

Chapter 2

Developing Country Bank Debt, Rescheduling and the Major Debtors

2.1 In this chapter we review and evaluate the way in which the debt crisis has been managed so far as it affects the banks. There is a description and evaluation of the process of debt renegotiation as it has evolved in relation to the major debtors, and a discussion of various proposals for changing the procedures and terms of renegotiation. The chapter is concerned with the process by which the crisis has been handled in general, rather than with particular cases, but Appendix 2.1 gives a summary of the agreements negotiated since January 1983.

2.2 Thirty countries have rescheduled their bank debt since then and other agreements (for example, with Venezuela) are being negotiated at the time of writing. Five Commonwealth countries have been involved: Jamaica, Guyana, Nigeria, Malawi and Zambia. The thirty countries account for half of the total debt of developing countries and the rescheduled amounts have totalled \$56 billion (in the calendar year 1983). These represent a dramatic increase from \$1.5 billion during the years 1978 to 1981 to \$5 billion in 1982.¹ Rescheduling reduced debt-service payments in 1983 by \$19 billion, equivalent to 4 per cent of exports. For 25 major debtors, debt service including amortisation accounted for 30 per cent of all export earnings in 1983, and the figure would have been 36 per cent had there been no rescheduling. In 1984 it is expected, on the basis of progress so far, that equivalent, or larger, sums will be rescheduled involving comparable numbers of countries.

1. All of these figures include some official, as well as bank, debt.

The Process and Procedures

2.3 Debt renegotiation takes place on a case-by-case basis with no over-riding rules or guidelines. But in practice there is considerable uniformity in the process adopted and the terms agreed. The essential features are:

- rescheduling of maturing principal on existing loans;
- debtor country adjustment within an IMF programme;
- new finance from the IMF and from the banks (usually in the form of ‘involuntary lending’ to meet interest payments) and, on some occasions, bridging finance.

2.4 It is not necessary to give an extended description of the various rescheduling packages but the following are the main recurring elements:

The IMF: The Fund has proved crucial to rescheduling packages not simply because of its own financial input but also for its catalytic role. From the point of view of the debtor, it has been necessary to have a high conditionality, upper tranche, programme with the Fund in order to reach agreement with the banks. For the banks, the IMF’s role is not merely one of giving a ‘seal of approval’, but also of tying the package to additional new (‘involuntary’) bank lending. This role is described further below and in Chapter 4.

Interest: Banks have generally been unwilling (barring a few exceptional cases) to reschedule their interest in arrears or future interest. Rescheduling payments have been at market interest rates. To meet interest payments banks have provided the major debtors with new medium-term financing.

Maturities: Maturities have generally been close to those of the loans they have replaced: seven to eight years with two or three years’ grace.

Coverage: The agreements essentially cover principal payments on medium- or long-term debt contracted by the public sector. Only in a few instances has non-guaranteed private debt been included in the restructuring (Mexico and Chile, for example) and then as a result of the debtor governments assuming liability.

Short-term debt: Short-term debt is traditionally not covered but is increasingly included in practice. When short-term debt is not formally rescheduled, it has been rolled over on an informal basis and its level maintained over time.

Consolidation and Coverage: Normally rescheduling has been restricted to debt due within 12 months from the onset of negotiations, and has covered at least 80 per cent of the principal

payments due. Total rescheduled amounts have generally represented between 15 and 30 per cent of the disbursed debt owed to banks, but sometimes more.

Spreads: The spreads applied to the basic rate have generally ranged from $1\frac{3}{4}$ per cent to $2\frac{1}{4}$ per cent. Fees have generally amounted to an additional 1 per cent of the amounts restructured.

Evaluation

2.5 Current rescheduling packages have essentially deferred rather than reduced the burden of bank debt servicing. But various positive results have flowed from this. They have eased debt service inasmuch as, for the eight largest bank reschedulings in 1983, the average debt-service ratio (including short-term debt) declined in that year from over 80 per cent to 50 per cent. They have thus created time for the system to evolve more stable financial mechanisms while helping to prevent default. They have also maintained creditor-debtor relations, preventing a complete breakdown in legal obligations and confidence.

2.6 None the less, a system which may have sufficed for a small number of special cases in exceptional circumstances, is inadequate when applied over a longer period to an increasing number of major borrowers, and many minor ones. Moreover, according to the IMF, even with rescheduling, arrears continue to mount, reaching \$27 billion at the end of 1983 compared with \$25 billion at the beginning of the year. Concern has been expressed about the present arrangements, regarding the following points:

- problems have been deferred only briefly. Consolidation periods are short—usually one year—and grace periods are only about two years. Hence there are significantly increased debt-servicing obligations after the grace period expires, involving a heavy ‘bunching’ of amortisation payments due on rescheduled loans. In the case of major debtors this will fall due in 1986/87;
- the system of annual negotiations on a case-by-case basis has introduced a strong element of brinkmanship and uncertainty on each occasion that a major debtor has been involved. This makes it impossible for the debtor countries themselves to undertake medium- and long-term policy reforms, since there is no predictable profile for debt service and new financial flows. Brinkmanship also creates uncertainty in already unsettled financial markets. The disadvantages in terms of instability substantially outweigh whatever advantages there are in keeping debtors ‘on a short leash’ in order to ensure observance of short-term financial policy objectives;

- rescheduling is concerned with loan principal, yet the success of the whole package hinges on the ability of debtors to meet interest payments. As interest rates have risen in recent months the deficiencies of using negotiated new ‘involuntary’ loans as the mechanism for ensuring interest payments have become more obvious. First, ‘involuntary’ lending was inadequate to cover interest payments even in 1983 when rates were 2–3 percentage points lower than they are in 1984. Second, at each renewed attempt to renegotiate a round of ‘involuntary’ lending the exercise becomes more difficult as a few more marginal banks decide to withdraw and major banks run up against exposure limits. Third, the small- and medium-sized debtor countries have great difficulties since their debt does not represent a high proportion of the banks’ portfolio; in the final analysis, creditors could cope with a default on the part of a small debtor without endangering their own solvency. Thus, even if current arrangements can accommodate the problems of major debtors—which is doubtful—they are wholly inadequate for most of the remainder;
- banks have frequently adopted a policy of seeking to maximise short-term returns on rescheduled debt by charging high penalty lending margins and arrangement fees for debt rescheduling. The practice followed is the opposite of that in many domestic restructuring arrangements, which provide for somewhat reduced lending rates to help a borrower back on to his feet. The Group of Thirty has suggested that banks may be earning as much as an extra \$1.75 billion a year on international debt recently renegotiated or being renegotiated. Thus, rescheduling has often been good business—creating a paradoxical situation where, in the midst of a serious deterioration in their international loan portfolio, some private banks are reporting to their shareholders surprisingly high rates of profits. Some bankers have come to see that what may be lucrative in the short run is unwise in the long run, as is reflected in reduced spreads recently;
- in general, rescheduling terms have been fixed almost regardless of different capacities to pay. The smaller and economically weaker debtor countries, in particular, have had little opportunity to moderate demands for high interest rates, fees and other commissions on rescheduled debt and have rarely been accorded long-term grace and repayment periods more appropriate to their capacity to pay.

Underlying these specific points of criticism is a judgment that the present ad hoc arrangements simply do not represent a feasible way of operating for any length of time. This point has been strongly made

by the major debtors, but it is a view shared by many bankers. Thus *Amex Review*, September 1983, wrote:

the present financing and adjustment effort is just keeping the boat afloat. The effort has succeeded in that no collapse of the international banking system has occurred. Yet it has failed insofar as the debt problem still looks a long way from solution observers and participants must surely still admit to a degree of unease as to the durability of the patched-up system.

And in April 1984, the bankers' journal *Euromoney* noted:

there is a feeling among a growing number of bankers that the present muddle-through approach to the ldc debt crisis will not suffice for much longer, that more radical solutions will have to be considered.

2.7 In looking at some of the possible remedies various ideas can be considered, but a distinction can most usefully be drawn between measures which involve adaptations to existing approaches and those which involve more far-reaching changes, requiring action at a multilateral level and more direct involvement by creditor country governments. There is clearly a good deal of overlap but, from a policy standpoint, the distinction is worth making.

Adaptations to the Current System

2.8 A variety of proposals for making rescheduling smoother, more equitable and more sustainable are currently under discussion.

Multi-year rescheduling

2.9 Multi-year rescheduling covering debt maturing in 3 to 5 years was one of the main policy recommendations of the 1984 Western Economic Summit meeting in London:

in cases where debtor countries are themselves making successful efforts to improve their position, encouraging more extended multi-year rescheduling of commercial debts and standing ready where appropriate to negotiate similarly in respect of debts to governments and government agencies.

2.10 There are two main arguments in favour of multi-year rescheduling. The first is that it reduces considerably the uncertainty and ineffectiveness associated with annual negotiations. The second is that it anticipates debt-servicing difficulties associated with a 'hump' of future repayments and seeks to create a smoother repayment profile. However, it would be an exaggeration to interpret multi-year rescheduling as representing a significant concession to debtors; the advantages

lie primarily in administrative simplicity and improved financial management. Moreover, to treat the proposal as a reward for 'good behaviour' in terms of short-term adjustment performance has the effect of forcing countries which need a longer time to develop successful adjustment programmes to operate entirely in a framework of short-term policy objectives. It is reported that many banks are still reluctant to agree to multi-year rescheduling, even for the most highly favoured debtors, because of the lack of an accompanying multi-year IMF programme. This points to the need for a greater emphasis on medium-term extended facilities as the basis for debtor adjustment programmes—a point pursued in more detail in Chapter 4.

Maturities

2.11 From the point of view of the banks it is the regular payment of interest at market rates which is the source of profitability, and solvency; principal can always be rolled over into new loans without loss.

2.12 At a time when even some moderate Latin American negotiators are demanding repayment over 20 to 25 years including the grace period, it seems realistic to rethink the current approach to rescheduling. A systematic approach would frankly recognise that much longer maturities are realistic, that the maturities should correspond to countries' stages of development (defined in terms of relatively low per capita income and/or structural weaknesses stemming from, say, highly concentrated exports), and that concessions on maturities may help debtors to service interest by not overburdening them with amortisation payments.

Interest rate proposals

2.13 Clearly there is need for action that, to quote the consensus reached at the meeting of Latin American debtors in Cartagena, Colombia, in June 1984, 'leads to a sharp and immediate reduction of nominal and real interest rates in international markets'. A narrower but more manageable issue is whether developing country debtors can be insulated from some of the effects of high international market interest rates.

2.14 One approach is to find ways of postponing, or rescheduling, part of the interest payments in a more effective way than via 'involuntary' lending. The main device being considered by bankers is 'capping'. 'Capping' means different things to different people, and there are many variants. The essential idea is that capitalisation should apply to interest above a certain maximum level, or 'cap'. In one version, if interest rates rise above the 'cap', the balance could be debited to a form of 'escrow' or 'rainy day' fund which could be paid off when

interest rates fall below the 'cap' rate. Alternatively, 'capped' interest would be rolled up into a payment at the end of the repayment period, and could, then, if necessary, be rescheduled again. Or, if interest rates rise above the 'cap', the loan maturity could be extended with the regular agreed payments of interest and principal remaining the same, and, if they fall below the 'cap', the maturity could then contract. There are technical problems, notably in establishing an underlying trend in real interest rates which could form the basis of the 'cap'. However, the main difficulty with 'capping' is not that it is too radical, but rather the opposite, that by postponing interest it piles up future problems which, in the case of some countries at least, should be met by interest relief.

2.15 Another idea, advocated by *The Economist*, is that the IMF's compensatory financing facility (CFF) could provide loans to offset fluctuations in interest payments. It has merit as being a mechanism which meets directly the debtors' concern about unpredictable surges in interest rates, with a minimum of new institution-building and of government intervention in capital markets. The scale of resources required would be considerable. If the facility were to cover the full range of fluctuations up to 4 per cent on each side of a base rate, the CFF would require something of the order of \$12 billion additionally and individual debtors would require much larger access limits. There is attraction in the scheme to the extent that it recognises that interest payments by debtor countries can be financed only by official, or officially guaranteed, flows on a very much larger scale than is available at present. But its value is limited by its treatment of the problem as one of instability rather than of the high level of interest rates, and because of the fact that it would require debtors to pay interest on the deferred interest payments and to repay their CFF loans when interest rates are still historically high and debt problems are still severe.

2.16 A third approach, which was given some prominence in the Cartagena consensus, is to limit debt-servicing payments to a fixed percentage of export earnings compatible with the debtors' productive potential and needs. The idea has some similarity with one put forward by various individuals from the US National Security Council (see Appendix 2.2) as part of a more far-reaching proposal for dealing with the debt problem. There are also precedents—within government loans which incorporate a 'bisque' clause deferring repayment instalments, because of changed conditions, to be repaid when the original maturity of the loan expires.² This idea is attractive inasmuch as it gives to what was previously a fixed debt obligation an element of risk-sharing; the greater the earnings, the more the service and vice versa. Moreover, by providing a form of compensatory financing, it has particular relevance

2. Anglo-American Financial Agreement of 1946.

and appeal to countries with highly unstable export earnings. But the mechanics of determining 'ability to pay' and obtaining agreement between debtors and creditors would present some problems.

2.17 Finally, going further than any of the above is the possibility of an element of concessionality in the interest rate, converting past debt into debt serviceable at below current market rates. This could be acceptable to the banks in some cases if the loan were to be at a fixed rate which is high by historic if not current standards—say 3–4 percentage points below the current market rate. However, if we introduce concessionality on a large scale we make explicit the need for bank losses or official subsidy to help with these losses; and this raises more fundamental issues about whether the debtor and the banks should be treated as having a liquidity problem rather than one of basic solvency.

Internalising obligations

2.18 Some debtor countries have the capacity to generate surpluses to service their debt obligations but, because of structural weaknesses, are not—in the short term—able to convert the surpluses into foreign exchange. In several cases, private debt has been rescheduled in such a way as to create assets which are freely negotiable domestically but not, except after a period of time, internationally. The technique may have wider application.

2.19 One possibility is counter-trading arrangements where an importing country links payment to reciprocal exports. There is some counter-trade in existence involving repayment of commercial bank debt in kind.

2.20 Another option is for the creditor to convert its debt into a local equity holding or even into real estate. Many developing countries will resist this encroachment on local ownership, though others are more relaxed. The more open the country's attitude to foreign investment and the more developed the local capital market, the more attractive this type of approach is likely to be; another factor is the degree of currency convertibility which can be offered for earnings and, eventually, repatriation of capital. Where there is a mutual interest between debtors and creditors, agencies such as the International Finance Corporation may have a role to play as intermediaries.

2.21 A third option is to convert commercial bank loans into long-term government bonds issued in local currency. To prevent a huge interest liability these bonds would be issued at a deep discount (possibly even with a zero coupon). But banks would need guarantees concerning

exchange rates, a time period for their redemption, and exchange conversion as well as free tradeability so as to enable the bonds to be regarded as performing.

More Fundamental Reforms

2.22 The further the above adaptations depart from current rescheduling practice, and the greater the crisis, the more likely are banks and creditor governments to look at various radical reform proposals which have been canvassed. While we cannot do full justice here to a large number of often very complex proposals, Appendix 2.2 sketches out some of the better known ones. They have two main generic components: first, mechanisms for shifting some or all of the accumulated stocks of 'non-performing' (or potentially non-performing) loans from the books of the banks in exchange for more marketable assets, thus giving banks time to write down loans; second, an easing of the developing country debt burden through a combination of principal or interest relief or an extension of repayments on the one hand, or through large-scale new lending on the other.

2.23 Without going too far into particular schemes, it is perhaps useful to distinguish the various kinds of options. The *restructuring* proposals attack the problem by trying to reduce the debt 'overhang'. Debtors benefit from debt relief on a scale in excess of what is being negotiated through rescheduling. Banks acquire marketable bonds in lieu of debt, but at a loss. Most critics have concentrated on the likely impact of a large-scale involuntary writing-down of bank debt on bankers' willingness to lend again in future (though net lending for a given gross flow would be higher because of reduced repayment). Banks also are reluctant at present to accept that, except in a few cases of obviously 'insolvent' nations, loans should be written down. Reflecting different views on both technical issues and questions of principle, the schemes vary greatly in their main features: scale; the form and extent of debt relief; the type of new asset offered to banks; the type of liability acquired by debtors; the degree of involvement by existing international institutions or by a new agency; the distribution of losses between debtors, creditor governments and banks.

2.24 The *lending guarantee* proposals attack the problem from the opposite direction by giving security to banks to continue to make new loans. They emphasise the need for substantial increases in resource flows to developing countries in order to enable them to resume acceptable rates of growth; and they do not require banks to absorb sudden losses. Safeguards would be built into the schemes to prevent overlending: linking guarantees to an IMF programme; limiting guaran-

tees to less than 100 per cent. A large-scale guarantee scheme would, however, involve industrial country governments in assuming a large additional contingent liability when their existing guarantee schemes—for export credit—are already in financial difficulty.

2.25 In addition to these proposals there are others, which we do not review here but which are more generally concerned with strengthening the banking system. Some envisage the Central Banks rediscounting banks' developing country loans, if necessary at a loss. The aim is to ensure that the banks have adequate liquidity to continue their lending operations. Others envisage an extension or clarification of Central Banks' existing lender of last resort role as it affects international loans. At present, there is considerable doubt over who exercises it. There are also 'grey areas' of ambiguous jurisdiction, such as off-shore banks. Essentially, it is assumed that the function would be exercised by Central Banks coordinating on an emergency basis. The ambiguity reflects in part the understandable traditional reluctance of lenders of last resort to specify in advance the extent and nature of the support they are prepared to offer under particular circumstances. There is clearly a difficult balance to be struck. Several critics of existing arrangements have argued that a reasonable price for greater security in this area could be tighter control over the direction and magnitude of international bank lending.

2.26 In practice, any workable set of arrangements is likely to be *eclectic* in character combining several of the more attractive features of the prototype schemes, by dealing simultaneously with the debt 'overhang', new lending and strengthening the banking system against the possibility of major shocks.