RESCHEDULING AS SEEN BY THE SUPERVISOR AND THE LENDER OF LAST RESORT

Remarks be

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It is about time that the regulators took a look at LDC lending. This is not because the banks have not done a fine job. The banks have done something absolutely amazing. They have moved capital to where it is needed. This would probably not have happened otherwise. I am a great believer in the bathtub theory of capital markets which holds that the water flows around at the same level no matter which way you pump it and whether you dip into the water with a pail on one side or on the other. I doubt however that the money would have gone round and round and come out at the LDC's.

The banks more or less discovered the LDC's at the same time they discovered roll-over credit. These two events made something possible that surely would have been difficult for the official institutions, since they just did not have the resources and could hardly have been involved with them. This would have been very difficult for the traditional bond market

to do. That has been limited to very few borrowers for obvious reasons. The banks certainly deserve a great deal of credit for the job they have done.

However, there can be enough of a good thing. One thing that does raise concern is the continuing rapid growth of LDC credit. Gordon Richardson has said that anything financial that grows at 25% per year bears watching. And that is the case for LDC credit.

This is to some extent almost like the filling of a vacuum. The discovery that LDC's were credit worthy and that their demands could be handled by medium term syndicated roll-over loans resulted in a disequilibrium in capital markets. That is to say, the stock of such loans was lower than it presumably would have been in equilibrium. When that happens there is typically a very rapid expansion. The problem is how quickly and at what level it stops. In the long run nothing can advance much faster than the overall growth rate of inflation. If the LDC's are increasing their indebtedness at much more than 15 percent, which is perhaps their rate of growth in nominal terms, there is a relative rise in indebtedness. You see this when you look at various measures of debt, including debt service relative to exports, or total debt to GNP. These ratios have been rising, although not at an alarming pace. There are, nonetheless, countries and groups of countries where that is not the case, but on the whole and over the last few years, indebtedness has been creeping up.

American banks have been on the forefront of this movement for some time, but they have been pulled back in recent years. American banks used to provide more than half of total LDC lending. Now it is on the order of 40 percent or slightly less. Banks of other countries have been taking their place. There has been a definite caution on the part of our banks reflecting creeping

debt ratios in developing countries. If all the money that they borrowed had been used for investment, debt ratios should have remained fairly stable. If they had plowed all of this capital into growth, one might think that their investment to GNP ratios would have risen, growth would have accelerated, and debt would not have risen, or not have risen much relative to these measures. But, of course, one must fear that some of this money has not been used for investment. Roll-over credits are typically balance-of-payments loans. In the old days banks typically lent to LDC's either for very short-term trade financing or for specific investment projects, like the World Bank does.

The typical syndicated Euro credit is not of that kind. Moreover, it has a maturity of 5 to 10 or 12 years which is not consistent with the pay-off period of most large,long-term projects. You cannot build a hydro power plant and make it pay over five to 12 years. There is some kind of asymmetry here that leaves one a little uncomfortable. The oil situation has made all the data of LDC exports and debt service seem a little worse than they look because the oil bill pre-empts, in effect, part of the exports of the LDC's. And if you apply the oil bill first to exports, then measure debt service in relation to the remaining exports, the ratios look less encouraging. Of course, the ratios vary greatly among countries, and a very high ratio is by no means a disaster. It depends on the policies of the country. It depends on the country's ability to turn itself around. I do not want to sound like an alarmist, I just think that the rise in LDC indebtedness ought to taper off. It has not done so and it is worth asking why.

That leads me to investigate LDC lending and the responsibilities of regulators with respect to the banks. Why focus on rescheduling? Rescheduling is becoming a more frequent event for banks, and it has not yet been explored thoroughly. It is something that must be examined in terms of what it means for the banks, what it means for the countries, how it has worked, and where it might be leading.

Let me begin by reviewing the arguments why sovereign lending is different from ordinary credit risk. A country is a country is a country. It cannot disappear from the surface of the earth. A corporation can very well disappear. You can make a corporation pay out every penny it has and after that it goes into receivership. While you cannot make a country pay every penny that it has, a country can, if it wants, continue paying because there is always room for further belt tightening that will generate enough of a balance-of-payments surplus or reduction in deficit to make that possible. Moreover, a country that shows good debtor discipline will usually have access to credit. Hence, policy is the decisive element on the part of countries.

Thus it is true that countries are different from corporate and other borrowers. They are immortal. Unless they positively repudiate their debt, one can always believe that one can collect from them. This is manifested in the fact that even when regulatory systems and accountants and bankers have to make a severe charge against country debt as a result of non-performance, they typically do not write it off entirely because that seems to imply that the country really has gone out of business. One exception to that was Cuba in one instance.

A certain element that provides re-assurance, with respect to a country's ability to pay, is the presence of the IMF. Here is an international institution with very large resources. Its function is by no means to bail out the banks. Its function is to turn a country around if the country is willing to be turned around, and to tell the country what policies it needs to follow in order to make itself bankable again. These are the familiar performance criteria that the IMF imposes in its stand-by agreements. It aims at an equilibrium exchange rate and limits the amount of foreign borrowing. It limits the amount a government can borrow domestically. It may limit total domestic credit expansion. It may put a ceiling on budget aspects and it may ask for reforms of things such as price subsidies, distortions of prices, and the tax system.

When these measures are undertaken, that is,by and large,an optimal economic position for the country. Politically, however, meeting the IMF standards often is very tough. It may threaten the stability of the country, and in that sense, a country that faces such a program deserves sympathy. Is it going to be cut off from credit? Is it going to be able to make it on its own? It can do it with the assistance of the IMF. Eventually the country's solvency will be restored. Even though there may be tough conditions they are clearly in the long-run interest of the country. That is what returns bankability to countries. The presence of the IMF in rescheduling agreements makes it possible.

There are other reasons from the point of view of the supervisor for wanting to watch these situations closely. Banks are under a great many pressures to lend to developing countries. One such pressure reflects low

domestic bank earnings in many countries. In the international market it is often possible to pick up another syndication and then sell another CD and earn all of 5/8's of one percent. That is an inadequate return, but it is something. Moreover, if the bank is part of the management group, it gets a fee. To some extent interest and fees are substitutes; when a bank or group of banks feels that it needs up-front earnings, it can structure a new loan to produce a lot of fees and a low spread. The fee goes into this year's earnings unless the bank decides to spread it over time.

The pressure on the banks is also considerable because of the alleged liquidity of the Euromarkets. There is always a reason why the Euromarkets are liquid, either the United States has a payments deficit or OPEC is pouring money in. But the fundamental reason why the Euromarkets are liquid is that they are just another part of the domestic market. Offering a little more interest than is offered in the domestic market can, at that interest rate, attract an almost unlimited supply of funds. The elasticity of supply of the Euromarket, at a given rate in the domestic market, is almost infinity. Thus, the Euromarket will, most of the time, appear very liquid.

For the banks, there are other reasons or temptations why these loans should be pushed. There are many collateral advantages to lending to LDC's. One may get a branch there. One may pick up letter-of-credit business and other business. In that way participation in a syndicated credit may become something like a loss leader. The business is done at 5/8's of one percent not because that is a fair rate of return or more than can be made at home, but because it is the key to other earnings.

There is also great difficulty for banks not to move with the crowd. What would a bank have done in 1968 or 1972 if it had decided it did not want

to get into the international business? It would have had to resign itself to being a smaller bank, though perhaps a more profitable bank.

For a money market bank, it would have been a very difficult decision not to participate in this upsurge of international lending. It might have meant that the bank would have become an unprofitable bank, a bank with a very low price/earnings ratio, and that its market to book value ratio would have been low. It might have been a takeover candidate.

A little should be said about the history of LDC rescheduling. There are really two tracks. One is for official debt and the other is for private bank debt. The official track has been in operation for a long time. And many respectable LDC's have been resheduled by their friendly creditors. The official lenders know eath other well. It is not a very large group. They are usually government representatives. The procedure has rules that must be followed. For instance, there must be joint negotiations. If there are separate negotiations with different national creditors, somebody may get the inside track. There may be trouble. There has to be equal treatment among countries for the same reason. If somebody has an advantage, that will lead to future friction. There also has to be an equal burden imposed on private creditors. That is to say, if there are private lenders on any scale, the official lenders will insist that the general conditions be imposed universally. If that is not done, the banks may pull their money out at the expense of the official lenders who have postponed their claims.

Another principle that has become apparent is that governments will watch for political objectives. Governments may be neutral with respect to economic objectives, for instance in deciding between rescheduling of interest versus rescheduling of principal. Typically rescheduling of principal is more easily accepted by the creditor than rescheduling of interest. But governments, of course, do have political axes to grind and so their attitudes in a rescheduling will reflect those.

Turning to private rescheduling, we have much less experience as regulators although the banks seem to have learned pretty quickly what needs to be done. It is a very difficult mechanism because contrary to the official level, where there are a few main creditor countries, there can be hundreds of banks in a major rescheduling. These all have to be kept in line. If a single bank, for instance, were to claim default and attach an asset of the borrower, it could create untold mischief because then the loan would be thrown into default. There may be cross-default clauses that throw other loans into default. Suddenly the whole thing could unravel. This has never happened, but great care has been exercised to ensure a favorable outcome.

Most of the loans have contracts underlying them that spell out the rights of the participating banks. Typically there is a majority voting on such things as whether to call a default. But a bank that is outvoted can still take its case to court. It may be dissuaded from taking this action since legally it has to share with all the others anything that it may get out of the borrower. There are additional forms of pressure the banks can bring to bear on each other. But there are often tense moments in these negotiations when somebody appears to be breaking rank.

There is then a question of how to set up national steering committees, each of which would have to keep its own banks in line. These things take a lot of time and work. By now the banks have no doubt developed a pattern. In earlier rescheduling it sometimes took years between the time a problem was recognized and the time when the bank began to talk to the borrower. From there on it could take years until a final settlement was reached.

The banks have learned a number of other things. One thing they have learned is that it is very difficult for them to impose conditionality on a country. They know that it makes no sense to reschedule or to provide new money for a country unless that country changes its policies along the lines that the IMF might counsel. But the banks do not have the power, the means, or even the techniques to replace the IMF. So the situation tends to crumble unless the IMF comes in. There are cases where the IMF cannot come in, such as when the country is not a member of the IMF. In that case, how do you establish conditionality? The banks can propose something,but there is no real way of monitoring a sovereign country. The country may not give the bank access to correct or sufficient information. There is no way of enforcing anything. If the bank has promised to lend a specified amount on a certain date and the country has not performed, then the bank can refuse to pay out that part of the loan. That could happen. But it is a cumbersome way of operating.

The banks have learned that it is important to be specific regarding what happens with shorter term trade credit. There is a temptation to pull out at the expense of the other banks. If that happens, the viability of the whole arrangement may be called in question. The country is dependent on short-term trade credit and if that is not flowing any more, it denotes a very desperate

situation for the country. The ability of the country to keep the economy going, to keep essential raw materials flowing, oil, parts, and machinery coming in, is put into question. Consequently, countries often give high priority to paying short-term credit even though medium-term credit may fall into arrears. But when banks do not continue to provide short-term credit, a serious problem is created.

It makes me uneasy when I hear a banker say that if anything were to happen in country X they would know how to get their money out. What that means is they would stop short-term trade credit, and that is not a good way of proceeding, except perhaps for that bank. But it is not a good solution for the overall situation, since there is a need to maintain a certain flow of trade credit.

Finally, banks have interests that differ from those of governments and differ from those of other banks. Banks have a strong interest in not having interest payments interrupted. Amortization is not so bad. But if interest is not paid, then the loan has to be put in nonaccrual status. That is a painful thing for the bank to have to show. Hence, the banks will go to much greater lengths than governments will to find some way of not interrupting interest payments. One way to avoid interrupting interest payments is to lend the country the interest. The bank can make a new loan and add that to the old, or else find a way of restructuring the loan that brings the whole thing up to date. Something could be done to make sure that interest service is not interrupted, and it comes down to either a rescheduling or a refinancing. Although banks like to speak of refinancing, which is the more clearly respectable thing, the economics of the two are not very different.

We turn now to the economics of rescheduling. Why is it bad for a bank to have rescheduled loans on its books? After all, the country is going to be there forever. In fact, if the country remains an LDC forever, it will probably be a capital importer forever. That means its debt will grow and grow. It will never repay the debt. But I am not particularly concerned if somebody comes and says that he has discovered that none of this money will ever be repaid. Analogously, neither will the debt of AT&T be repaid, so long as that is a going concern and a growing corporation. The debt of both country and corporation will keep rising. Is that something terrible? The answer is, of course, in the case of AT&T, there is something behind its liabilities. In the case of a well-managed country there is also something behind its liabilities. In the case of the country, there is a viable economy that can generate foreign exchange and can generate growth. But if that is not the case, there is a difference between the country and the corporation and it becomes a problem when the debt continues to grow.

A bank cannot be satisfied with a situation in which the debt continues to rise, always rescheduling or adding a new debt to an old debt. Rescheduling reduces the liquidity of the bank. After all, the bank presumably had been counting on this cash flow coming in. They make plans on how to use it. When expected cash is not forthcoming, they have to replace it with something from another source, presumably at some cost. If it turns out that short-term debt is also rescheduled, and therefore will be repaid only over time, then the bank loses liquidity even in terms of its balance sheet. It may find it has a greater mismatch of its assets and liabilities. These are costs and risks. Return that depends on the terms of the rescheduling may be relatively low. The banks, of

course, try to raise the spread over LIBOR. They do not always succeed. Sometimes they even have to reduce the interest rate. In that case, the difference is paid later, so that interest is never reduced or forgiven. These devices may satisfy generally accepted accounting principles, but not an economist.

At the far end of this process, it really could become a kind of Ponzi game. Mr. Ponzi borrows offering a high interest rate which encourages people to lend to him thus enabling him to keep paying interest. And if he can keep it going, he may be able to skim some cream off that game for a long time. Eventually, it will catch up with him. Similarly it would catch up with the country if the country was not growing, but the debt was growing.

From the point of view of both the bank and the country, there is a discipline in having to face particular maturities. Indeed companies such as AT&T can incur increasing amounts of debt because they are well-managed, pay their debts on time, and face the test of being able to refund. They incur new debts, but at least whatever the debt, it is serviced punctually. That is really the least that you can ask of a well-managed developing country.

Behind this vision of building up debt, at some point the economist if not the accountant or the banker begins to ask himself whether there is not an optimal point for default. At what point would a country that lacks conscience and fails to live up to generally accepted accounting principles find it in its own interest to default? There is a paper at the Federal Reserve Board where Dick Freeman examines this question. Fortunately he arrives at the conclusion, which is intuitively plausible, that the more anxious a country is to grow, the less likely will it find default to be in its interest. This is because future

growth depends very heavily on past credit. The more the country wants to grow, the less it can rely exclusively on its own savings and the more therefore it needs credit. If the availability or the cost of future credit depends on previous debt performance, then it is not sensible to default. This is not an implausible model, and borrowers should understand it.

A better reason for thinking that countries will not find it in their interest to default is to look at the evolution of countries that once were borrowers and have graduated to become capital exporters. It is likely that all countries in the world, except Great Britain, started out as capital importers and borrowed from Great Britain. Gradually, many of them, like the United States, became capital exporters. They must have gone through a phase in which their trade balance, which must have started out in deficit, then went into equilibrium. Their current account would still be in deficit, reflecting the interest on past borrowings. At that point, they would still have been borrowing, but purely to pay this interest. They would not be receiving goods from abroad in excess of the volume of goods they were exporting. At that point, therefore, the country might say: If we are borrowing only to pay the interest, why keep this up?

No country, so far as I know, has ever said that. Those countries that grew to be capital exporters passed through that phase of borrowing only to pay interest and thereafter gradually stopped their net borrowing and began to be net exporters of capital. They passed that phase without a tremor.

Similar developments can and will occur in some of the present LDC's. They will graduate from the ranks of net capital importers. They may still be gross capital importers, but also gross capital exporters. They will reach a

point where net capital flows are zero, and move on to positive net capital outflows. What, then, is the correct role for the supervisor? He should respect the business judgment of the banks.

Nonetheless it might be desirable to move toward setting up reserves against badly rescheduled loans. When a supervisor finds a loan to be doubtful or even substandard, he will classify that loan and he will take it into account in evaluating the capital adequacy of the bank, 20 percent against substandard, 50 percent against doubtful. But he is not going to make this appear on the balance sheet, only on the examination report. This does not reduce the bank's capital. It just changes the supervisor's evaluation of whether the capital is adequate.

There is probably no country in the world today where there is a well-defined and overt recognition on the balance sheet of rescheduled loans. There are individual banks that do this, probably for tax as well as for risk reasons. In our environment the Internal Revenue Service is very hard to convince of a need to write anything off unless a clear case can be proven. The loan loss reserve of banks has become much more limited under the 1969 legislation. Furthermore, if a bank held reserves against rescheduled foreign loans, regardless of whether tax deductible or not, there is still the question of how general that treatment would have to be. Can foreign loans be treated differently from domestic loans? If a given procedure were established with respect to foreign loans, would accountants or lawyers decide that it would have to be applied domestically?

It must be recognized that what is being suggested here, i.e., allowing banks to hold reserves against rescheduled loans, is not easy to fit into our institutional framework, but this seems to be precisely because internationally, there seems to be a clean slate. Other countries do not do anything like this either. It may be possible to get some kind of common action internationally. Usually, that is very difficult in the supervisory field because every country has its own bank legislation and is not going to change that. Therefore, if there is no precedent, perhaps something could be done.