, 2017). Given the size and diverse interests of larger Chinese commercial lenders and stakeholders, and their differing levels of sophistication and appetite for risk, this has been a long process.

In the early years of 'Going Out', Chinese corporates and lenders had little experience operating internationally. As a result, lenders developed their own in-house processes around due diligence, documentation, structuring and execution. Inexperienced lenders at times insisted on using loan contracts developed for certain purposes for wholly unsuitable contexts: for example, using short-form domestic loan contracts for major cross-border lending transactions. It was not unusual to see US or European lending documents and practices being presented by lawyers unfamiliar with international finance as being the 'market standard', without consideration of Chinese regulatory and/or market practices.

The use of unsuitable documentation often leads to difficulties post-disbursement, which can necessitate subsequent amendments and supplemental agreements. This issue is particularly widespread in Latin America, where borrowers more familiar with US-style documentation often insist on its use, and some Chinese lenders agree without appreciating the potential difficulties this could cause until much later. Some loan facilities involving Latin American sovereign borrowers are reportedly supplemented almost on an annual basis, making loan agreements virtually living documents. One common example is the need for parties to subsequently relax Western-style hair-trigger contractual provisions which can cause frequent and repeated technical defaults. This reflects how Chinese lenders sometimes approach the borrower–lender relationship differently vis-à-vis Western lenders: because of the onerous internal process for Chinese lenders to waive defaults, representatives work with borrowers to avoid them; some international finance lawyers representing Chinese banks also take a risk-averse approach and apply Western lending practices without appreciating the regulatory and institutional nuances.

Over time, lenders learned from experience and significantly improved their capabilities and specialist BRI finance lawyers started to emerge, leading to the development of more sophisticated documentation and risk mitigation practices. Chinese lenders also sought to draw from international best practice: the CDB, for example, made significant investments in its internal processes and commissioned the UK law firm Clifford Chance to draft a suite of bilateral and syndicated loan templates around 2014–2015. These were based on documents recommended by the Loan Market Association (LMA) and the Asia-Pacific Loan Market Association (APLMA) and was reviewed by a number of other international law firms (and made available for comment by one of the authors) before it was adopted. Driven by a push to develop a Chinese syndicate loans market and client demand, other major Chinese lenders also invested in their respective processes: over time, the use of LMA/APLMA style documentation thus became the market standard for cross-border commercial lending by Chinese lenders.

While LMA/APLMA-style loan documentation is now widely accepted by Chinese lenders for cross-border lending transactions, several notable differences have developed in the documentation, due to Chinese regulatory requirements and lending practices.[2] Some of these clauses have understandably raised concerns around how they may potentially be used to create political leverage. We discuss a few of these clauses below. However, the salience of these risks should also be evaluated in the context of the lender and lending relationship, which we discuss in Section 4. While there are differences in BRI loan documentation and lending practices between official and commercial loans, and strong concerns that contracts can potentially be used as leverage to extract concessions, in practice, this has yet to be seen. In general, BRI loans tend to reflect China's policy of non-interference, and loan documentation does not impose ideological, governance or economic requirements as a condition for financial assistance.

3.2 Project-specific cross-default clauses

In the context of lending, a 'cross-default' clause refers to a contractual provision which triggers a default when the borrower (including any other party providing credit enhancement) defaults under a separate loan agreement. Depending on the terms of the agreement in question, typically if a default is triggered the lender will be entitled to refuse disbursement of any undisbursed loans, and/or require immediate repayment of any outstanding loans. Cross-default clauses are ubiquitous across Chinese contracts, while they are far less common for multilateral or DAC creditors. Gelpern et al. argue that this could allow Chinese institutions to 'act in concert' and

[2] These include reciprocal confidentiality clauses, requirements for a Chinese supplier, Sinosure subrogation (where applicable), fixed repayment dates and stapled interest payment dates, project-specific cross-default clauses, 'No Paris Club' language, risk on gross-up obligations in relation to withholdings under the US Foreign Account Tax Compliance Act, use of international arbitration and prevalence of 'waiver of sovereign immunity' clauses.

‘amplify … political influence over a sovereign borrower’ (Gelpern et al., 2021).

The cross-default clause focuses on the potential anticipatory breach of the borrower, and may be triggered even if no other default exists under the loan agreement (see Box 2). Cross-default clauses are often viewed by lenders from the perspective of creditworthiness. If a borrower cannot repay or fails to perform their agreed contractual obligations elsewhere, it is unlikely to be able to repay or perform its obligations towards the lender. This gives the lender the benefit of the default provisions of every other loan agreement entered into by the same borrower, as well as protecting a lender’s priority when the borrower is distressed. For these reasons, the inclusion of cross-default clauses is almost *mandatory* for lenders, including multilateral lenders such as the International Finance Corporation, as well as other private creditors, and is recommended as the default position by the LMA on its various templates.

Box 2 Cross-default clauses

A typical cross-default clause triggers a default when a borrower:

- is unable to pay any debt when due;
- has any outstanding debt accelerated as the result of default;
- has any loan commitment (e.g. loan promised but not yet disbursed) cancelled as the result of default; or
- placed in a position where its other creditors are able to accelerate its outstanding debt as the result of default.

Some Chinese lenders include references to specific projects in cross-default clauses, which has raised concerns over lenders linking multiple projects to gain bargaining power and thus influence (Gelpern et al., 2021, p. 38). From a legal perspective, however, the inclusion of a project-specific cross-default clause is usually unnecessary, since a properly drafted market-standard cross-default clause should always be triggered by a project-specific cross-default, making the addition of a specific clause somewhat tautological.[3]

Why this practice developed may be attributed in part to Chinese banking regulatory requirements. Chinese bankers are legally and personally accountable for any mistakes or non-compliance subsequently uncovered (PBOC, 1996). As a result of this personal accountability, bankers request these clauses as a kind of over-diligence, to demonstrate in post-disbursement audits that they have

[3] Given the complexity of large projects, interdependent projects are becoming increasingly common, particularly in emerging economies with limited existing infrastructure. Example of such projects may include power projects which may depend on the timely construction of transportation and transmission infrastructure facilities in order to be viable, or highway projects connecting population centres with industrial parks.

sufficiently discharged their duties and strictly adhered to the terms of the credit approval. These institutional pressures and self-interest encourage a conservative approach to documentation and may encourage the extra inclusion of such clauses.

In this light, the rationale for the development and inclusion of other BRI-style contract clauses, such as ‘no Paris Club’ clauses, becomes more understandable. China is not a member of the Paris Club; participation is ostensibly voluntary and commercial loans do not typically fall within the group’s ambit, but at an individual level, a prudent banker may include the clause as a hedge against the possibility of being later blamed for potentially having acquiesced to any restructuring process.

3.3 Use of special reserve accounts

Like all creditors, Chinese lenders try to mitigate their risks and maximise their prospects of repayment, including taking security as credit enhancement (Gelpern et al., 2021). Taking security and control over the borrower’s bank account(s) is common for limited-recourse financings and is not unique to Chinese lenders. However recent analysis including Gelpern et al. (2021) and Malik et al. (2021) note that this can take on a more sinister tone in the context of a sovereign creditor, particularly in dealing with high-risk resource-rich LICs.

This is an understandable concern, and historically special reserve accounts have been used in this way. As one of the conditions for participation in the Marshall Plan, for example, payment for US goods and/or services provided under the plan had to be deposited into a special account under US control[4] and there are numerous well-documented examples where the US threatened to withhold funds in special accounts to exert economic and political leverage. James Clement Dunn, US Ambassador to Italy in the late 1940s and early 1950s, once observed that the US ‘controlled the entire economic policy of Italy’ through its control of special accounts and deposited funds (Grünbacher, 2012).

China’s BRI is a different context, however. The BRI’s focus on infrastructure, connectivity and productive sector projects reflects a geo-economic and industrial strategy to offshore excess capacity and capital goods to gain better commercial returns overseas through the banking sector, resulting in a glut of funds searching for bankable projects (Cai, 2017). Given the higher risk profiles of BRI countries, lending tends to focus on projects with proven future cashflow as the source of repayment and involving sovereign stakeholders. This has cemented a practice of using special reserve accounts as a credit enhancement mechanism and a tool for managing lending risk, rather

[4] Section 115(b)(6) of the Economic Cooperation Act of 1948. Also see Brown, William Adams and Opie, Redvers. (1953). “American Foreign Assistance”. Washington: The Brookings Institution.

than a mandatory legal requirement as in the case of the Marshall Plan. Using special accounts in such a way is likely not realistic in any case, given the absence of a central coordinating agency for the BRI.

As a matter of law and practice, taking security over future assets is both challenging and legally difficult, since the nature of the secured asset changes over time, and different rules apply to the creation and perfection[5] of security interests over different assets. This challenge is compounded with cross-border financing, where the security package may span multiple countries, and particularly so where government stakeholders are involved. Different countries have different legal systems and requirements, and it is not always clear which laws should be applied. In the case of LICs with robust foreign exchange controls, this risk can result in the lender being unable to recoup its losses should the borrower fail to repay. Even if the security was valid when it was created, a subsequent change in local law could invalidate the security and expose the lender to risk. All these factors contribute to the widespread use of offshore reserve accounts as a method to mitigate potential risks associated with lending to LICs.

Box 3 Special reserve accounts as security assets

For political, legal and/or commercial reasons, it is often not feasible to take security over a borrower's bank accounts as would apply to textbook limited-recourse project financing. Eventually, a solution that generally involves some variation of the below gained acceptance in the BRI lending and legal community:

1. taking security over the lynchpin sale and purchase agreement, typically under English law;
2. taking security or, if not practicable, contractual control over the borrower's local bank accounts;
3. contractual agreement on cross-border cash-sweep and currency conversion at periodic intervals;
4. taking security and control over the offshore bank account(s) of the borrower.

The above aims to mitigate potential risks to the lender by providing not just legally enforceable security interest over the bank accounts and the lynchpin contract, but also contractual control over the expected future cashflow.

As the commercial context changes over time, the account structure often requires amendment or supplement and the continued engagement of the stakeholders. While a lender's control over a

[5] In a legal context, "perfection" refers to the completion of certain actions after the creation of a security interest to ensure the security interest will be legally effective against third parties and/or in cases of insolvency. Examples may include payment of stamp duty, registration of the security interest on a public register or notarisation, The actual actions required will depend on the applicable law, which can vary from jurisdiction to jurisdiction.

special account gives it some leverage over the borrower and the power to appropriate funds, this is in practice difficult given the decentralised nature of Chinese lenders. The absence of a central coordinating agency, the high proportion of loans provided by commercial lenders, the project-specific nature of special accounts and the institutional and personal accountability for the administration of loans all make this unlikely in practice.

3.4 Reciprocal confidentiality clauses

Another area of concern in Chinese contracts are the use of broad confidentiality clauses, which Gelpern et al. suggests is broader than the standard 'LMA template'. It should be noted that most lenders, including many official OECD and non-OECD lenders, do not disclose their loan documentation. This is because disclosure risks divulging client information or sensitive commercial information, which many borrowers would find objectionable. The disclosure of loan contracts also makes business difficult for lenders, as it provides the borrower with commercial leverage by demanding comparable treatment, even where the underlying credit may not be comparable. Chinese commercial lenders are no exception to this practice, though as Gelpern et al. also point out, disclosure due to legal, regulatory or stock exchange requirements is permitted as a matter of course unless removed at the request of the borrower, making transparency a significant area where borrowers can exercise agency.

4 A relational approach to contracts

Moving away from features of contract design, this section looks in practice at the differences in approach to contract implementation. Participants in the international finance market typically view loan contracts from the perspective of classical common law-style contract theory. Under this lens, loan contracts are commonly conceptualised and drafted to be an independent source of obligations, one which reflects the agreement of sophisticated counterparties, and that are permanent and binding on all parties. However, outside of common law legal traditions, contracts can be considered differently, with a relational lens: as a response to events, or a snapshot in the context of an ongoing relationship (Macneil, 1987, 2003).

Financing by Chinese lenders shows a blend of these two approaches. BRI loan terms are usually vigorously negotiated by Chinese lenders and, once signed, there is an expectation that contracts should be honoured by all sides. In this regard Chinese lenders do not differ significantly from other lenders. However, beyond the black letter terms of the contract, Chinese lenders appear to also view lending in a more relationship-focused way than US and some European lenders.

One notable feature of Chinese loan documentation for overseas loans is that contractual terms which do not impact on any payment are often intentionally drafted or enforced after signing in a way that is considerably more borrower-friendly. For example, it is not unusual to see significantly longer remedy periods being agreed for non-payment defaults than in the US or European lending market, which can help ensure the borrower does not so easily end up in default.

This different treatment of payment and non-payment-related defaults can also in part be attributed to China’s banking regulatory requirements and rules imposing personal accountability for defaults, mistakes and/or non-compliance. Chinese lenders, their management and individual bankers are legally prohibited from agreeing to any loan forgiveness without the express approval of the State Council of the People’s Republic of China, China’s highest administrative authority (PBOC, 1996). The rules also expressly prohibit any individual or agency/institution from requiring any lender to forgive loans without the State Council’s approval. Against this

background, restructuring proposals are unsurprisingly subject to intense scrutiny and handled with extreme care. This means that refinancing or reprofiling of default loans is the dominant restructuring option for Chinese lenders (Rudyak and Chen, 2021).

More informally, bilateral relationships can influence negotiations around loan contracts. For example, lenders often waive non-payment defaults if relationships are good and a reasonable explanation can be provided (for defaults that are financial in nature, this is far more onerous). The waiver fee, which is standard in US and European markets, is reportedly often discounted or waived if the overall relationship is strong and prospects of repayment remain robust. Beyond the lending relationships, however, we also see the importance of bilateral relations evident in high-profile loan restructuring, particularly where loan projects are politically salient, as with many BRI infrastructure projects. Where lending institutions may be recalcitrant to provide significant debt relief, this may require top-down political approval to authorise and coordinate lenders. In the case of Ethiopia, high-level meetings between leaders were critical to the decision to restructure the terms of the loan. However, even prior to restructuring, Chinese lenders (namely the Export-Import Bank of China) took a far more flexible stance around repayment deferrals compared to other creditors, given Ethiopia was considered a reliable partner (Chen, 2020, 2021). This kind of flexibility appears more discretionary than systematic, and cannot be relied on as a matter of course by sovereign borrowers.

What this implies is that the salience of legal clauses in the context of Chinese lending should be evaluated in a slightly different light to contracts in a European or American context, where contractual phrasings and legal obligations entail a much harder outcome. Transparency and an ongoing relationship of trust is valued by Chinese lenders, and can result in tangible benefits for the borrower in difficult times. It should not be discounted that, despite the proliferation of the use of special reserve accounts and clauses providing for their seizure in the event of default, in practice there have to date been no reported cases of this occurring on sovereign loans, despite Chinese creditors being legally entitled to do so.

Likewise, the application of confidentiality clauses does not extend beyond the sovereign laws of the borrower. Contracts cannot override mandatory legal requirements, and neither lenders nor borrowers are likely to agree on a provision which forces any party to break the law. As a result, the question of transparency, and whether any loan should be disclosed, will depend on the requirements of applicable local law and the borrower’s interpretation of what it needs to do to fulfil its obligations.

5 Conclusion

For emerging economies, over the last two decades China has become a viable and attractive alternative to loans from the traditional Paris Club and multilateral lenders. This is evident in BRI lending, much of which is driven by both state-to-state relationships and commercial viability.

While often compared with the Marshall Plan, the BRI is a decentralised initiative and does not benefit from the same kind of strategic coordination. Instead, there has been a dynamic akin to 'directed improvisation'. Government, quasi-government, quasi-commercial and commercial participants all operate in China's foreign lending market, with other stakeholders, such as lawyers, accountants and technical and financial advisors, each contributing to shaping market practice from very different perspectives. As a result, Chinese creditors' lending and documentation practices have developed in an organic, experimental and ad hoc way, rather than in line with a coordinated strategy.

As with China's broader growth model, there has been a process of 'crossing the river by feeling the stones': Chinese commercial lenders have had significant freedom to compete with each other by experimenting with novel approaches to lending and documentation for financing large projects in LICs. Approaches that worked and lessons learned were retained and disseminated to other stakeholders through the market. Over time, this has led to a greater degree of standardisation in lending and documentation practices among the more sophisticated Chinese commercial lenders, while entrenching differences in practices and documentation as compared to US and European lenders. Distinctive features, such as the use of pre-export finance models and collateralised lending, are remnants of this path-dependent process.

This paper has cast light on some of the nuances of Chinese foreign lending practices, and some of the historical and institutional factors behind the emergence of distinct practices in lending and documentation. The most important takeaway is that Chinese lenders may appear to operate in a way that is superficially similar to their US or European counterparts, but with different legal and regulatory considerations that can result in a fundamentally different approach to dealing with distressed borrowers.

All creditors seek to ensure they are repaid by the borrower. They do this through due diligence, maximising commercial leverage through

negotiations, and mitigating risks through documentation and credit enhancement. Chinese lenders are no different. However, compared to other lenders, the regulatory focus on repayment and institutional and personal accountability for loans means that Chinese lenders tend to give more weight to perceived long-term creditworthiness and the quality of the relationship with the borrower over technical contractual terms. Contractual terms should be evaluated within this broader relational context.

This focus on relationships also provides motivation for Chinese lenders to work flexibly with borrowers in genuine distress. At the same time, it can have the effect of penalising non-cooperative borrowers more significantly over the medium to long term. While institutions and individual bankers are generally highly motivated to reach a successful restructuring, past credibility also matters: a decision to restructure can be significantly delayed or derailed if stakeholders raise concerns arising from past dealings. In the context of Covid-19-precipitated debt distress, borrowers seeking to renegotiate with Chinese lenders should identify the key stakeholders and understand their motivations and limitations. As with all restructuring, borrowers should initiate discussions with the lender as early as possible and be transparent about their difficulties and objectives. With Chinese creditors, communication and commitment to an ongoing relationship is highly valued and can significantly contribute to a successful restructuring. In the longer term, increasing transparency and building capacity in debt management is also key in bolstering the credibility and leverage of negotiating borrowers, and this is an area where borrowing governments have unilateral agency.

Different lenders have different processes and approaches, but one common theme is that restructuring decisions are always subject to intense scrutiny. In the Chinese context, however, regulatory and institutional barriers for individual bankers around debt restructuring can entail a more rigid negotiation process, which means that, for borrowers in distress, seeking rescheduling or refinancing of existing debts is a more productive course. At a broader level, however, the regulatory, legal and institutional constraints highlighted in this paper also have difficult implications for Chinese lenders’ capacity to meaningfully participate in broader debt restructuring and multilateral debt relief initiatives. In the absence of political authorisation from the highest level, debt forgiveness remains highly unlikely.

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