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Political risk, project finance, and the participation of development banks in syndicated lending

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ABSTRACT

How should loan contracts for financing projects in countries with high political risk be designed? We argue that non-recourse project finance loans and the participation of development banks in the loan syndicate help mitigate political risk. We test these arguments by conducting a study with a sample of 4978 loans made to borrowers in 64 countries. Our results show that if political risk is higher, then project finance loans are more likely to be used, and development banks are more likely to participate in the syndicate. We also show that the terms of the loan contract depend not only on the political risk but also on the legal and institutional environment as well.

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1. Introduction

How should a company finance a project located in a country in which political risk is high and in which investor protection is weak? Such a project will only be realized if the risk can be reduced to a bearable level. Coasian bargaining theory and a growing number of empirical studies on law, institutions, and finance clearly show that loan contracts can be designed to mitigate deficits in the legal and institutional environment and thereby provide the project with access to finance. The following case illustrates how a loan contract can help mitigate political risk:

> The South African petrochemical group Sasol opts for a unique hybrid project finance structure to finance a gas field project in Mozambique. Under this hybrid structure, lenders initially have full recourse to Sasol, which assumes almost all project-related risks. The sole – but important – excep-

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tion is the project's political risk. The loan contract specifies that, if well-defined political risk events occur, the financing structure automatically changes from the full-recourse structure to a project finance structure. In this case lenders have recourse only to the project but no longer to Sasol. Cadwalader (2004), the project's legal consultant, emphasizes the role of development banks in actively mitigating political risk: "Sasol would like to maximize the influence that the political risk providers [...] bring to the deal – their ability to exert political pressure on, in this case, the Mozambican government to prevent or cure a political risk event."

This case shows that there are two important features of the loan contract for managing political risk. First, the degree of recourse that the lender has helps manage political risk. In this respect, we discriminate between full-recourse loans and non-recourse project finance loans.[1] Second, the participation of development banks in the loan syndicate also helps manage political risk. Development banks provide a so-called "political umbrella" because these banks can use their leverage to influence governmental decisions and deter adverse events that would negatively affect the project's outcome.[2]

This paper analyzes the determinants of these two features of the loan contract, i.e., its recourse structure and the participation of a development bank in the loan syndicate. We base our tests on a sample of 4978 loans made to borrowers in 64 countries from 1996 to 2005. We run logit and multinomial logit regressions to explain how the two loan characteristics depend on political risk as well as the legal and institutional environment. The results clearly show that higher political risk increases the probability that project finance loans will be used and that development banks will participate in the syndicate. We also exploit major changes in political risk to validate the results of the cross-country regressions via a difference-in-difference approach. Our study demonstrates that the design of a loan contract is determined by not only the legal and institutional environment but also by *political risk*.

Our study contributes to the growing literature on the effects of *country-level risks* on the design of loan contracts. Some studies investigate how law and institutions determine one particular feature of the contract. Esty and Megginson (2003) show that strong creditor rights and reliable legal enforcement are correlated with smaller and more concentrated syndicates. More recent studies emphasize the importance of studying more dimensions of the loan contract to capture its complexity. Qian and Strahan (2007) provide evidence suggesting that stronger creditor rights lead to a more concentrated syndicate structure, longer maturity, and lower interest rate. Bae and Goyal (2009) show that both creditor rights and the enforceability of a contract affect loan size, maturity, and interest rate. However, none of these papers explicitly address the role of political risk. There is evidence only for the rating and pricing of corporate bonds that political risk matters (Qi et al., 2010).

As the Sasol case shows, political risk is critically important to the design of the loan contract, particularly in risky countries. Therefore, we contribute to the literature by investigating how political risk influences the choice between project finance and full-recourse loans and the syndicate structure of these loan contracts. Our paper is closely related to Subramanian and Tung's study (2009). They show that project finance loans are more often used in countries with weak creditor rights and poor protection against insider stealing. In contrast, we investigate political risk in more detail while controlling for the legal and institutional environment. We explain not only the use of project finance loans but also the participation of development banks in the loan syndicate. This latter feature is not considered in the existing literature, with the exception of Esty and Megginson (2003). These researchers use the participation of development banks as a control variable while explaining the syndicate structure of project finance loans.

Our study yields two main results. First, we show that projects in countries with higher levels of political risk are more likely to be structured as project finance loans and that development banks are more likely to participate in the syndicates. This finding suggests that the particular features of the project finance structure – i.e., separate incorporation, high leverage, and extensive contractual

[1] In this study, we will use the terms 'project finance' and 'non-recourse loan' synonymously and in contrast with the term 'full-recourse loan'.

[2] However, there are two arguments against a state-contingent financing structure, which may explain why this deal structure is not commonly used. First, how one can define specific political risk events ex ante is unclear. Second, the switching provision limits the incentives of banks to mitigate political risks in situations in which a predefined risk event occurs. Thus, the provision does not exploit the political umbrella of the development banks.

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