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Research Report

How Africa Borrows From China: And Why Mombasa Port is Not Collateral for Kenya's Standard Gauge Railway

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POLICY POINTS

As a middle-income country, Kenya is moving beyond the world of foreign aid. China Eximbank operates like a commercial bank. Understanding this world requires new tools and language.

Chinese **loan contracts allow disclosure** when required by borrowers' laws. Kenya's Constitution is ambiguous on this point. Parliament might consider legislation requiring loan contracts to be routinely published in a government gazette

Understanding how complex, international commercial loan contracts work is a daunting, but necessary, step for civil society, researchers, and media professionals who want to understand how China lends.

How Africa Borrows From China: *And Why Mombasa Port is Not Collateral for Kenya's Standard Gauge Railway*

Deborah Brautigam, Vijay Bhalaki, Laure Deron, and Yinxuan Wang

IN DECEMBER 2018, RUMORS BEGAN CIRCULATING that Kenya had staked its valuable Mombasa Port as collateral for US\$ 3.6 billion in Chinese loans for the Standard Gauge Railway (SGR). New research from CARI shows why the collateral rumor is wrong. A CARI team of scholars and practitioners of international commercial law, auditing, and project finance spent nearly two years collecting and investigating all available SGR contracts and documentation.¹

Solving the mystery of the collateral rumor through reconstructing the contractual arrangements also allowed the team to diagram for the first time how China Eximbank and its borrowers structure financing relationships and payment flows in a large Belt and Road Initiative (BRI) project (Figure 1), blending project finance into sovereign loans.

The collateral rumor originated in a critical mistake by Kenya's Auditor General (AG). In a routine audit, the AG wrongly labeled Kenya Ports Authority (KPA), owner of Mombasa Port, as a "borrower" responsible for repaying the China Eximbank SGR loans. The AG—and many others—also misunderstood the "waiver of sovereign immunity" clause signed by Kenya's National Treasury, KPA, and Kenya Railway Corporation (KRC). Instead of a deliberate debt trap, we find that the railway project was carefully and creatively designed to reduce the risks of a sovereign default and enhance the bankability of a project with high costs but significant long-term benefits for Kenya and the region.

BACKGROUND

THE SGR, THE FIRST STAGE OF THE EAST AFRICAN Community's [2004 Master Plan](#) for railway modernization (Figure 2), became a flagship project of China's BRI in 2013. The rumor that Kenya had used Mombasa Port as collateral for the SGR originated in a [leaked letter](#) from Kenya's AG, who was completing the [2017/18 audit of KPA](#). The AG warned that KPA's assets—of which Mombasa Port is the most valuable—risked being taken over by China Eximbank if Kenya defaulted on the SGR loans.

¹ All of these terms are explained in more detail in the working paper accompanying this brief, which also contains detailed notes and sources - access [here](#) or <https://tinyurl.com/y9ws7hd3>.

Fears that China planned to seize the valuable port if Kenya defaulted on the railway loan fit into the “debt trap diplomacy” conspiracy theory (the idea that China was deliberately extending loans that could not be repaid in order to seize borrowers’ strategic assets) that was then [widespread](#) and [essentially unchallenged](#). The Chinese and Kenyan governments both denied that Mombasa Port was collateral but offered no explanation.

MAPPING THE PROJECT STAKEHOLDERS AND FINANCES

FOR MANY OBSERVERS, THE DEBATE OVER the SGR and Mombasa Port was complicated not only by geopolitics, the lack of transparency around the public contracts, and a deep trust deficit between Kenya’s government and many of its citizens, but by technical terms and practices used routinely in the law and business of international project finance.

Figure 1 maps the four key stakeholders in the financing of the SGR—Kenya’s National Treasury (the Borrower), KRC (the project company), KPA (the main customer, and owner of East Africa’s premier port) and China Eximbank (the Lender)—diagramming their contractual and payment arrangements.

As a [UK law firm](#) notes, most complex international project financings in emerging and frontier markets require credit enhancements. These back-up means of financial support reduce repayment risks and align the incentives of the various parties.

Kenya’s National Treasury explained the SGR’s financing arrangements and credit enhancements in some detail in a [2013](#)

[briefing](#) to Kenya’s parliament. The government expected to repay the loans through the SGR’s operational revenues “to the extent possible” but had arranged several credit enhancements. KRC (owner of the SGR) and KPA signed a 15 year “take or pay” agreement (TOPA). Every year, KPA promised to ship a specific amount of freight on the SGR (i.e., “take” shipping services from KRC) or make up (“pay” to KRC) the shortfall.

The new railway added value to KPA’s goal of enhancing its competitive position in East Africa’s shipping market. The TOPA contract gave KPA a contingent liability, and an incentive to bring cargo smoothly from Mombasa Port onto the SGR. If cargo levels dropped below levels spelled out in the TOPA agreement, KPA, a profitable company, would draw on its own revenues to pay KRC. KPA is thus the SGR’s major client, not its collateral.

Kenya’s government also set up the Railway Development Levy (RDL), a tax on all imports into the country, as a credit enhancement. Kenya’s National Treasury [confirmed](#) that the RDL “will act as insurance in case revenues under the take-or-pay arrangement [TOPA] falls short of the amount required to service the loan.”

THE AUDITOR GENERAL’S MISTAKES

TO OUR SURPRISE, OUR TEAM FOUND that the collateral rumor stemmed from a seemingly tiny but critical misreading by the AG. The AG mistakenly labeled KPA as a borrower, responsible for repaying the SGR loans. Relatedly, the AG misunderstood how a waiver of sovereign immunity, a standard feature of international commercial project finance, works. He charged that Kenya’s government had “waived immunity” on the KPA’s assets and “expressly guaranteed” that they could be used to repay the Chinese loan. The AG was mistaken in both charges.

(1) WAS KPA A BORROWER, LEGALLY RESPONSIBLE FOR LOAN REPAYMENT?

One of our most important findings is that the AG was mistaken to call KPA a borrower. If KPA was a borrower, it would mean that KPA had co-signed the Chinese loans and was equally responsible for repayment. But KPA is not in any sense a borrower.

Clause 17.5 of the four party Payment Arrangement Agreement quoted by the

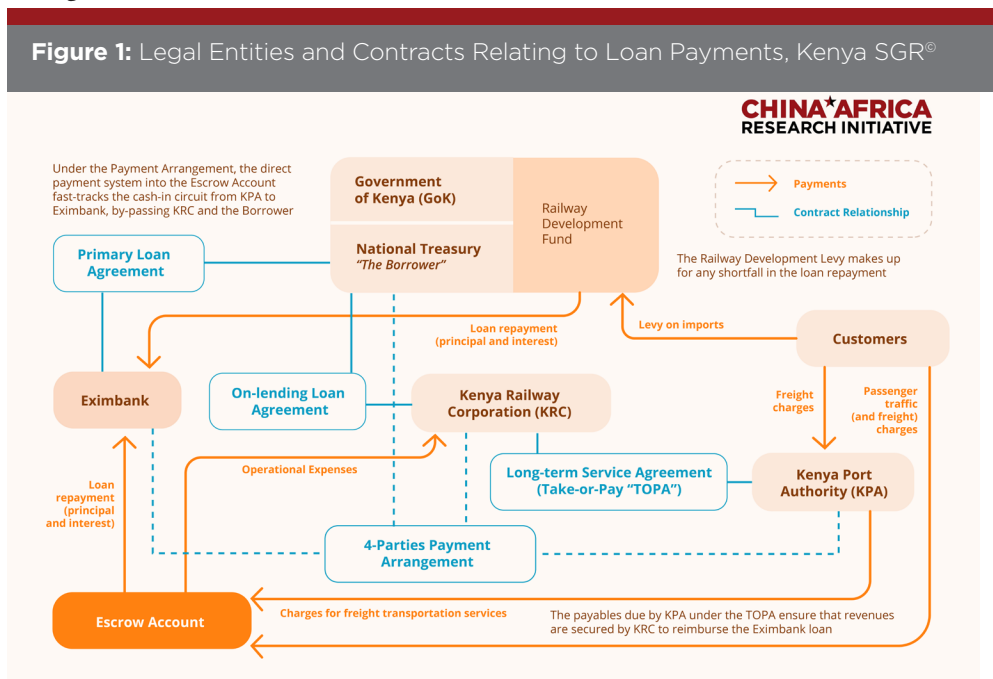
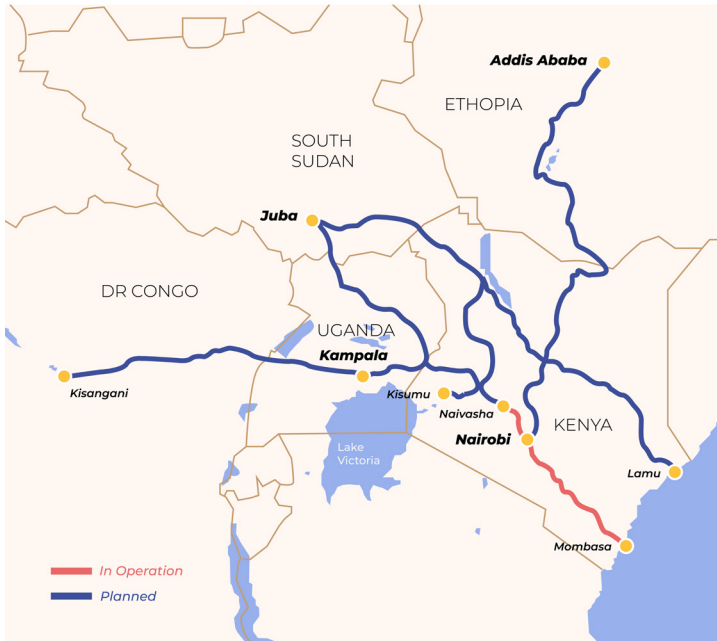


Figure 2: Map East Africa SGREast African Standard
Gauge Railway c.2022CHINA+AFRICA
RESEARCH INITIATIVE

AG in its report spelled the relationships out clearly: “*Each of the Borrower, KRC and KPA agrees...* [emphasis added].” To a legal expert, the capitalization of Borrower makes it immediately clear that Clause 17.5 refers to three parties: the Borrower (i.e., Kenya’s National Treasury), KRC, and KPA. The phrasing and syntax support this: “Each” of the three “agrees”. Kenya’s National Treasury is the only borrower.

Yet this distinction was missed by the AG, who wrongly paraphrased Clause 17.5 as follows: “Under this Clause, the Agreement provides that *each of the borrowers, in this case Kenya Railways Corporation and Kenya Ports Authority* [emphasis added] agrees ...”. Without noticing the mistaken paraphrasing, the AG pointed to Clause 17.5 to support its interpretation that KPA was a borrower with a borrower’s duty to repay the loan to China Eximbank and had not disclosed this during the audit. “The KPA assets are exposed since the Authority signed the agreement *where it has been referred to as a borrower* [emphasis added] under clause 17.5”. This suggests that throughout the analysis, the Auditor General was operating from incorrect assumptions that influenced its opinion on KPA’s risks.

(2) WHAT DOES THE WAIVER OF SOVEREIGN IMMUNITY MEAN?

The National Treasury, KPA, and KRC all signed “waivers of sovereign immunity” as all three were parties to various

contracts in the overall project lending package (Figure 2). Under international law, sovereign states and entities they control have sovereign immunity, i.e., they are generally immune from lawsuits and cannot be compelled to appear before a foreign court or arbitration venue, or to enforce a judgment rendered outside their borders. Yet few international banks will offer a loan if there is no legal path to recover their money should the borrower default.

Therefore, it is rare to find an international commercial loan or sovereign bond contract that does not contain the sovereign immunity waiver clause. The waiver used in Clause 5.5 of the China Eximbank Preferential Export Buyer’s Credit loan contract for the SGR is typical:

Neither the Borrower nor any of its assets is entitled to any right of immunity on the grounds of sovereignty or otherwise from arbitration, suit, execution or any other legal process with respect to its obligations under this Agreement.

A published [cache of loan contracts](#) signed by Cameroon with banks and export credit agencies from Austria, Belgium, India, Germany, Spain, Turkey, and the UK shows that all required these clauses. As one American lawyer noted, “leaving out a sovereign immunity waiver in an international commercial loan contract would be professional malpractice.” However, there is quite a large gulf between a general sovereign immunity waiver signed by all the parties to an international project finance contract, and the specification of a particular asset like a port as collateral.

HOW WILL KENYA REPAY THE SGR LOANS?

OUR CASH FLOW ANALYSIS FOR THE project shows that KPA will comfortably meet its obligations under the TOPA, even with shortfalls of up to 40 percent in freight volumes. However, although the SGR’s freight and passenger revenues can already pay for its operation, they cannot cover annual debt service for the three loans. Debt service peaks in 2022 and will largely come from the RDL. The IMF reports that even with the SGR project, Kenya’s overall debt remains [at a sustainable level](#), and Kenya is expected to continue to grow at an average rate of six percent.

III. THE SIGNIFICANCE OF OUR FINDINGS

(1) KENYA AND THE SGR

For Kenyans, we provide the explanation that Kenya’s government has failed to give: a detailed account of why Kenyans

can rest easy that Chinese banks are not going to be seizing their port – or indeed, any port. The project history and cash flow analysis we conducted reveal how the SGR's multiple credit enhancements made the project viable. In 2022, the peak year for debt service, the SGR loans accounted for about six percent of Kenya's total public debt, and 12 percent of external debt.

(2) HOW CHINA LENDS (AND HOW AFRICANS BORROW)

Getting the details right matters in understanding the big picture of China's BRI investments. All the features we uncovered – the take-or-pay agreement (TOPA), escrow accounts, sovereign immunity waivers -- are common elements in any large, complex, revenue-generating, public infrastructure project financed by foreign commercial loans or export credits, whether the bank is in Brazil or Beijing. Yet these normal features of capitalist lending are not well understood by those accustomed to the world of foreign aid and World Bank projects. As more countries seek to borrow commercially for infrastructure, these features will come to be seen as routine.

(3) PUTTING “DEBT TRAP DIPLOMACY” TO REST

Our findings clarify similar rumors that borrowing governments have pledged strategic assets like land or ports in exchange for finance, or even “seized” these assets. These rumors have swirled around other large BRI projects in [Sri Lanka](#) (Hambantota Port), [Zambia](#) (Kenneth Kaunda Airport and Zambia National Broadcast Corporation), [Uganda](#) (Entebbe Airport), and [Montenegro](#) (Bar Boljare Highway). The “debt trap

diplomacy” fear that borrowers’ strategic assets and sovereignty are directly at risk from China is appealing in its narrative simplicity, and clearly useful for politicians, but lacks supporting evidence.

(4) VALUES, NORMS AND RULES OF THE INTERNATIONAL ORDER

Rather than a deliberate debt trap, we documented a straightforward commercial deal. When it comes to following the rules and norms of international project finance, China Eximbank turns out to be not very different from global banks based in the West. All commercial financiers (except multilateral banks, which have preferred creditor status), are wary of relying solely on a government’s promise to repay, hence the use of routine, yet complex, risk mitigation techniques. Blended into sovereign loans, these techniques enabled Chinese banks to lend where others feared to go. Whether this was a step too far remains to be determined. ★

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THE SAIS CHINA-AFRICA RESEARCH INITIATIVE at the Johns Hopkins University School of Advanced International Studies (SAIS) in Washington, D.C. was launched in 2014. Our mission is to promote research, conduct evidence-based analysis, foster collaboration, and train future leaders to better understand the economic and political dimensions of China-Africa relations and their implications for human security and global development.

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