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COLLATERALIZED TRANSACTIONS: RECENT DEVELOPMENTS AND POLICY CONSIDERATIONS

EXECUTIVE SUMMARY

This note provides an update to "Collateralized Transactions: Key Considerations for Public Lenders and Borrowers" prepared by the IMF and the World Bank (2020) in response to a request from the G20 IFA Working Group, to assess collateralized transactions from a development perspective**.** It restates the findings from that note, including the different dimensions collateralized transactions can take, how collateralized financing can benefit borrowers and lenders, and also the pitfalls associated with such arrangements. The note takes stock of recent developments, including how recent restructurings have been affected by the presence of collateralized loans, and the limited progress made in terms of addressing information and data gaps. It concludes with a discussion of a set of policy recommendations and a way forward.

The pros and cons of collateralized borrowing as discussed in the 2020 note remain relevant. Specifically, collateralized financing of projects where future revenue streams are directly linked to repayment under adequate disclosures that mitigate the risk of mispricing for both unsecured and secured creditors has the highest potential for benefiting the borrower and protecting the longer-term development relationship with creditors. Conversely, collateralized financing, even if related to a project, can cause more harm than good when one or more of the following criteria are met: (i) it does not improve borrowing terms; (ii) it weakens debt sustainability; (iii) it is not disclosed; or/and (iv) it does not respect negative pledge clauses.

This note contributes to the IMF and World Bank's Multi-Pronged Approach (MPA) to address debt vulnerabilities, which comprises pillars on transparency, capacity building, analytical tools, and international financial institution (IFI) policies for sustainable lending. It also underlines the need for greater transparency across borrowers and lenders, institutional capacity development in borrowing countries, and financing practices that protect longer-term development relationships between debtors and creditors.

The note highlights the limited progress that has been made in improving the transparency of collateralized debt data. The data of collateralized transactions are not collected systematically by borrowing country Debt Management Offices (DMOs) and are sparsely available for IFIs. Creditor-led voluntary disclosure efforts have not been very fruitful. The IMF Debt Limits Policy (DLP) requires reporting of related and unrelated collateral in the debt holder profile table accompanying country documents relating to program requests or reviews. However, reporting on collateral has been limited, including due to capacity constraints. The World Bank is currently revising its Debt Reporting System (DRS) template to identify which loans are collateralized, with effective rollout expected in 2025. Some incremental progress has been made through reconciliation with various external debt datasets.

The prevailing environment of high debt levels and associated vulnerabilities makes it even more important to carefully weigh the costs and benefits of collateralized transactions. This implies appropriate transparency and disclosures, and internalizing of all near-, medium-, and long-term costs of collateralization (including for future non-collateralized borrowing) before a cost-benefit analysis is done by borrowers of collateralized versus non-collateralized financing options.

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INTRODUCTION

1. **Collateralization of a debt instrument gives creditors rights over a borrower's asset or revenue stream** that in the case of default, could allow the creditor to secure repayment of debt. Any asset that can be identified, isolated, seized, traded, or provides a predictable cash flow can serve as collateral. These include physical assets such as buildings, ports, and industrial plants; as well as financial assets such as cash, stocks and negotiable bonds, irrevocable letters of credit, and certificates of deposit. Flows include receivables such as commodity trading, other export earnings, electricity generation charges, road tolls, telecom receipts, and lottery ticket sales.

2. **Used extensively in private sector financing, collateralized borrowing is also used by governments and sub-sovereigns.** In the private sector, collateralized financing is pervasive and is largely characterized (depending on the law governing the transaction) by enforceability, established resolution mechanisms, clear disclosures, and oftentimes, used by private stakeholders that are encumbered to a limited set of creditors. In particular, private collateralized project-financing is characterized by careful project design for ensuring viability and efficient use of financing. In contrast, sovereign borrowing is often not defined by project financing, being unrelated (such as budget financing). It tends to involve limited disclosure and information-sharing mechanisms especially in the context of a wider array of creditors to the public sector, creating issues around mispricing of risk for unsecured creditors and destabilizing resolution mechanisms by further complicating restructurings, especially by leading secured creditors to seek better terms. Moreover, private collateralized borrowing, when conducted by state-owned enterprises (SOEs) for commercial reasons, could have implications for the government balance sheet as a whole and as such be part of the perimeter of a sovereign debt restructuring, even if an individual project related to the collateral remains profitable.

3. **Given their highly complex and often tailored structures, the design of collateralized transactions can vary across a range of (overlapping) dimensions** as discussed in **"***Collateralized Transactions: Key Considerations for Public Lenders and Borrowers*" (henceforth "IMF and World Bank 2020")**:**

- **Collateral vs. quasi-collateral.** The legal nature of the repayment "protection" / credit enhancement that the creditor receives. Collateral entails the formal granting of a security interest or lien. Quasi-collateral does not entail liens but can have a similar economic effect. For instance, they give lenders a "first mover advantage" by being able to withdraw funds from a debtor's deposit/collection account ahead of other legally unsecured lenders.

- **Related vs. unrelated collateral.** The relationship between the collateral and the debt transaction. It is related when the asset being financed is also the one generating the resources used as collateral. Conversely, collateralized debt is considered to have unrelated collateral if the financing received is not directly linked to the purchase or construction of an asset, such as a budget loan collateralized with oil receivables.

- **Marketable vs. non-marketable instrument.** A collateralized debt instrument is considered marketable when it can be readily sold to a third party on the secondary market, such as notes, commercial papers, and bonds.[1]

- **Underlying collateral: stock vs. flow.** The underlying collateral can be: (i) an existing or future asset (stock); or (ii) a future stream (flow), also called future receipts or future receivables. Such a future stream can be measured in financial amounts (e.g., revenue from the sale of crude oil), or in physical amounts (e.g., barrels of crude oil).

- **On balance sheet vs. off balance sheet treatment of debt.** This relates to the accounting treatment of collateralized transactions. On balance sheet transactions involve the sovereign (or a public enterprise) directly pledging assets or receivables as collateral, which are kept on the sovereign (or the public enterprise's) balance sheet. Conversely, transactions that are routed through a special purpose vehicle (SPV) are indirect and not on the balance sheet of the sovereign or public enterprises, with the holders of the collateralized debt not having any relationship with the government of public enterprise.[2]

- **Transparent vs. opaque.** This relates to the level of disclosure to other creditors including IFIs and to the public. A transparent collateralized transaction involves adequate reporting and disclosure, allowing future creditors to correctly assess risks and lend sustainably. An opaque collateralized transaction can lead to problems in connection with debt sustainability, correct pricing of the risk by other creditors and compliance by the debtor with Negative Pledge Clauses (NPCs) in its other outstanding debt.[3]

4. Collateralized transactions have pros and cons, for both borrowers and lenders.

a. For lenders, using collateral can reduce the risk of non-repayment and decrease monitoring costs. Under perfect enforcement, individual creditors can use the underlying collateral to ensure repayment in case of default. This in turn may decrease the need to mitigate fiscal risks, decreasing associated monitoring costs.

However, collateralized transactions can:

[1]Marketable collateralized debt instruments tend to be subject to stricter oversight arrangements and are more likely to generate better borrowing terms and conditions than non-marketable, and hence illiquid, collateralized debt instruments (IMF and World bank 2020).

[2]SPV arrangements should be assessed on a case-by-case basis. It is possible that underlying legal documentation may grant investors claims on government resources in the event of default, notwithstanding the assignment of collateral to the SPV. Moreover, a determination should be made, based on the IMF's Government Financial Statistics Manual (GFSM) 2014, about whether the SPV is truly independent or if it should be classified as part of the general government. (IMF and World Bank 2020).

[3]A negative pledge clause is a covenant that limits a borrower's ability to pledge assets to other lenders. The covenant would typically define the scope of indebtedness covered and types of collateral as well as any remedies available to the affected lender in the event it was breached.

- **Be difficult to enforce.** For creditors, collateral on its own is insufficient to ensure repayment security unless it is enforceable. And enforcing liquidation or acquisition of the underlying collateral is not always straightforward, especially when the design of secured debt is complex or the relevant legal and institutional system is weak.

- **Reduce debt carrying capacity of the borrower.** Encumbering sovereign assets, and especially future flows, can reduce the sovereign's fiscal space and shrink debt carrying capacity. Specifically, collateralization can increase the risk of debt distress by: (i) constraining fiscal flexibility through ringfencing of resources (assets or revenues); (ii) increasing risk of overborrowing, especially in the absence of effective debt management; and (iii) constraining the borrower's ability to obtain unsecured financing especially after stress episodes, particularly when debt reporting has been opaque prior to the episode. Reduced capacity of the sovereign to carry debt can adversely affect a longer-term development relationship with creditors.

b. For borrowers, collateralized borrowing can:

- **Increase access to financing when conventional unsecured financing is not available.** This is especially true in times of liquidity crises, and as a bridge to conventional financing when immediate access to the latter is disrupted. Alternatively, the use of collateral may help the borrower secure financing greater than could be borrowed in the absence of collateral (and in the limiting case, the alternative to collateralized loan may be not getting the loan).

- **Reduce borrowing costs for a particular transaction.** The underlying collateral and enforceability of the collateralized debt agreement can in theory provide better terms to the borrower. However, Mihalyi et al. (2022) do not find evidence for lower interest rates on collateralized transactions compared to similar unsecured loans in Sub-Saharan Africa.

But collateral can lead to significant adverse effects, such as:

- **Raise transaction and administrative costs and contribute to transparency problems due to complex collateralization structures.** The legal and design dimensions of collateralized debt are typically more complex than conventional borrowing. This includes the additional layers of complexity and costs such as remuneration of financial intermediaries, legal fees, and non-monetary "costs," such as lender step-in rights, and other lender controls over the management and disposal of the secured asset. This complexity can increase both legal risks and transaction costs, contribute to opacity and increase scope for corruption.

- **Alter de facto seniority, discouraging lending by other creditors.** If collateralized debt receives better treatment, unsecured lenders would bear a disproportionately large burden of potential arrears, default, or debt restructuring. This may well lead to collateralized borrowing increasing the costs to the borrower as a whole (even as collateral reduces the costs of individual loans). This can be exacerbated by uncertainty over the extent of present and future collateralization.

Even under full transparency, the impact of collateral is inherently complex to price especially for other lenders not involved in the transaction.

- **Complicate a restructuring.** The possibility of restructuring provides an implicit method, albeit costly, for risk-sharing between borrowers and lenders. However, the presence of collateralized debt and the subordination of unsecured creditors can cause this risk to be borne disproportionately by the borrower and unsecured creditors. Secured creditors have weak incentives to negotiate given their access to collateral. This is especially true when collateral is easily enforceable (e.g., when financial collateral is stored in offshore escrow accounts). And once negotiations do start, secured creditors can demand more favorable terms in exchange for releasing their collateral. Such imbalances across creditors create complications for the comparability of treatment principle, which was reaffirmed as part of the G20 Common Framework for debt treatment beyond the Debt Service Suspension Initiative (DSSI) by all participating official bilateral creditors. Uneven burden-sharing can undermine creditor collaboration and the prospects for resolution. An additional source of inter-creditor tension is when the extent of the collateral is not known to all creditors and only becomes public after the restructuring process commences. Such a situation can undermine trust in the coordination process and add delays.

- **Exacerbate problems with other lenders due to improper disclosures.** Improper disclosures reduce oversight and can lead to high-risk premia on unsecured loans, while also affecting the sovereign's ability to ensure compliance with existing NPCs and permitted lien clauses.[4] Collateralized borrowing also has a potential impact on debt carrying capacity, cross-interactions with other borrowing (e.g., NPCs in unsecured borrowing), impact on access to financing from unsecured lenders after negative shocks, and complexity of designing collateralized debt (which requires a high degree of legal and technical capacity).

Box 1. Suriname Escrow Account

In the context of their request for an IMF-supported program in December 2021, the authorities confirmed to the IMF that no collateral had been provided and no escrow accounts had been funded with regards to external debt to be included in the perimeter of the restructuring.

As part of the first review under the IMF-supported program in March 2022, the authorities shared that a payment had been made from an offshore account associated with a US$ 94 million loan extended by China Exim to the government and on-lent to Telesur, a state-owned enterprise. That escrow account was not included in the original contract and only became known to the Ministry of Finance once the withdrawal was made. The authorities further confirmed that no other collateral arrangement was in place and that "Payment from the repayment reserve account for the Telesur loan will be reflected in the eventual debt restructuring to ensure there is comparability of treatment with other official creditors.[1]

[4]NPCs in debt contracts can disincentivize or limit collateralized borrowing. A breach of NPCs may give rise to an event of default under the terms of the bond or the loan agreement, and it may trigger cross-default provisions contained in other debt instruments (IMF 2003). In practice however, there can be monitoring and/or enforcement challenges e.g., due to lack of transparency and legal complexity.

Box 1. Suriname Escrow Account (concluded)

In January 2023, another erroneous payment was made through the escrow mechanism (repayment reserve account). In response, the authorities requested a full repayment and implemented further control measures to ensure such payments could not happen in the future. Notably, through a letter from the Ministry of Finance and a presidential decree, authorities have put safeguards in place to ensure that no payment to would be made before a restructuring agreement is concluded.

The presence of this collateralization has not proved a major obstacle to the restructuring efforts. However, the experience of Suriname illustrates how difficult it is to assess the extent of collateralization including across different government entities of the debtor, and that collateralized borrowing may only become visible once the restructuring process is underway and the collateral is called.

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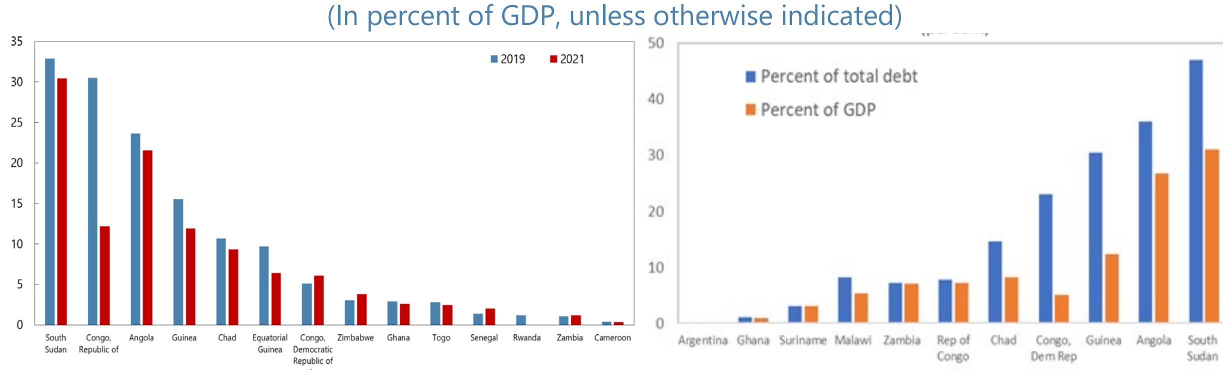
[1]See IMF Country Report No. 22/90. https://www.imf.org/-/media/Files/Publications/CR/2022/English/1SUREA2022001.ashx

RECENT DEVELOPMENTS

5. **Collateralized sovereign borrowing grew fast among low-income countries (LICs) before the pandemic but seems to have moderated recently.** Collateralized borrowing tends to be higher for non-investment grade or non-rated countries, or during tighter credit conditions. Albertin et al. (2023, forthcoming) surveyed a sample of 45 Sub-Saharan countries and found that 14 had collateralized borrowing, ranging from 1 to more than 60 percent of their external borrowing and averaging 8.4 percent of GDP as of end-2021, slightly lower than pre-pandemic levels (Figure 1, left panel). The IMF's Debt Limits Policy (DLP) database, which includes debt data required for all Fund-supported programs since June 2021, has so far collected data for 51 countries. Out of those, 11 have reported collateralized debt, averaging 16.2 percent of total debt and 9.7 percent of GDP (Figure 1, right panel). In recent years, LICs identified as being at higher risk of debt distress have also increasingly tapped into collateralized financing. Most commonly used forms of collateral are commodity resources, future revenue generated by projects and general government revenue, with natural resources such as oil and minerals as the main types of collateral used in these transactions.

Figure 1. Collateralized Debt Reported in Select Countries

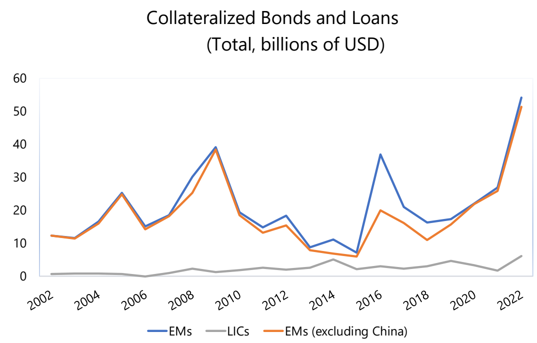
(In percent of GDP, unless otherwise indicated)



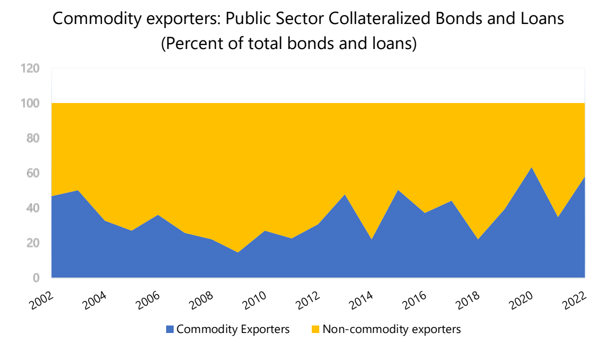
Source: Albertin et al. (2023, forthcoming), and IMF country reports, 2022-23.

6. Borrowing using collateralized bonds and securities has also increased, particularly for EMs. EMs tend to borrow externally through Eurobonds, which do not involve collateral (except for very rare exceptions), so on aggregate, collateralized borrowing is less of an issue for EMs. While EM SOEs may still use collateral for some borrowing, they tend not to aggregate to a large share of total external borrowing. However, EM borrowing with the use of collateral has increased since the pandemic. In general, collateralized borrowing has seen an uptick for commodity exporters with available assets that can be collateralized. Such cross-country data on LICs is sparse, but available market data shows that after a temporary drop in 2021, collateralized bonds and loans have picked up again in 2022 (Figure 2). However, such trend must be read with caution, as Dealogic has incomplete coverage particularly of non-marketable debt, which represents the majority of LICs' collateralized debt.

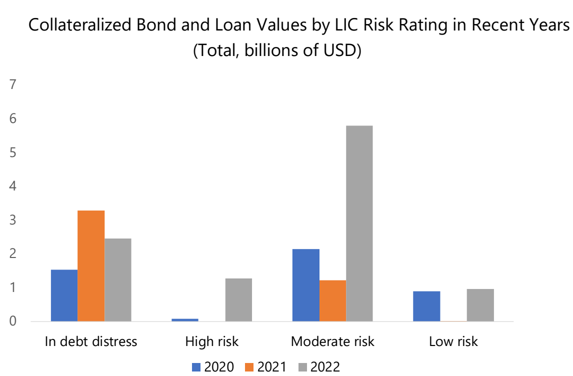
Figure 2. Collateralized Syndicated Bond and Loan Issuance



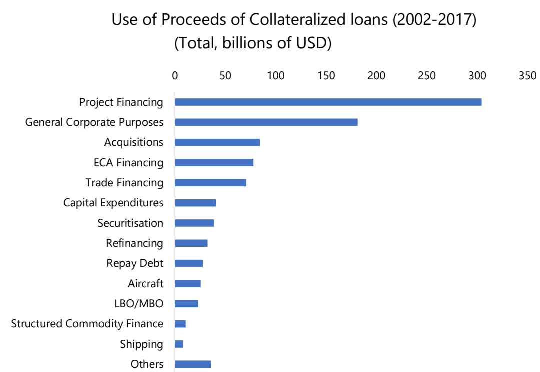
Source: Dealogic



Source: Dealogic.



Sources: Dealogic and Fund staff calculations.



Source: Dealogic.

7. Most countries with collateralized debt in the IMF's DLP database have experienced heightened debt risks, though the direction of causality can run both ways**.** Eight of the 11 countries that have reported collateralized debt in the IMF's DLP database use the joint Bank-Fund Debt Sustainability Framework for Low Income Countries (LIC-DSF), and six out of them have recently been assessed to be in debt distress or at high risk of debt distress. Among them, three have requested a debt treatment under the G20 Common Framework (Chad, Ghana, and Zambia). The remaining three countries use the Sovereign Risk and Debt Sustainability Framework (SRDSF) with two assessed to be at high risk of debt distress, while all three have gone through some form of debt restructuring since 2020.[5]

Table 1. Collateralized Borrowing and Risk of Debt Distress

Country	Last Reported in DLP	Risk Of Overall Distress 1/	Debt Treatment 2/
Angola	Jan-22	N.A.	Yes
Argentina	Apr-23	High	Yes
Chad	Jan-23	High	Yes
Congo, Dem Rep	Jul-23	Moderate	
Ghana	Mar-23	High	Yes
Guinea	Jan-23	Moderate	
Malawi	Nov-23	In distress	Yes
Rep of Congo	23-Jun	In distress	Yes
South Sudan	Mar-23	High	
Suriname	Mar-22	High	Yes
Zambia	Jul-23	In distress	Yes

1/ Results are from either latest assessment from SRDSF or LIC-DSF.
2/ Debt treatment includes debt restructuring that took place since 2020.

Sources: DLP database, LIC-DSA database, SRDSF database, Bank and Fund staff calculations.

8. **Collateralized debt has increased the complexity of some recent debt restructurings.** For example, exclusive oil prepayment contracts led to protracted restructuring negotiations in the case of Chad. In fact, lenders holding significant control over commodity acquisition and distribution often have strong leverage during restructurings, as they are frequently awarded the right to also sell future commodity shipments on behalf of the government. When commodity traders offer pre-sale facilities for instance, they retain proceeds from the sale of the commodity to reimburse themselves first. In such cases, the authorities' options are limited to revoking the trader company's offtake agreement or preventing the delivery of some cargoes,[6] but such options may not be credible given the potential economic losses to the borrower.

[5] None of these refer to DSSI rescheduling.

[6] See negotiations between the Republic of Congo and oil traders in 2018.

Box 2. Protracted Debt Restructuring Negotiation for Collateralized Loans

Chad's multiple restructurings illustrate the difficulty for a debtor to negotiate with commodity traders. The loan contracted between Chad's national oil company (SHT) and Glencore was collateralized by oil. This factor contributed to the prolongation of the debt restructuring negotiations under the Common Framework, which lasted nearly two years.

Malawi is another example where debt was assessed as unsustainable, and the presence of collateral has complicated its restructuring. The loans from AFREXIM Bank include collateral and continued to be serviced, even as Malawi went into arrears on its debt to another creditor (Trade and Development Bank).[1] Collateralization has contributed to slow progress in the restructuring despite over a year of engagement with the creditors.

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[1]IMF Country Reports No. 22/352 https://www.imf.org/-/media/Files/Publications/CR/2022/English/1MWIEA2022001.ashx and 23/299 https://www.imf.org/-/media/Files/Publications/CR/2023/English/1MWIEA2023001.ashx.

PROGRESS IN ADDRESSING INFORMATION AND DATA GAPS

9. There has been very limited progress in improving the availability of data on collateralized debt. Often, the full extent of collateralization only becomes known in the context of debt distress.

10. Across EMDEs, lack of transparency is a key impediment in monitoring collateralized transactions. The terms of collateralized transactions are not collected systematically by borrowing country Debt Management Offices (DMOs), are sparsely available for IFIs, and creditor-led voluntary disclosure efforts have also fallen short. Often, the existence of collateralization only becomes known in the context of debt restructurings. Limited progress in improving the availability of data and reporting standards has been achieved so far.

11. Debtor DMOs are often not exercising close oversight of collateralized transactions. Such loans are often borrowed by SOEs or SPVs with limited or no DMO involvement, neither as approving nor as recording entity. The administration of collateral-related clauses is also typically outside the DMO's purview: when they are aware of such loans, they do not maintain records related to the collateral and do not necessarily monitor compliance with collateral clauses (e.g., ensuring that income flows, assets, or balance used as collateral meet needed thresholds).

12. The IMF Debt Limits Policy (DLP) requires reporting of related and unrelated collateral in the debt holder profile table. Implementation over the past couple of years has yielded some results, as discussed in Section 2. However, there were still a few cases (e.g., Cameroon, Senegal, and Togo) where no data was reported despite the presence of collateral being publicly known. There have been efforts to improve reporting, but country authorities point to capacity constraints as well as the need for more guidance as to the scope of collateral to be reported (some types of collateralizations may be in the grey zone).

13. Coverage under the World Bank Debt Reporting System (DRS) has also been limited. Reporting under the World Bank DRS is currently unable to identify which loans are collateralized, as the current template used by borrowers to disclose the terms of new loans does not include fields on collateral-related features. An effort is underway to update the DRS template, but its rollout is not expected until 2025. Since the DRS is de facto the main compulsory public external debt database,[7] the reform of its template may have a significant impact on the disclosure of collateral going forward. In the meantime, progress has been made in closing the previously reported gap in coverage of known collateralized transactions through reconciliation with various external debt datasets and retrospectively adding the missing loans.

14. The latest Extractive Industries Transparency Initiative (EITI) encourages its members to disclose details of barter transactions and resource-backed loans since 2021 (EITI 2021). Participation is voluntary among its more than 50 member governments. Voluntary disclosures include some high-profile cases such as Chad, Guinea, the Democratic Republic of Congo, and the Republic of Congo. However, many other countries that have known and relatively large, collateralized debt have not publicly disclosed the contents of relevant loan contracts.

15. Creditor-led initiatives to foster debt transparency have so far fallen short. The OECD Debt Transparency Initiative (DTI) for voluntary reporting of private creditors on their lending to sovereigns and SOEs in LICs, includes reporting on collateral.[8] Participation has been limited so far (six loans by two banks as of June 2023), with no reporting of any collateralized transactions. Multiple G-7 members have set up their own loan-by-loan repositories and that of the US Treasury include fields for collateralization features, but so far neither have disclosed any collateralized transactions – the entities involved are not known to rely on collateralized lending.[9] One prominent commodity trading firm has started disclosing the terms at which it provides commodity prepayment facilities to various SOEs (Trafigura Group 2023).

16. Academic institutions have been documenting collateral and quasi-collateral features in debt contracts from Chinese creditor entities. Recent studies (e.g., Gelpern et al., AidData) and related databases that rely on mixed sourcing have so far provided the most detailed account of key contractual features. While such sourcing remains partial and not necessarily representative, it reveals both the complexity of such transactions and the wide range of types of collateral applied. While the studies cited above focus on lending by China, other official creditors as well as commercial creditors use collateralized features in their lending.

[7]Countries that have borrowed at least once from the World Bank are required to meet certain reporting obligations, including the completion of DRS standardized templates on their external public and publicly guaranteed (PPG) debt on a quarterly and annual basis.

[8]This portal provides data collected from creditors based on the 2019 IIF Voluntary Principles for Debt Transparency.

[9]Based on the G20 Operational Guidelines on Sustainable Financing (2020).

CONSIDERATIONS FOR MITIGATING RISKS AND ENHANCING BENEFITS OF COLLATERALIZED BORROWING

17. The IMF and World Bank 2020 note highlighted conditions under which collateralized borrowing can be beneficial for borrowers. The conclusions from that paper remain relevant and can continue to guide policy makers. These conditions include:

- **The transaction generates assets and/or revenue streams that can be directly used for repayment.** This ensures lower risk to the borrower and more sustainable financing. It can also reassure unsecured creditors, to the extent that the collateralized borrowing does not violate NPCs.

- **Reduced risk to creditors due to collateralization is reflected in better financial terms.** All else being equal, borrowers should ideally opt for unsecured borrowing if better financial terms are not obtained on collateralized financing, unless access to unsecured borrowing is disrupted and borrowers are forced to tap into collateralized borrowing as bridge financing. Even then, careful consideration should be given to the near- and medium-term impacts of collateralized borrowing.

- **A rigorous debt sustainability assessment is implemented and passed, which fully incorporates the collateralized transaction.** Transparency is key for such an assessment. The debt sustainability assessment should also account for the effect of collateralized borrowing on other sources of financing such as unsecured debt, with an eye on solvency and liquidity.

- **Collateralized transactions are accurately reported in debt statistics and are fully and publicly transparent on all contractual terms to the extent possible.** This is critical both for informing a robust debt sustainability assessment and to ensure that the borrower's credit risk is accurately priced. In the event of a restructuring, surprises such as the discovery of unreported debt – especially collateralized debt – can put significant upward pressure on spreads, worsen the liquidity situation of the borrower, and complicate and potentially drag out the restructuring process further.

- **Collateralization respects and complies with any applicable Negative Pledge Clauses (NPCs).** This ensures that collateralized borrowing does not impinge on prior rights of unsecured lenders, avoiding the risk of negative financial consequences to the borrower and ensuring smooth functioning of the long-term relationship between borrower and lenders.

18. Transparency appears as a critical feature. This is true not only to the extent that it improves accountability of decision makers, but also because it makes monitoring and hence, pricing of risk by other creditors easier. In that regard, transparency is a key dimension that can complement and enhance all the considerations above. On the other hand, since collateralized debt is often contracted in scenarios where the borrower has limited market access or limited funding sources, there is a significant risk of poor negotiation outcomes, given the asymmetry in bargaining power and capacity between borrowers and lenders. This risk is higher when the outcome is subject to limited public awareness and there is, therefore, little scrutiny and accountability by the borrowing government (World Bank 2022).

19. There is significant scope for improving reporting by borrowers. Many collateralized transactions are not reported at all, and the extent of collateralization is rarely disclosed. For example, debt restructuring negotiations involving Malawi and Suriname revealed previously undisclosed collateral. Enhanced reporting and disclosure of external debt contracting can help identify such transactions. Most low-income countries routinely publish debt bulletins, but none touch on collateral.[10] However, some countries (such as Sierra Leone) publish their full debt contracts online, which enables dedicated third parties to identify collateralized transactions. Angola disclosed its collateralized debt in bond prospectuses. Mitigating measures by borrowers include developing legal framework and systems that can help record and disclose information on collateral.

20. Collateralization involving unrelated assets or revenues, when undertaken on a large scale to finance government consumption, is likely to create problems. Project finance-related collateralization can generally be designed to be beneficial, but this is far from a sufficient condition. Ideally, project finance is invested into an asset that generates sufficient returns to repay the loan, allowing the collateral to be left untouched. Even in the best-case scenario, such collateral can still carry costs such as complicating an eventual restructuring and discouraging other creditors to the extent that the project cannot be seen in isolation to the public balance sheet. Such sustained borrowing increases the risk of a liquidity crisis by increasingly subordinating unsecured lenders, adversely affecting fiscal discipline, and reducing fiscal space as the stock of collateral gets progressively encumbered.

21. Enforcement of standards and guidelines for debt reporting developed by IFIs to promote accurate and timely debt reporting, such as by using Public Sector Debt Statistics Guide for Compilers and Users (PSDSG), is challenging. This is especially true for international debt reporting and transaction-level disclosure standards with respect to collateralized and quasi-collateralized borrowing, which should be reported in accordance with the Government Finance Statistics Manual 2014 GFSM 2014 and the PSDSG, and overarching debt transparency standards also set up in the IMF's Fiscal Transparency Code (FTC). Collateralized borrowing is often excluded from debt statistics because it is often not systematically recognized and classified as debt by the borrower.[11] Further, off balance sheet debt incurred by SOEs or SPVs can fall through the cracks. Additionally, international databases do not currently require countries to report the collateralization features of debt (World Bank 2022).

22. The use of escrow accounts should consider debt management benefits as well as the cost in terms of cash management. Kenya's Standard Gauge Railway project financed in 2014 is an example of using rail traffic revenues deposited into an escrow account to facilitate debt servicing.

[10]Debt Transparency: Debt Reporting Heat Map (https://www.worldbank.org/en/topic/debt/brief/debt-transparency-report)

[11]While there are some transactions that may be hard to classify (i.e., may fall into a grey zone), many of the transactions where collateral is not reported fall very clearly into category of collateralized borrowing.

While an escrow account could assure creditors that resources are not diverted away from debt servicing, in particular in the case of lower credit worthiness or institutional capacity, it is important not to overcollateralize, especially when the country faces high interest rates. The use of escrow accounts to enhance creditors' control over the cash windfall could also delay the resolution of sovereign restructurings, as in the case of Chad and the Republic of Congo.

Table 2. Selected Loan Contracts with Special Accounts

Loan	Loan amount	Minimum account balance	Source
Ecuador – CDB, 2010	US$ 1 bn	Initial amount: US$ 50 m Long Term Required Amount: US$ 113 m.	Contract p. 4
Ghana – Sinohydro, 2018	US$ 390 m	"The aggregate amount of the two upcoming Repayments"	Contract p. 21
Guinea – ICBC, 2020	US$ 546 m	Required amounts not public, but US$ 80m balance kept in 2020	Contract p. 12
Rep Congo – China Exim, 2006	US$ 1,600 m	20% of outstanding loans	IMF report p. 9
Suriname – China Exim, 2016	US$ 94 m	Required amounts not public, but US$ 2.9 m balance was kept in Feb 2022	DMO report p. 8 IMF report p. 19

Source: Mihalyi and Rivetti (2023, forthcoming).

23. The possible benefits of overcollateralization should be weighed against their risks. In fact, certain types of financial collateralization can also have specific detrimental effects on restructurings. It is the case for instance, of repurchase agreements (repo) transactions, backed by the borrowing countries' own bonds. These repos may be over-collateralized to achieve the expected cost-reduction. Because these deals are usually marked-to-market, when borrowing costs rise, governments are required to top up the collateral significantly. Similar margin calls can apply to other types of securities or commodities used as collateral. Since this is especially true in the case of default and restructuring scenarios, governments have a strong incentive to repay such loans in advance when facing sovereign stress, giving these claims de facto priority over other creditors, and depleting foreign exchange resources.

Box 3. Ecuador Over-Collateralized Repo

In 2018, Ecuador issued four-year repos with Goldman Sachs and Credit Suisse to cover funding gaps during difficult financial conditions. The transactions involved over-collateralizing the amount borrowed with bonds never included in public debt statistics. The amount of bonds pledged was US$ 2.4 billion against US$ 1 billion received. Although the repo interest rates were over 300 bps below Eurobond market rates at the time, Ecuador saw the true costs of the repos rise due to margin calls linked to the marking-to-market of the financial collateral. In May 2020, Ecuador agreed to repay the full repo, so these securities were not included in the eventual restructuring with commercial creditors, but the repayment reduced the country's foreign exchange reserves.

Source: World Bank Debt Transparency on Developing Countries, 2022.

24. Borrowers should implement a robust institutional and legal framework to ensure the safeguarding of the sovereign's debt sustainability and fiscal position, creditors' rights, and longer-term development objectives. A robust review and assessment of contractual terms is important and should be supported by actions to boost capacity. Further, strengthening governance and ensuring transparency, public disclosure, and accountability can enhance the benefits of collateralized transactions and minimize harmful effects. A key first step is to have more stringent authorization procedures for loans involving collateral. For instance, ensuring that the DMO is represented in all discussions pertaining to collateral, even with SOEs or agencies outside of the central government, can facilitate oversight.

POLICY RECOMMENDATIONS AND NEXT STEPS

25. Borrowers should enhance technical capacity and improve governance of collateralized transactions:

- **Establish sound governance frameworks for approving and managing collateralized transactions.** A key first step is to ensure that collateralized borrowing involves more stringent authorization procedures than regular borrowing. This would require agencies and procedures for reviewing the proposed transactions, authorizing the borrowing, monitoring the execution, and timely reporting of relevant transactions. The framework should be able to assess the terms and conditions of the transactions, evaluate their consistency with the overall debt strategy, identify sources of risk, and promote transparency and accountability. To help limit risks from these transactions, countries should specify the types of collateral that can be used and the limits on borrowing. They should also avoid over-collateralization.

- **Build capacity to evaluate collateralized transactions.** Borrowers should conduct comprehensive cost-benefit analyses to determine which types of collateral are most beneficial, whether the terms and conditions of collateralized loans are standard, and what are the long-term impacts of such borrowing. DMOs may seek to work more closely with SOEs typically involved in collateralized transactions. Borrowers should exercise caution with non-standard contract terms and seek technical or legal advice to avoid unwanted outcomes.

- **Enhance communication and coordination with creditors.** Since collateralized transactions could potentially infringe on the rights of other creditors, it is important to ensure such transactions are disclosed properly to all creditors to avoid complications in the future. Countries should be aware of the possible legal implications of non-disclosure (for instance, under NPCs). Close communication with creditors and other development agencies to understand the legal implications on such borrowing would be very beneficial in this respect.

- **Disclosure of loan contracts provides an alternative transparency regime.** A number of collateralized contracts are now in the public domain including long-term prepayment facilities from commodity traders secured by oil cargoes and from Chinese SOEs with escrow account arrangements (see Table 2). This can be the result of voluntary, routine publication of loan contracts as already exercised by some LICs such as Sierra Leone. Contract publication can also be part of the additional oversight requirements in the approval of collateralized transactions.[12] Similarly, disclosure of collateralization in bond prospectuses (e.g., Angola March 2022 Global Medium Term Note Programme) is also a best practice.

26. Lenders should enhance transparency and coordination with other creditors to:

- **Improve disclosure.** Lenders should make these transactions more transparent. Ideally, greater transparency would apply not only to loans going forward, but also the existing stock (for example, by releasing the borrower from the constraints of Non-Disclosure Agreements). Lenders should also make sure the terms and conditions of the loan are consistent with local legislations and industry standards and avoid any non-standard terms and conditions that might complicate potential debt negotiations. The variety and complexity of collateral or quasi-collateral features observed underscores the difficulty in implementing uniform disclosure standards. Such standards in theory could help DMOs keep these records into debt recording systems, as well as facilitate creditor disclosures and data collection by IFIs. Key preconditions include (i) sufficient capacity at the country level, (ii) a legal and operational framework conducive to debt data collection, and (iii) centralization at the DMOs.
- **Strengthen coordination with other creditors.** Comparability of treatment across creditors is a key principle of debt restructuring negotiations and lenders should understand the implications that collateralized transactions can have on the existing resolution framework. Conforming to widely accepted disclosure requirements among creditors and abiding by local legislative requirements will not only generate valuable information to assess debt conditions of a borrowing country but also help a smoother debt restructuring negotiation if needed.

27. IFIs should promote transparency and support sustainable lending practices to:

- **Strengthen reporting platforms.** The IMF Debt Limits Policy requires all program countries to report collateralized transactions. These requirements could be more strongly enforced. The World Bank DRS also records loan-level information but inclusion of information on collateral will be an

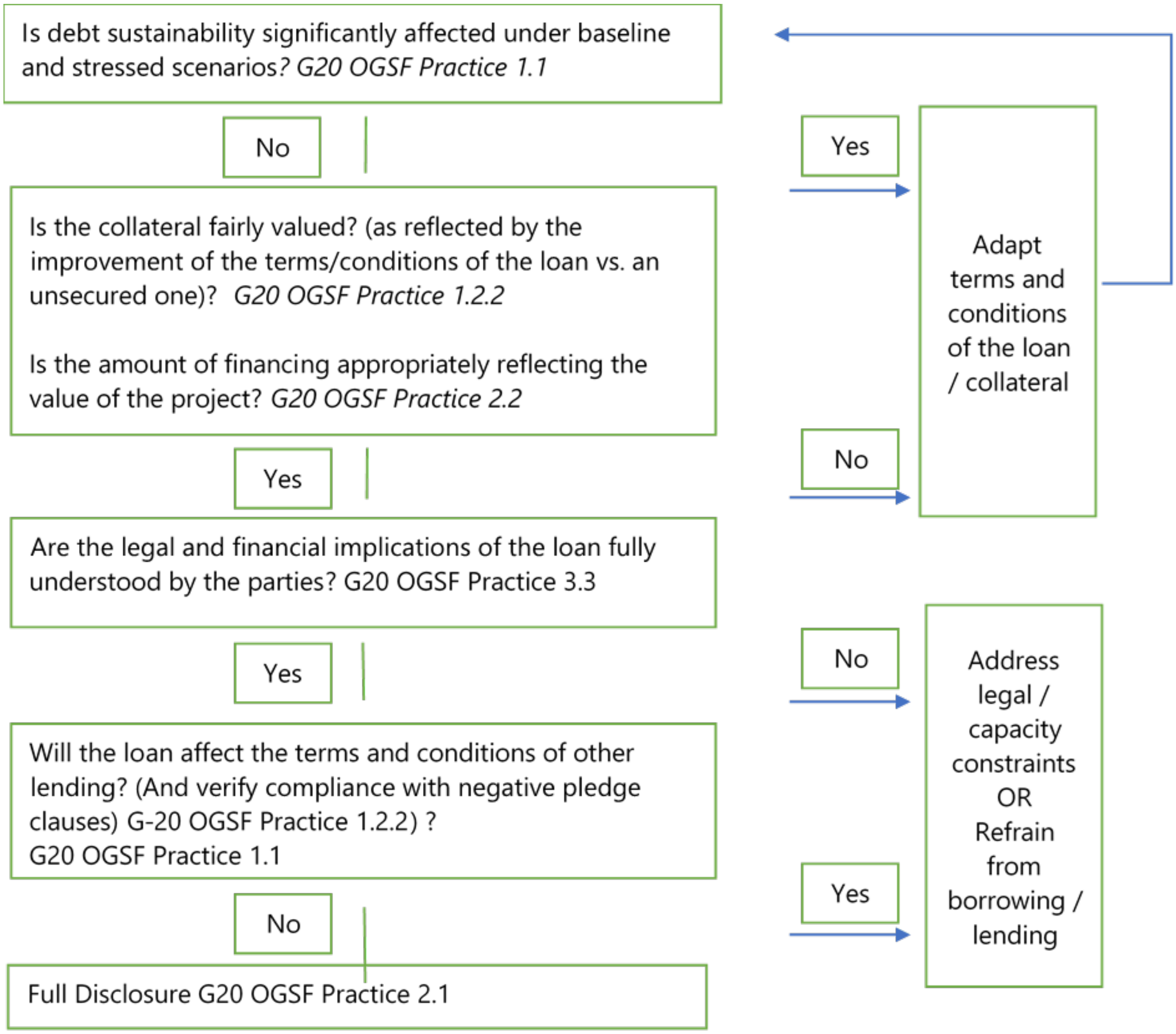
[12] Any information deemed commercially sensitive or infringing on national security can be retracted.

important next step. Coordination between IFIs regarding the consistency of definitions and reporting requirements is also important.

- **Enhance capacity building.** Training should be provided to both borrowers and creditors to help them better understand the definition of collateral and establish regular reporting systems. Technical assistance should focus on improving the borrowing countries' capacity to evaluate such transactions and establish a robust governance framework. Training on the debt sustainability assessment tools used by the IMF and World Bank can also improve understanding of the overall risk assessment approach during multilateral debt restructuring negotiations and how collateralized transactions fall into this framework.

Annex I. Borrowers and Lenders Decisions on the Use of Collateral

Figure AI.1. Borrowers and Lenders Decisions on the Use of Collateral



Sources: IMF and World Bank (2020).

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