This chapter traces out the evolution of commercial bank debt restructuring since the outbreak of the debt crisis in early eighties. In chapter 2 while discussing the history of the debt crisis we have noted the extent and nature of the international commercial banks' exposures in the highly indebted developing countries, most of which are situated in Latin America. As we have already seen, these large exposures of the commercial banks resulted in a potential threat of default and related risks to the banking community at large following the eruption of the debt servicing difficulties and caused a psychological shift in banks' attitude towards the debtor developing countries in eighties in terms of their reluctance to lend new money to the third world. In this chapter we will see how different debt management strategies in dealing with the large exposures of the commercial banks were evolved and the empirical facts and figures associated with them. The major concepts and issues underlying different debt management strategies have already been analysed in the chapter 4 while discussing debt management in theory.

The chapter begins with the discussion of the rescue...
operations in four major borrowing nations in 1983–84 which followed as an immediate response to the crisis. Section 1 deals with these rescue operations. Section 2 involves a discussion of the case-by-case approaches of debt financing and debt rescheduling operations along with the Baker Plan. Section 3 deals with the market-based menu-driven approaches of debt and debt services reduction including the Brady Plan. Section 4 offers an analysis of the implications of changes in banking practices in terms of loan loss provisioning and changes in tax and regulatory environment and international banking regulation on the third world debt management policies. Section 5 evaluates the commercial banks debt restructuring efforts linking them up with the real economic scenario in the developing world. Section 6 provides a summary of the major findings of the discussion in this chapter.


The major creditor country governments, especially the US, and the international financial institutions responded promptly as the debt servicing difficulty emerged in several heavily indebted countries of Eastern Europe and Latin America. The Board of Governors of the Federal Reserve System (the US Fed) and the Bank for International Settlements (BIS) played an active role in coordinating these operations.

The essence of the rescue operations was to convince the creditor commercial banks not to severe their credit lines
abruptly to the debtor countries where the exposures of the commercial banks were quite large relative to their capital. After the debt problems of several borrowing countries came out in the open the banks became reluctant to extend new money to the indebted countries for the reasons already discussed in chapter 4. Rather, the banks were insisting upon full debt payments by the debtors. This could have led to substantial accumulation of arrears and might have pushed many severely indebted countries to the brink of default. Consequent upon this many banks would have faced threats of closure. As pointed out in chapter 2, by 1982 net exposures of creditor commercial banks in proportion to their capital were quite high. Hence the emergence of global debt servicing disruptions put their future and that of the world financial system into jeopardy. The aversion of these threats of default warranted new lendings by banks to Latin America and Eastern Europe, net out in flows towards these two regions. As noted in chapter 4, in the absence of voluntary lending when potential risk of debt repudiation was quite high there was bound to be a divergence between individual and collective interests of creditor commercial banks. Individually each one of them might be better off by withdrawing from new lending. But collectively they were better off by not withdrawing as collective lending by banks might prevent the immediate collapse of the world financial system, as we have seen in chapter 4. This led to the notion of debt financing. The new loans thus provided were involuntary in nature. The strategy popularly came to be known as concerted lending approach. Apart from providing some short-term bridge

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2 See Table 2.17 and 2.18 in Chapter 2.
loans to the problem ridden countries in 1982-83 the major objective of the rescue operations was to ensure that creditor commercial banks would provide new money to the highly indebted countries in their collective interests to diffuse the threat of impending collapse of the international financial system as a whole.

Four major rescue operations were carried out during 1982-83, each for Mexico, Brazil, Argentina and former Yugoslavia. The IMF played a major role in all the four operations. For Mexico, Brazil and Argentina US authorities led the operation while for former Yugoslavia the lead was taken by Switzerland. The rescue packages consisted of the following four major components:

(i) adjustment in the economy of the debtor country,
(ii) imposition of IMF programme,
(iii) new lendings by commercial banks, and,
(iv) official bridge loans.

Table 5.1 indicates the key elements of the rescue packages for Argentina, Brazil, Mexico and former Yugoslavia. Initially when arrears piled up for Argentina following the Falklands crisis and Mexico suspended its principal repayments in August 1982, the US and the European Central Banks mobilised, through the BIS, short-term bridge loans. These loans were provided in anticipation that IMF lending would be forthcoming to these countries. In fact, IMF lent to Argentina, Brazil and Mexico under its stand-by, EFF and CFF and other facilities, as
indicated in table 5.1.

Table 5.1
Rescue Packages
for
Argentina, Brazil, Mexico and Former Yugoslavia

(in billion US $)

<table>
<thead>
<tr>
<th>Source of Financial Support</th>
<th>Argentina</th>
<th>Brazil</th>
<th>Mexico</th>
<th>Yugoslavia</th>
</tr>
</thead>
<tbody>
<tr>
<td>IMF:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standby</td>
<td>1.70</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>EFF</td>
<td>--</td>
<td>4.60</td>
<td>3.70</td>
<td>--</td>
</tr>
<tr>
<td>CFF &amp; Others</td>
<td>0.50</td>
<td>1.30</td>
<td>0.22</td>
<td>--</td>
</tr>
<tr>
<td>World Bank</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>0.30</td>
</tr>
<tr>
<td>BIS</td>
<td>0.50</td>
<td>1.20</td>
<td>0.93</td>
<td>0.50</td>
</tr>
<tr>
<td>United States:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oil Payments</td>
<td>--</td>
<td>--</td>
<td>1.00</td>
<td>--</td>
</tr>
<tr>
<td>Commodity Credit</td>
<td>--</td>
<td>--</td>
<td>1.00</td>
<td>0.20</td>
</tr>
<tr>
<td>Federal Reserve</td>
<td>--</td>
<td>0.40</td>
<td>0.93</td>
<td>--</td>
</tr>
<tr>
<td>Treasury</td>
<td>--</td>
<td>1.53</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Bank Loans</td>
<td>1.50</td>
<td>4.40</td>
<td>5.00</td>
<td>3.80</td>
</tr>
<tr>
<td>Govt. Trade Credits</td>
<td>--</td>
<td>--</td>
<td>2.00</td>
<td>1.10</td>
</tr>
<tr>
<td>Total</td>
<td>4.25</td>
<td>13.40</td>
<td>14.70</td>
<td>6.50</td>
</tr>
<tr>
<td>Debt Rescheduling Amount</td>
<td>5.50</td>
<td>4.90</td>
<td>19.50</td>
<td>--</td>
</tr>
</tbody>
</table>

Source: Cline (1983), op. cit.
Note: EFF = extended fund facility
       CFF = compensatory financing facility

The IMF forced the banks to provide new loans to the problem-ridden debtor countries. It became the pre-condition for the IMF stand-by lending to these countries. Lending under stand-by programmes was pre-conditioned by a commitment by the debtor country to undertake domestic economic adjustment efforts. This new action on part of the IMF in forcing the banks, on the one hand, to extend new credits and in pre-committing those nations,
on the other, to pursue domestic adjustment programmes in their economies was unprecedented in the post war era since the inception of this Bretton Woods Institute, and hence, it was of historical significance. As Cline (1983) wrote: "In a situation in which many banks sought to withdraw, this strategy gave them no alternative but to bear their fair share in extending new loans." However, as we will see later, there was no substantial expansion of bank credits to the developing countries in the eighties. Rather, the net debt flows from the commercial banks dried up over the years since 1982 and fell far short of the interest payments incurred by the indebted countries on their debt obligations owed to the commercial banks.

The loans from the BIS, US Treasury and the US Fed, as shown in table 5.1, were extended for a very short period - 90 days, the time by which the IMF and new bank credits were expected to arrive. The former loans were known as the bridge loans because they were meant for filling the gap between the time when the debt servicing problem of the debtors came to the surface and the time when the credits from the IMF and the banks were supposed to arrive. Commercial banks extended new loans just for one year - that is for 1982-83 only. The IMF, on the other hand, extended new credits to the problem-ridden debtors for three subsequent years. Each year the Fund renewed its contracts with these countries and reached fresh agreements with them.

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3 See Cline, W.R. (1983); op. cit.
4 See Table 2.24 and 2.25.
New lending based on the concerted approach continued in the subsequent years as well. And the IMF's role remained the most important one in inducing the banks to extend new money to the debtors collectively.

One of the major components of the rescue packages was debt rescheduling through which some debt relief was intended to confer on the debtors. IMF insisted the creditor banks to reschedule some portion of the latter's debt claims which were falling due by then and set it as one of the pre-conditions for extending new credits to the debtors. These reschedulings were done on a 5 to 8 year basis. Rescheduling fees varied from 0.5% for Mexico to 1.5% for Brazil. Interest rate spread was relatively high - about 2 points over LIBOR or the US prime. Table 5.1 indicates the amounts of debts rescheduled in rescue packages. Only in former Yugoslavia instead of formal rescheduling principal repayments, which were due, were allowed to roll over.

The rescue packages of 1982-83 met the immediate challenge, posed by the risks of default to the international financial system. They provided short-term liquidity relief to the countries with severe debt servicing difficulties. By the end of 1983, comprehensive agreements were reached with Brazil, Chile, Ecuador, Mexico, Peru and Uruguay in Latin America; Poland, Romania, and the former Yugoslavia in Eastern Europe; and Liberia, Sudan and Zaire in Africa. By mid-1983 it was clear that problem was not going to be a short lived one. To cope with it,
therefore, the developing country debts owed to the commercial banks needed to be restructured thoroughly.

5.2 : Case-by-case Approach:

The restructuring of the debts owed to the international commercial banks by the debtor countries since 1983-84 can be classified into two distinct phases of debt relief and debt reduction operations (apart from the initial refinancing exercises through the concerted lending approach). The debt relief operations were mainly concerned with the reduction in the present value of the payments that were due to the creditors, while debt reduction measures attempted to reduce the present value of the debt payments due to the creditors. The major debt relief operations which were carried out during the mid-eighties consisted mainly of rescheduling of terms and conditions of the debt payments which were due. Both debt relief measures and debt financing through new lending continued till 1986-87 when the mid-term evaluation of the Baker Plan was carried out. By that time, as we will see, it was clear that banks were no longer interested in providing new money and also, certain changes had already started taking place in the realm of banking policy and regulations and, also in creditor country tax and regulatory regimes which affected the banks' decisions in this regard to a certain extent. This was the time when market-based menu options came to the fore as an alternative debt management strategy. By 1989 with the formulation of the Brady Plan market-based debt

\[\text{See Chapter 4, Section 4.3.}\]
reduction became the dominant debt strategy replacing the previous strategies of debt financing and debt rescheduling.

5.2.1 : Debt Rescheduling:

The basic idea of debt rescheduling exercises was to provide some breathing space to the indebted nations in terms of extending the maturity structures of the past loans. This was supposed to render some liquidity relief to the debtor. However, banks adopted a rigid stance in negotiating a rescheduling with a debtor country unless the latter had already entered a stand-by agreement with the IMF for adjustment of its own domestic economy.

Debt restructuring through rescheduling exercise was a tripartite game. The three players involved were the IMF, the creditor commercial banks and the problem ridden individual debtor countries. The participation of each party was actually contingent upon the necessary actions or pre-commitments by the others. The IMF would supply credit to a debtor if and only if banks provided new loans as well as rescheduled some portion of debt falling in arrears. Banks would extend new loans and/or would undertake rescheduling of debts in arrears if and only if an individual debtor undertook domestic adjustment of its economy. The debtor would adjust its economy if and only if the IMF extended new loans. In the entire game, IMF's role was most

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See Appendix 5.A at the end of the chapter.
crucial. Because given its multilateral status of a primary financial institution in the post war era, only IMF could impose conditionalities on a debtor. Simultaneously, it could urge the creditor commercial banks not to cut back their new credit lines to the debtor countries abruptly, and also, to grant the latter some debt relief. Banks were reluctant to extend new loans to a debtor developing country aftermath of the debt crisis. For the time being they virtually became residual suppliers of funds. IMF usually set the domestic policy targets for a debtor country. These targets were based upon the IMF's own estimates of the financial requirements of the debtor during the period covered in a debt rescheduling agreement. After the IMF had finalised its own contribution under the stand-by agreement the gap, as remained in the debtor's need for financing, was supposed to be filled up by disbursements from multilateral agencies under bilateral export credits, credits from other official sources (such as US commodity credits), and private sources including foreign investments and bank loans. This residual financing by banks and other multilateral agencies, other than the IMF, was known as co-financing.

In the first Mexican rescheduling, this residual financing requirement amounted to 7% of the then prevailing commercial bank exposure in Mexico. A contribution of this size from the banks was made a pre-condition by the IMF for implementing its own part of the Mexican loan package.

For carrying out rescheduling negotiations, the commercial
banks adopted a case-by-case approach. Each individual debtor country was dealt with separately by the banks through their debt negotiation forum - the London Club.

Commercial banks were more interested in rescheduling debt service payments than providing deferment or extending new long term money and short term credit maintenance loan. By doing so they probably intended to maintain the book value of the existing stock of debts as rescheduling helped them to consolidate the affected amount of debt into new long term obligations. They preferred consolidation of debts on long term basis to short term roll over of maturities for three different reasons. First of all, it was imminent by 1983-84 that debt crisis was going to persist for a period longer than could be perceived otherwise initially. This ruled out the possibility of the full recovery of debt service payments in near future. Secondly, even if everything went well, debtor countries (undertaking adjustment efforts) would take at least 3 to 4 years of time to generate surpluses on their trade balances. But there was a hope that outcomes of these adjustment efforts would be positive, and hence, banks would be able to recover their debt payments in full in future when good state would arrive. And lastly, banks thought it to be prudent on their part to consolidate debts into new long term obligations at once than going for short term deferment almost every year for each and every debtor.

Banks were, however, cautious, if not reluctant, to extend

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See Table 5.A.2 in Appendix 5.A at the end of the chapter.
new long term money or short term credit maintenance. The individual banks were not interested in extending new loans to the indebted countries as every such individual loan was to be made at an expected loss when such loan was made in isolation, as noted in chapter 4. Of the 29 countries whose bank debts were rescheduled during 1982-1984, only 10 received new long term money. Most of these countries, which received new money, were located in Latin America. Their total debt obligations constituted the larger exposures of the commercial banks, as we have seen in chapter 2. As a contrast, the bank exposures in the remaining countries, which did not receive any new money during this period, was not so high that they would be pressing concern for the banks. Moreover, the possibility of free riding by small banks as well as large banks with relatively smaller exposure to an indebted country prevented all the banks from new lending. Most of the banks feared that new money would only go to add to the bandwagon of bad debts. Especially for new banks new lending was a kind of tax if it was used to repay the old creditors. This problem was there since hardly any provision for seniority of new loans over old ones could be spelt out in clear terms in any of the rescheduling agreements. Some new loans were extended in proportion to the banks' individual claims at the insistence of the IMF.

By 1984 it was clear that debt servicing difficulties were going to persist, and hence, debtor countries would be requiring liquidity relief longer than that was thought of previously. In

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8 See Table 5.A.1 in Appendix 5.A at the end of the chapter.
the context of persisting debt problems year by year rescheduling involved uncertainties owing to rapidly changing perceptions of individual creditors. Also, the IMF aided adjustment programmes in several debtor countries, in order to succeed, seemed to have required 3 to 4 years of time gap to generate surpluses in their trade balances. Thus the commercial bank debt restructuring entered a new phase of consolidation of debts, which were falling due over a multiple number of years. This was known as the Multi-Year Restructuring Agreements (MYRAs).

5.2.2 : Multi-Year Restructuring Agreements (MYRAs):

By 1984 it became evident that there might be circumstances where a country, undertaking domestic adjustment efforts, was confronted with a bunching of amortisation payments, especially those on medium term debt. Under such circumstances it was thought that granting an extended consolidation period could facilitate in smoothing out debt payments which were falling due over a number of years.

In order to help debtor countries undergoing strong adjustment of their economies at the insistence of the IMF, commercial banks introduced the MYRAs so that the debtors' international liquidity position might improve. This required that the debtor country should normally be in a position to

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Consolidation period refers to the period in which debt payments which are due are rescheduled in terms of current maturities. The beginning of the period may precede, coincide with, or come after the date of the Agreed Minute, where the terms agreed upon the multilateral rescheduling meeting are embodied. See Lomax, David F., (1987, Reprinted), The Developing Country Debt Crisis, Macmillan Press, 1987.

See Appendix 5.B at the end of the chapter.
finance its current account deficits without borrowing from external sources. Secondly, it was thought that as the adjustment in the individual debtor economies would start showing positive results in terms of generating trade surpluses, private capital flows to these countries would also resume. The percentage of principal rescheduled should decline over the consolidation period in conformity with the expected progressive transitions to commercial financing.

The case-by-case approach continued. MYRAs involved much less new money extension compared to the previous debt rescheduling exercises. Out of 14 MYRAs reached with 10 debtor countries during 1985-87 only in 2 cases new money was extended and in other 2 cases short-term credit lines were maintained.\textsuperscript{11} In MYRAs, compared to the previous rescheduling exercises, consolidation periods for the maturities of the past debts were extended substantially.\textsuperscript{12} Actually, more emphasis was laid upon rigorous internal adjustment efforts undertaken by the severely indebted countries. It was held that debtor countries would be able to generate trade surpluses because of these adjustment efforts, and would meet their debt payment obligations when they would be due.

An unfavourable external environment, combined in some cases with policy errors, warranted that the MYRAs themselves, for most countries, be restructured. Also, the banks became more and

\textsuperscript{11} See Table 5.B.1 in Appendix 5.B at the end of the chapter.

\textsuperscript{12} See Table 5.A.2 in Appendix 5.A and Table 5.B.1 in Appendix 5.B at the end of the chapter.
more reluctant in negotiating MYRAs with the indebted countries. In fact, in agreeing to MYRAs the banks raised the question whether they were providing too many concessions to the debtors. The answer to this question can best be put in the words of one of the most prominent UK bankers: "The banks had to face the reality that in any case the amortization would not be possible in the years ahead. The banks wished to encourage the borrowers to continue handling their finances responsibly, and thus to give benefits to countries which had done that. The wear and tear of perpetual negotiation applied to banks as well as countries. Moreover, if one had the continuing treadmill of negotiation there was an increasing risk that something would go wrong, thus bringing the debt structure of a particular country crashing down. It might be essential in the earlier stages to undergo severe negotiating pressures as the participants worked out in their own mind where their interests lay. Once one was past that situation it was clearly advantageous to minimize unnecessary tensions"\(^\text{13}\).

5.2.3: The Baker Initiative:

Since the outbreak of the debt crisis in 1982 the debt problem was addressed on a short-term basis till 1985. In 1983 the World Bank with its characteristic optimism argued that: "There is no generalized debt crisis; rather the mutual difficulties of developing countries in servicing foreign borrowing and of commercial banks in obtaining service payments on foreign lending

\(^{13}\) See Lomax (1987) op. cit.
are an outgrowth of the broader economic problems", growing out of three years of global disinflation which began towards the end of 1979.  

The Bank emphasised the restoration of economic growth in order to overcome these transitory difficulties. However, what followed was more than a typical cyclical downturn in the world economy. It was a widespread crisis for major Latin American and African countries which had to engineer massive domestic adjustment of their economies in order to come out of it. As shown earlier, the real threat ensued from the cascading sovereign debt problems, coupled with high interdependence of international banks, which could trigger a meltdown of the financial system. Some even feared a 'meltdown' similar to what happened in thirties during the Great Depression.  

By 1985 the vulnerability of the commercial banks was reduced to a great extent. However, the debt-servicing problem of the developing countries persisted. And, hardly any troubled debtor could gain access to the private credit markets which was one of the assumptions behind the debt rescheduling and new money exercises. The World Bank reported that: "Of the countries that have rescheduled debts since 1982, only Cote d' Ivoire and Uruguay have been able to raise long term loans from financial markets outside the context of a formal restructuring.


agreement. Eichengreen and Portes (1985, 1987) showed that even countries which did not encounter any debt servicing problem found their access to the private capital markets greatly shrunk.

Thus what remained after four years of intensive effort to restructure external debts and restore growth was a debt servicing crisis. In many cases developing countries continued to service their external debts only at a very high cost of foregone economic growth and drastic declines in per capita income, with little prospect of a return to voluntary lending. For them the eighties, in contrast to the seventies, remained a lost decade in terms of economic development.

It was clear by 1985 that despite domestic adjustment processes bank lendings to the developing countries would continue to remain frozen over a length of period which was uncertain. Growth recovery was not imminent in the foreseeable future for the highly indebted nations. There was mounting domestic political pressures on Latin American policy makers who adhered to the IMF adjustment programmes. Changes in governments from military to civilian rule took place in Argentina and Brazil, and in both the countries adjustment efforts were slowed down during 1985. On the other hand, there was a shift in economic policy stance of US, as could be evidenced in the Plaza

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Agreement initiated by the new US Treasury Secretary James Baker in September 1985. It aimed at reducing the value of the overly strong dollar in a bid to avoid a protectionist outbreak in United States which could lead to reprisals in the rest of the developed economies. It was in this background the US Treasury Secretary James Baker proposed a new strategy for dealing with the debts of the highly indebted middle income countries at the IMF/World Bank Annual Meeting of October 1985 which came to be known as Baker Initiative or Baker Plan.

Baker Initiative did not earmark any shift in the debt strategy. In the case-by-case framework it tried to continue with the principle of financial support by creditor banks and official creditors, matched by intensive adjustment efforts on part of the debtor countries. It did not allow for any debt forgiveness as that would have meant admitting defeat and, as the plan’s architects judged, might cut off borrowers from capital markets for many years to come. Rather the target of the Plan was set out in the high optimism that the fifteen major borrowing nations could grow and come out of the debt servicing difficulties, and in a cooperative world economy would be able to expand their exports over time in order to reduce their relative debt burdens to sustainable levels. This would also be conducive to a return to more normal credit market access.

The Baker targets were never attained. During 1986-88, commercial bank creditors provided only $ 1.53 billion annually and official creditors extended $ 1.73 billion annually. During
1986-88 annual average capital flows from both the official and private sources taken together to the fifteen Baker countries amounted to $5.96 billion. And, the banks extended only $4.6 billion of new money as against the targeted $20 billion.

During the Baker Plan period there seem to be an institutional shift from the IMF to the multilateral development banks (MDBs), especially the World Bank, as the lead institution in debt management. Cline (1989) appraised this shift as "a move away from short-term balance of payments stabilization, particularly through programmes which could have contractionary effects, to longer term development objectives." This shift from the IMF to the World Bank as the lead multilateral financial institute in debt management might have been induced by the creditor countries' assessment about the debtor economies in general. It was felt that short term stabilisation programmes, at the insistence of the IMF, alone would not be sufficient in alleviating the structural problems inherent in the debtor economies. Rather, it would call for medium term structural adjustment in those economies. Note that almost around the same time the Fund introduced the Structural Adjustment Facility (henceforth, SAF) in 1987. For that the IMF perhaps did not have the adequate resources and infrastructure. The World Bank, on the other hand, from its inception was engaged in developmental financing for its member countries and possessed the

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18 See Table 5.C.1 in Appendix 5.C at the end of the chapter.
19 See Table 5.C.2 in Appendix 5.C at the end of the chapter.
infrastructure along with the Fund to provide long term developmental loans to the indebted countries. As can be seen from table 5.C.1, the IMF played an extremely active role in providing new money to the problem debtors in the initial years of the crisis (1983-85). From 1986 a posture of minimal new lending was adopted by the multilateral agencies, especially by the IMF. This may be because it was imminent by then that the immediate threat of default was no longer prevailing and thus there was no need to extend new money on a large scale to finance the debt service payments of the highly indebted countries. Rather it was needed to ensure that there would not occur any disruption in debt service payments of these countries in the near future. For that, domestic economic adjustment was adjudged as more important in increasing these countries’ capacity to pay. The actual extension of new credits to the Baker fifteen countries by the multilateral agencies remained far below the net capital contribution, expected from them.

The net transfer of resources to the highly indebted Baker fifteen countries fell from $ 18.3 billion in 1981 to $ -26.5 billion in 1985, a decline of $ 44.8 billion.21 It appears that the Baker target was highly optimistic for the period 1986-88. It envisaged a net bank lending of $ 20 billion for the period without adequately addressing the difficult mechanism of concerted lending approach in which all banks were to lend additional amounts in proportion to their exposures. The mechanism could not enthuse the banks to lend adequate amounts

21 See the World Debt Tables (1988-89).
voluntarily. From the very beginning of the crisis it was apparent that the free rider problem would bring bank lending to grind to a halt. A third party intervention was necessary to deal with this externality. In the early stages of the crisis IMF played this role. The Baker Initiative failed to achieve much over the medium term. It became clear by 1987-88 that banks had become more reluctant to extend new money through the existing concerted approach because of the fear that their new loans could also become part of the overall bad debts. This, in fact, construed the self-limiting character of the concerted lending approach.  

Also, as noted earlier in this chapter, the banks were no longer willing to confer concessions to the debtors in terms of debt rescheduling either. As a result of this by 1987 new lending by banks and debt rescheduling operations almost came to an end. A switch by then had already started taking place from the involuntary concerted lending and debt rescheduling to market-based menu-driven approaches.

5.2.4: An Evaluation of the Case-by-case Approach:

The case-by-case approaches, which include the debt financing, debt rescheduling and the Baker Initiative aimed at reducing the debt exposures of the commercial banks in the third world. During 1983-89 gross as well as net flows in the direction of the developing countries declined continuously. This decline is linked with the changes in the pattern of international capital

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flows aftermath of the emergence of the debt crisis. In eighties, as a contrast to seventies, the major industrial economies started absorbing most of the private capital flows, leaving a small margin of residual flows for the developing country borrowers. Most importantly, there was a change in the composition of these flows. Syndicated bank credit, which had a booming business during seventies, was substantially replaced by securities of various categories as the main instrument of financial assets. Developing countries, most of whom had very little or no access to the security market for international borrowings, had a natural drawback in reaching out these emerging markets till the early nineties when a few could have a limited degree of access. A steady decline in the gross flow of capital to the developing countries, matched by simultaneous increases in accumulated borrowings made the financial and the real flows in the direction of the borrowers rather small or negative. During 1983-90, total bank capital flows to the non-OPEC developing countries were $ -19 billion in contrast with the flow of $ 26 billion during 1979-82. A significant part of this decline reflected the changes in the value of the banks' claims on developing countries. After 1988, a part of this change in value of banks' claims was due to various debt conversion schemes, asset sales and write-offs. There was hardly any capital reflows in the direction of the developing countries over the period.

See BIS (1990), International Banking and Financial Market Developments: August 1990; Basle, BIS.
Following the debt services disruption in several third world countries in the early eighties, the commercial banks withdrew from their developing country lending business in no time. And, they decided to limit the total amount of loan assets in a developing country. It is interesting to see formally the implications for the developing country economies of the banks' decisions to reduce their exposures and restrict new lending to these countries.

Let us recall the equation (3.13) in chapter 3 which spelt out the relationship between net transfers-to-GDP ratio 'n', interest rate 'i', rate of change of debt stock 'r', and debt-to-GDP ratio 'd' in terms of "sustainable" debt process, defined as declining debt-to-GDP ratio over time:

\[ n = d(r-i) \]

Now, let us assume that all the variables in the above equation correspond to the bank debts only of a debtor country. Note that 'r' then reflects the proportional change in banks' new lending in the debtor economy. A negative 'n' would then imply net transfer to the banks as a proportion of the debtor's GDP which is possible when \( r < i \) given \( d > 0 \). If \( i \) is held high above \( r \), then by restricting new lending banks actually intended to increase net transfer to them from the debtor's economy. A "sustainable" debt process, as described in chapter 3, warrants that debt-to-GDP ratio to fall over time. When no new flows were forthcoming, the onus then fell upon debtor's internal adjustment efforts to enable it to meet its past debt obligations. The adjustment efforts, thus, became determined by the size of the bank
exposures in the debtor economy. As discussed already in chapter 3, the internal adjustment efforts implied that a debtor country would enhance its exports and restrain its imports to generate trade surpluses. The relationship between debtor's adjustment effort, spelt in terms of export growth, and its required debt payment obligations, spelt in terms of net transfer from therein, in the context of "sustainable" debt process can be established formally.

Dividing both sides of the above equation by $Y/X$, GDP-to-Exports ratio and rearranging the terms we obtain:

$$\theta = \beta/(r-i)$$

where $\theta = D/X$, debt-to-exports ratio; $\beta = N/X$, net transfer-to-exports ratio.

A "sustainable" debt process in terms of debt-to-exports ratio warrants that

$$\theta \leq 0$$

Now,

$$\theta = (g_n-x)/(r-i)$$

where $g_n = N/N$ and $x = X/X$.

For $\theta \leq 0$, $x \geq (r-i)/g_n$.

The above inequality shows that debtor's export growth rate was determined by the new lending to it by the creditors, interest rate and growth rate of net transfer of financial resources. When the growth rate of net transfers fell export growth must rise, at least, by the amount, given by the right hand side of the above inequality which constitututed a lower bound on export growth rate. When net transfer to the debtor economy was negative 'g_n' would be low implying that export growth needed to be high for
"sustainable" debt process, given \( r \) and \( i \). This explains why during the period under case-by-case approach of debt financing and debt rescheduling more and more emphasis was laid upon debtor's internal adjustment efforts.

The involvement of the IMF in the debt management strategies during 1983-89 was to ensure that a debtor country reduced imports by tightening spending and also, it took measures to enable it to divert resources to the production of either exportables or goods which could be used to replace imports. The official capital flows from the IMF, the World Bank and the bilateral donors during the period to the indebted countries during 1983-89 mainly went out to meet the debtors' private debt obligations which remained uncovered by their trade surpluses. This confirms the 'sidepayment' hypothesis of Bulow and Rogoff (1989) which was discussed in chapter 4.\(^{24}\)

The way different debt management policies were implemented during the period indicates the presence of a strong creditors' cartel in dealing with the third world loan assets of the commercial banks.\(^{25}\) The debt management policies were guided by the interests of the most active partners in the debt process viz. the private financial institutes in the creditor countries. Even official agencies seem to have displayed a disproportionate concern for financial outflows from the third world economies to

\(^{24}\) Also, see Chapter 6, Section 6.1 for further analysis of official involvement in the debt management game in the eighties.

\(^{25}\) In this regard International Lending and Supervisory Act (ILSA) is noteworthy. See Appendix 5.H at the end of the chapter.
save the private financial system at the cost of foregone real economic growth in these countries. A major factor behind such tendencies was the reality that finance by then had become the main conduit of profit generation in the creditor countries. These policies were at the cost of a relative neglect to the real economy in the process of production and employment generation in their respective territories. In the process the developing country borrowers remained too vulnerable in terms of the rather limited options left to them at the stage of debt negotiation.

As a result, the developing countries were forced to adjust to a smaller level of real expenditure which also cut back real growth therein. The global implications of these adjustments remained harmful, not only for the developing countries, but also for the industrialised countries which lost, as a consequence, the opportunities of an expanding market in these areas. It seems that the Baker Initiative, realising this potential for expansion of market areas through third world debt management, emphasised on growth recovery in the major indebted economies. But, as we have seen, the Baker targets were never reached. This may be explained by the dominance of the financial interests over the trade-creating interests of the creditor countries. The dominance of finance in the world economy was thus manifest in the policies to manage third world debt, resulting in a widening gap between the performance of finance and the real sectors of the economy.

The ultimate consequence of the case-by-case approach was that by 1988 debt held by the third world countries fell considerably. Unlike what the Baker Plan promised the voluntary bank lending to the developing countries were not initiated. The steady reduction in the commercial banks' third world exposures during this period can be explained by the tapering off in the gross as well net flows to this region. Gross flow to the developing countries during 1983-87 fell from $ 84 billion to $ 79 billion and net flows declined from $ 49 billion to $ 25 billion. Gross flows from the banks to the developing countries during 1983-87 declined from $ 33 billion to $ 24 billion and net flows declined from $ 24 billion to $ 0.9 billion.  

By 1987 financial condition of most of the commercial banks improved substantially. The ratio of the world’s top hundred banks’ net exposures in Latin America to their equity holdings declined to 57% in 1987 from 125% in 1982. The sharp reductions in the developing country exposures in proportion to the total assets and equity of the banks led to substantial modification in the key motivating forces behind the case-by-case approach. The commercial banks no longer considered the debt problem of the highly indebted countries as of a pressing concern. Third world debt scenario by then went through significant changes, which coincided with the changes in the financial sector in the creditor countries. Banks, by then, had little interests in debts as

27 Also, see Table 2.24 and 2.25 in chapter 2 which indicate the declining trends of international capital flows to Eastern Europe and Latin America.

instruments, and leaned more to holdings of securities in their portfolios. The case-by-case approach tended to be substituted by a menu-driven approach with sales of debt at discounts and equity swaps. The latter heralded the end to creditors' cartel which came up during the early phase of the third world debt management. This end was forced by the competition from the Japanese and the European banks which got a fillip with deregulation of finance at home. This competition and also, the question of asset diversification replaced the case-by-case approach of debt financing and rescheduling, by market-based menu-driven approaches of debt buy-backs, debt equity swaps and debt securitisation. Led by the interest of the active partners of the finance viz. the private financial institutes, the official concern swung in favour of a voluntary and market-based menu-options for the banks in 1989. By that time, banks, burdened with much less third world debt, were already in debt trade business.

5.3 : Market-Based Approaches:

At the annual meetings of the IMF and the World Bank in September 1987, the US Secretary of State James Baker put forward a new proposal to tailor the forms of bank participation in terms of the varying interests of the individual commercial banks. The approach came to be known as 'menu approach'. The major motivating factor behind debt conversion measures was the prevailing discount on the developing country claims of the banks in the secondary market for developing country debts. To arrive

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at a critical assessment of these debt conversion schemes it is necessary to know the functioning of secondary market for the developing country debts.

5.3.1: The Secondary Market of Developing Country Debts:

The secondary market for developing country debts emerged in 1984. It grew from a volume of $5 billion in 1986 to more than $100 billion in 1991. The distinguishing feature of the secondary market for the developing country debts was the steep discounts at which the commercial banks' debts owed by these countries were traded. Over the years the average discount at which the developing country debts were traded improved. Still in December 1991 the discount was over 50%.

Initial transactions in the secondary market were characterised by the attempts of the banks to reduce their net exposures in one currency while increasing their exposures in another one. This was known as debts for debts swap. Debt was swapped, often at a face value, between the banks as they sought to alter the country compositions of their asset portfolios. Attempt was to reduce their loan exposures in the countries where they had less expertise to manage the risks, or where the high exposure was considered as quite risky given the country's ability and willingness to pay in the near future. On the other hand, the banks attempted to increase their exposures in other

countries or other assets, mainly securities. For example, some European banks swapped their Latin American debts for the East European debts of the North American banks. 31

The impetus for the growth of the market stemmed, also, from the small regional banks, reluctant to take part in the developing country lending business, and the multinational companies which were then looking for the cheaper avenues to finance their developing country investment programmes.

Finally, the Brady Plan helped to accelerate the secondary market operations in 1989 by replacing case-by-case approach by market-based menu-driven approaches as the dominant debt management strategy.

The emergence of the secondary market operations in the developing country debts reflected the change in the perception of the creditors regarding the nature of the crisis. It was argued that the secondary market steep discount was a prima facie evidence that the creditors were not expecting full repayments from the debtors in near future. 32 In other words, the existence of the secondary market was attributed to the insolvency of the indebted developing countries. This meant that the present value of the future stream of debt payments, expected by the creditors from the debtors, was less than that of the required debt

31 The loans were swapped between the banks or sold for cash. These were brokered by investment and commercial banks, mainly in New York and London. These included ING, Citicorp, Chemical, JP Morgan, Bankers' Trust, Standard Chartered, Salomon Brothers, Merill Lynch and Chase Manhattan. See United Nations (1990); op. cit.

payments; and hence, the creditors expected to incur loss. This loss to the creditors was sought to be eliminated through the secondary market operations by setting the market prices of the developing country debts right. Quite analogous to the function of the secondary market for bonds and shares, the major objective of the secondary market operations in the developing country debts was to establish market clearing price levels for the developing country debts. Following Krugman (1985, 1988, 1989) and Sachs (1982, 1986) this problem can be formulated in two ways - under certainty and under uncertainty.

For the sake of simplicity, let us assume a two period framework. Let the total inherited stock of outstanding debt obligations of the country be $20 billion, and the required payment in each period is $10 billion. Suppose it is known to the creditors that the debtor is able to pay $6 billion in the first period and $12 billion in the second period respectively. That means of the $20 billion debt obligations only $18 billion would be paid actually, implying a default of the order of $2 billion in nominal terms. Then the present value of the debt payments, if the market discount rate is 0.5, will be $(6 + 12/1.05) = $14 billion, which is less than the present value of the required debt payments $(10/1.05 + 10/1.05) = $19.04 billion where 5% is the interest rate, say. Note that with the rise in the insolvency of the debtor, creditors may seek to enhance the interest rate. For the sake of simplicity we are taking here interest rate to be constant. This causes a loss of $5.04 billion ($19.04 billion - $14 billion) to the creditors in
terms of the present values of the actual and required debt payments.

In the present example, the market clearing discount rate should be -0.11 at which the present value of the actual debt payments will be equal to that of the required debt payments indicating a decline of 122% in the discount rate.

The above example can be set in a formal manner. Suppose, the total debt obligation is \( D \) where \( i \) is the constant rate of interest, and \( D_1, D_2, \ldots, D_n \) are the amounts to be paid in the periods 1, 2, \ldots, \( n \) where \( n \) is the maturity period. Then the present value of the required debt payments is

\[
\sum_{t=1}^{n} \frac{D_t}{(1 + i)^t}
\]

On the other hand, if \( X_1, X_2, \ldots, X_n \) be the actual payments expected by the creditors, and if \( \delta \) be the market discount rate then the present value of the actual debt payments is

\[
\sum_{t=1}^{n} \frac{X_t}{(1 + \delta)^{t-1}}
\]

The creditors do not expect to be repaid in full if

\[
\sum_{t=1}^{n} \frac{X_t}{(1 + \delta)^{t-1}} < \sum_{t=1}^{n} \frac{D_t}{(1 + i)^t}
\]

Given \( i \), the equality between the above two expressions is attempted through the reduction in \( \delta \). The same could have been done through the reduction in the nominal value of the initial stock of debt \( D \). But creditors might not be interested in reduction in their claims in anticipation of some future good
state when they would be able to recover their claims. In this context the debt management mechanism is spelt through reduction in the discount rate, as noted down here.

Now let us incorporate uncertainty in our example. For the sake of simplicity we are introducing uncertainty only in the second period which means that the creditors know about the first period’s debt payments to be made by the debtor. In the second period, the debt payment depends upon whether there will be good state or bad state in the debtor economy. In the good state debtor will make a payment of $14 billion, say, while in the bad state only $12 billion of payments is made. If the probability of the good state is 1/3 and that of the bad state is 2/3 then the present value of the expected debt payments will be $6 + [1/3 \times 14 + 2/3 \times 12]/1.05 = $14.44 billion, which is far less than the present value of the required debt payments of $19.04 billion. In such an event, the market clearing discount rate should be -0.03 implying a reduction of 160% in the discount rate.

It was held that the debt trading at the secondary market would help to enhance the market prices of the developing country debts and, thereby, would restore private capital flows to them. In our hypothetical example, we have seen attaining market clearing prices for developing country debts in the secondary market required substantial reduction in the discount rate on

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33 See Chapter 4, Section 4.3.
34 See Krugman (1989); op. cit.
debt. Attaining market clearing prices depended upon number of factors. Moreover, the pertinent question was whether secondary market operations were capable of dealing with the third world debt overhang adequately. First of all, prices of any secondary issue can go up only when there exists sufficient excess demand for them, just like any other commodities in a market, and also, if issues are price elastic. Some studies have reported the price elasticity of the developing country debts, traded at the secondary market, to be less than one. Secondly, the buyers of the developing country debts were mainly the private multinational companies and, in some cases, the debtor governments themselves. These companies wanted to take advantage of the deep discount prevailing in the secondary market. The debtor governments were constrained by their own resources to purchase their debts owed to the banks. Thirdly, secondary markets were thin in nature compared to the overall debt outstanding of the entire third world nations and, hence, even if prices would go up substantially it was doubtful whether secondary market operations would be able to deal with most of the debt outstanding of the third world. Lastly, like any other market, secondary market could also be manipulated by the dominant buyers of the secondary issues - most importantly by the multinational companies - to buy these debts cheaply. Because of these it was quite unlikely that the secondary market operations would be effective enough to reduce the overall debt overhang of the third world countries.

36 See Dooley (1989); Krugman (1989); and, Bulow and Rogoff (1988); op. cit.
Till now we have left out the issue of new lending. However, the entire question of secondary market operations and debt conversions must be set against this issue. Krugman (1988) has shown that there exists trade-off between debt forgiveness through voluntary debt conversion schemes and debt financing through the concerted lending approach. Retiring some debts through market-based approaches might create incentives for debtors to adjust as against when there exists debt overhang, and thereby, it enhances the likelihood that the debtor would repay in full the remaining debts. On the other hand, creditors would like to keep their claims at the existing level, as noted earlier, if by chance the debtor turned out to be able and willing to pay in near future. However, a large debt overhang might create disincentives, as noted in chapter 4, for debtors to undertake adjustment efforts. In reality this dilemma between keeping the present value of the nominal debts high enough and providing some incentives to debtor for adjustment warranted an optimum mix of both debt forgiving and new lending, as mentioned in chapter 4. But by the mid-eighties the banks were no longer interested in extending new loans to the indebted developing countries. Therefore, a third party intervention was deemed necessary, as shown in chapter 6, in adopting a debt management strategy which would incorporate the appropriate mixes of the both debt financing and debt reduction. The Baker Initiative and later, the Brady Initiative were attempts in this regard to some extent. Theoretical debate on optimal borrowing has completely

37 See chapter 4.
38 See Section 4.3 of Chapter 4.
missed this aspect of the third party. By 1986, as shown in chapter 6, prevention of widespread default was ensured mainly by this third party intervention. Debt distressed economies were not in a position to experience high growth rates as in seventies. There was no point for the banks to continue with the sovereign lending as it was no longer profitable for them; rather, the opportunity costs for such lending was too high in eighties. Secondary market operations rendered them some leverage to reduce some of their developing country debt exposures and, also, to diversify their asset portfolios. It is in the context of reduction of the commercial banks' claims and their asset diversification rather than the restoration of the creditworthiness of the debtors that the role of the secondary market operations vis-a-vis the market based menu-driven options need to be appraised.

During 1986-89, which was prior to the arrival of the Brady Plan, inter-bank swaps and trading by market intermediaries and different kinds of debt conversions remained the major forms of transactions in the secondary market. Debt conversions can be classified as formal and informal. The formal conversions were concluded with the official set-up while the informal conversions were arranged outside the official set up. Again, they can be classified as: (a) conversions which altered the original value of the loans, and, (b) conversions which transformed the nature of claims from loan to bond or equity, say. The major debt conversion instruments included debt-equity swaps, debt securitisation, debt buy-backs, debt for goods swaps, debt for
nature swaps, local currency pre-payments, round tripping and
debt for debt swap. Table 5.2 describes the different debt
conversion instruments in a matrix framework which indicates that
most debt conversion instruments aimed at altering nature of
claims (assets) from debts to some other claims, which include
securities and equities.

As a result of the emergence of the secondary market
operations in the third world debts of the commercial banks, a
market rationale was replaced by the system rationale of the
_case-by-case_approach._The_market-based_approach_made_the_
participation of the individual commercial banks voluntary. The
de-regulation of finance in the creditor countries rendered
securities and other non-banking business more profitable for the
banks than their third world lending business. Market-based
approaches helped the private financial institutes which include
banks to alter their debt claims into other assets which by then
had become attractive.

The menu approach tried to evolve different market-based
options taking into account the diversity of commercial banks’
constraints and motivations. In particular, it envisaged a way
for the banks, especially for the small and regional banks, to
reduce and diversify their developing country loan assets. Table
5.3 gives an account of the reduction in exposures by the top 29
US banks during 1987-88. It can be noted that out of 29 banks 10
reduced their exposure by more than 50% (4 banks reduced by more
than 90%), 4 banks by more than 30% and 9 banks by more than 10%.
This reduction in exposure took place during the period June 1987-September 1988 through market-based menu-driven approaches. The smaller and regional banks reduced their exposures more than the larger ones. All the four banks which reduced their exposures by 90% were small and regional ones.
Table 5.2
Matrix of different Debt Conversion Instruments

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Type of Conversion [Formal (F) or Informal (I)]</th>
<th>Alteration in original contractual value</th>
<th>Alteration in nature of claims</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt-equity swap</td>
<td>F</td>
<td>No</td>
<td>Yes (equity)</td>
</tr>
<tr>
<td>Securitisation</td>
<td>F / I</td>
<td>No</td>
<td>Yes (bond)</td>
</tr>
<tr>
<td>Buy-backs</td>
<td>F</td>
<td>Yes (at a discount)</td>
<td>No</td>
</tr>
<tr>
<td>Debt-for-goods swap</td>
<td>F</td>
<td>No</td>
<td>Yes (repayment of loans with goods now and in future through collateralization)</td>
</tr>
<tr>
<td>Debt-for-nature-swap</td>
<td>F</td>
<td>No</td>
<td>Yes (conversion in local currency or debt instrument donated to environmental organisations for specific projects)</td>
</tr>
<tr>
<td>Local Currency Payments</td>
<td>I</td>
<td>Yes</td>
<td>Yes (local currency equity investments)</td>
</tr>
<tr>
<td>Round Tripping</td>
<td>I</td>
<td>No</td>
<td>Local currency repayment</td>
</tr>
<tr>
<td>Debt-to-debt swap</td>
<td>F</td>
<td>Yes</td>
<td>Local currency repayment indexed to dollar</td>
</tr>
</tbody>
</table>
Table 5.3

Reduction in exposure to Developing Countries of 29 US Banks

(in US billion $)

<table>
<thead>
<tr>
<th>Banks</th>
<th>Total Exposure</th>
<th>Exposure Reduction</th>
<th>Reduction (in per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>June 1987</td>
<td>Sept 1988</td>
<td></td>
</tr>
<tr>
<td>Citi Bank</td>
<td>14.60</td>
<td>12.10</td>
<td>2.50</td>
</tr>
<tr>
<td>Bank of America</td>
<td>10.35</td>
<td>9.00</td>
<td>1.35</td>
</tr>
<tr>
<td>Manufacturers</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hanover</td>
<td>9.23</td>
<td>8.69</td>
<td>0.55</td>
</tr>
<tr>
<td>Chase Manhattan</td>
<td>8.74</td>
<td>7.95</td>
<td>0.79</td>
</tr>
<tr>
<td>Chemical Bank</td>
<td>5.94</td>
<td>5.90</td>
<td>0.04</td>
</tr>
<tr>
<td>Morgan Guaranty</td>
<td>5.40</td>
<td>4.70</td>
<td>0.70</td>
</tr>
<tr>
<td>Bankers Trust</td>
<td>4.00</td>
<td>4.00</td>
<td>--</td>
</tr>
<tr>
<td>First Chicago</td>
<td>3.12</td>
<td>2.43</td>
<td>0.69</td>
</tr>
<tr>
<td>Continental Illinois</td>
<td>2.40</td>
<td>2.80</td>
<td>0.48</td>
</tr>
<tr>
<td>Irving Bank Co.</td>
<td>1.95</td>
<td>1.89</td>
<td>0.06</td>
</tr>
<tr>
<td>Mellon</td>
<td>1.60</td>
<td>1.39</td>
<td>0.21</td>
</tr>
<tr>
<td>Security Pacific</td>
<td>2.20</td>
<td>1.26</td>
<td>0.94</td>
</tr>
<tr>
<td>Bank of Boston</td>
<td>1.40</td>
<td>1.00</td>
<td>0.40</td>
</tr>
<tr>
<td>First Interstate</td>
<td>1.61</td>
<td>0.99</td>
<td>0.61</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>1.91</td>
<td>0.76</td>
<td>1.15</td>
</tr>
<tr>
<td>Bank of New York</td>
<td>0.54</td>
<td>0.47</td>
<td>0.74</td>
</tr>
<tr>
<td>Rep. of N.York</td>
<td>0.49</td>
<td>0.46</td>
<td>0.26</td>
</tr>
<tr>
<td>PNC Financial</td>
<td>0.48</td>
<td>0.29</td>
<td>0.19</td>
</tr>
<tr>
<td>First Fidelity</td>
<td>0.24</td>
<td>0.18</td>
<td>0.60</td>
</tr>
<tr>
<td>Northern Trust</td>
<td>0.32</td>
<td>0.15</td>
<td>0.17</td>
</tr>
<tr>
<td>South East</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banking</td>
<td>0.21</td>
<td>0.12</td>
<td>0.10</td>
</tr>
<tr>
<td>MNC Financial</td>
<td>0.22</td>
<td>0.11</td>
<td>0.12</td>
</tr>
<tr>
<td>Bank of New England</td>
<td>0.31</td>
<td>0.11</td>
<td>0.20</td>
</tr>
<tr>
<td>Valley National</td>
<td>0.15</td>
<td>0.06</td>
<td>0.09</td>
</tr>
<tr>
<td>Fleet/Norstar</td>
<td>0.14</td>
<td>0.05</td>
<td>0.09</td>
</tr>
<tr>
<td>First Wisconsin</td>
<td>0.29</td>
<td>0.02</td>
<td>0.27</td>
</tr>
<tr>
<td>Northwest Corp.</td>
<td>0.51</td>
<td>0.02</td>
<td>0.50</td>
</tr>
<tr>
<td>First Wachovia</td>
<td>0.21</td>
<td>0.01</td>
<td>0.20</td>
</tr>
<tr>
<td>NCNB Corp.</td>
<td>0.25</td>
<td>0.004</td>
<td>0.24</td>
</tr>
</tbody>
</table>

Source: Cited in Macdonald, Lindsay & Green (eds.) (1990).

The menu approach paid heed to the free riding problem by
enabling banks to reduce their exposures and by not insisting upon them to extend new loans. For example, in the Argentine agreement of April 1987, a bank could buy exit bonds, usually at a below market interest rate which were exempt from new money calls. Other alternatives were securitised claims with enhanced tradeability, and debt-equity swaps. By the end of 1988 menu approach became firmly entrenched as the most important vehicle of commercial bank debt restructuring.

5.3.2: The Brady Plan:

The Brady Plan was launched in 1989 to give fillip to the market-based menu-driven approaches and, like the previous Baker Initiative, laid down its targets for different creditors involved in the third world debt management. It intended to reduce debt and debt services payments through buy-backs at a discount or exchange of loans for securities. As table 5.E.1 indicates, in the seven Brady agreements reached during 1990-92 total debt and debt services reduction was $69.5 billion ($31.2 billion debt reduction and $38.3 billion debt services reduction) whereas new money flow was $11 billion only. In fact, leaving Mexico and Venezuela total debt and debt service reduction for the remaining four countries was $12.9 billion only. Philippines and Nigeria did not receive any new money while Mexico and Costa Rica received the major share of the new money flow.

39 See Appendix 5.E at the end of the chapter.
The most notable feature of the Brady deals is the use of the third party bonds as collateral. If the bonds were in a currency other than the US dollar the discount bonds and par bonds of debt and debt services reduction agreements were collateralised with zero-coupon US Treasury securities or comparable instruments. In the Mexican Morgan Guaranty deal US zero-coupon Treasury bonds were used as collateral. Interest payments were often covered by a 12-18 months rolling guarantee. These enhancements were purchased in part from the international organisation of bilateral donors, mainly Japan.

The Brady deal sought to link creditors’ future claims with debtors’ economic performance. Value recovery provisions were made in agreements with Costa Rica, Mexico, Nigeria and Venezuela. For Mexico, Nigeria and Venezuela if the price of oil should rise above a reference price, bond holders could recapture part of the bond discount. Otherwise, the yield on interest reduction bonds would increase. For Uruguay, value recovery was based on a partial terms of trade index based on Uruguayan domestic prices of wool, beef, rice and oil. The value recovery clause for Costa Rica was based upon economic performance; recapture was supposed to be triggered by GDP exceeding 120% of the 1989 figures in real terms. These provisions were set up in anticipation of some ‘good’ state in the debtor economies, expected to be fuelled by their internal adjustment efforts.

Debt reduction of all types amounting $18.1 billion in 1988

40 See Appendix 5.D at the end of the chapter.
increased to $28.8 billion in 1990 with the conclusion of large scale Brady operations, and fell to $5.3 billion in 1991. Table 5.4 indicates the volume of debt conversion through different instruments over the period 1985-92. About 80% of the debt conversion volume was concentrated in four Latin American countries: Argentina, Brazil, Chile and Mexico as shown in table 5.5, indicating the inequitable nature of the debt reduction operations under Brady deals at the global level.

Table 5.4

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt Equity Swaps</td>
<td>0.50</td>
<td>0.82</td>
<td>3.30</td>
<td>6.87</td>
<td>4.51</td>
<td>9.47</td>
<td>1.82</td>
<td>1.55</td>
</tr>
<tr>
<td>Local Currency payments</td>
<td>--</td>
<td>0.06</td>
<td>0.09</td>
<td>3.43</td>
<td>2.43</td>
<td>2.19</td>
<td>1.28</td>
<td>0.09</td>
</tr>
<tr>
<td>Buyback Local conversion</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>1.86</td>
<td>0.65</td>
<td>10.7</td>
<td>1.25</td>
<td>9.23</td>
</tr>
<tr>
<td></td>
<td>0.16</td>
<td>0.44</td>
<td>0.80</td>
<td>1.67</td>
<td>2.27</td>
<td>4.85</td>
<td>0.80</td>
<td>0.28</td>
</tr>
<tr>
<td>Private sector reform</td>
<td>0.09</td>
<td>1.60</td>
<td>3.45</td>
<td>4.34</td>
<td>3.11</td>
<td>0.34</td>
<td>0.77</td>
<td>0.24</td>
</tr>
<tr>
<td>Total</td>
<td>0.74</td>
<td>1.62</td>
<td>7.63</td>
<td>18.2</td>
<td>13.0</td>
<td>27.5</td>
<td>5.92</td>
<td>11.4</td>
</tr>
</tbody>
</table>

### Table 5.5

**Debt Conversion Programme in Selected Countries**

(1985-91)

<table>
<thead>
<tr>
<th>Country</th>
<th>Amount of Debt Conversion (in billion US $)</th>
<th>Per cent of Total Debt of the Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>8.85</td>
<td>11.7</td>
</tr>
<tr>
<td>Bolivia</td>
<td>0.79</td>
<td>1.1</td>
</tr>
<tr>
<td>Brazil</td>
<td>17.94</td>
<td>23.8</td>
</tr>
<tr>
<td>Chile</td>
<td>10.44</td>
<td>13.9</td>
</tr>
<tr>
<td>Colombia</td>
<td>0.33</td>
<td>0.4</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>1.27</td>
<td>1.7</td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>0.00</td>
<td>0</td>
</tr>
<tr>
<td>Ecuador</td>
<td>0.47</td>
<td>0.6</td>
</tr>
<tr>
<td>Jamaica</td>
<td>0.07</td>
<td>0.1</td>
</tr>
<tr>
<td>Mexico</td>
<td>22.68</td>
<td>30.1</td>
</tr>
<tr>
<td>Nigeria</td>
<td>0.26</td>
<td>0.4</td>
</tr>
<tr>
<td>Philippines</td>
<td>4.04</td>
<td>5.4</td>
</tr>
<tr>
<td>Uruguay</td>
<td>0.76</td>
<td>1.0</td>
</tr>
<tr>
<td>Venezuela</td>
<td>4.02</td>
<td>5.3</td>
</tr>
<tr>
<td>Former Yugoslavia</td>
<td>3.39</td>
<td>4.5</td>
</tr>
<tr>
<td>Others</td>
<td>0.24</td>
<td>0.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>75.63</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: World Debt Tables (various issues).

Debt conversion instruments which were most commonly used in different Brady deals were debt buy-backs at a discount and debt securitisation. The impacts of buy-backs and debt securitisation on the debtor economies were not certain which have been discussed in chapter 4.\(^{41}\) Debtor countries used their accumulated foreign exchange reserves to repurchase their debts. Debt conversion was beneficiary to a debtor if savings on principal repayments and interest payments on retired debts would exceed the benefits which would accrue to them from alternative uses of these resources. But the most important question is how

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\(^{41}\) See Chapter 4, Section 4.3.
a debt-distressed economy accumulated foreign exchange reserve when no other external credit lines from private sources were open to them. Debtors were forced to undertake contractionary internal adjustment efforts to generate sufficient trade surpluses. Foreign reserves, thus, accumulated were used for buy-back operations. Third party resources which came were used to pledge as a collateral in these operations. At heart of the debt-management effort debtor's internal adjustment remained most vital for the success of the Brady operations which explains the huge net transfers of financial resources under different debt management policies including the Brady Plan.

5.3.3 : Debt Reduction of the Severely Indebted Low Income Countries:

In addition to the Brady initiative for debt reduction of the middle income countries, which are eligible for the IBRD resources, the World Bank approved a Debt Reduction Facility for low income countries, eligible only for IDA resources, and contributed $100 million to it. On a case-by-case basis the sum was allocated. The receiving country must have an adjustment programme acceptable to the World Bank. Table 5.E.2 summarises the agreements with the IDA only countries during 1991-92 under this plan.

Debts and debt services of the IDA-only countries were reduced through buy-backs and discounted exchanges. Also, bilateral official co-financing support was made available for
the debt conversion operations in few severely indebted low income countries.

These countries were forced to undertake rigorous adjustment efforts to support their debt reduction programmes. But most importantly, they were forced to finance their trade by whatever means were at their disposal because along with other private credit lines short-term trade credit lines were also cut. Some limited trade finances were available from the commercial banks but at a very high spread. As a result, they had suffered a deterioration in terms of their trade finances which put lot of pressure on their adjustment programmes.42

Because of the debtor country difficulties in carrying out adjustment programmes in their respective economies and problems in negotiating mutually acceptable buy-back discount rates with commercial bank creditors debt reduction under the Facility was slower than anticipated. In March 1992, the Facility was extended up to June 30, 1994. Facility resources could now be used to hire financial and legal advisors to help prepare for debt reduction operations and also, to reduce short-term debt, provided that such inclusion would not impair renewed access to short term credits markets.

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5.3.4: An Evaluation of the Market-Based Approaches:

The market-based menu-driven approaches emerged with the breaking up of the creditors' cartel, established in the early phase of the debt crisis, due to the competition among private financial institutions to diversify their asset portfolios. The latter was attempted through by debt-sales at discounts in the secondary market of developing country debts.

The benefits of market-based approaches accrued to the creditors were multiple. Usually, in the open secondary market operations debts were traded at the market prices of debt. Sellers were generally forward looking and would not sell for less price. Therefore, the prices at which debts used to be sold were higher than the pre-deal market prices of the debts. Sellers received a higher margin per unit of debts sold. In the Brady deals debts were sold at an average price which was lower than the post-deal prices of the debts. Table 5.6 indicates pre-deal, post-deal and average debt prices. Menu-driven approaches supposedly replaced system rational by market rational. Applying the same "market perception" to the debtors' perspective it can be said debtors actually paid more per unit of their debts. This was, also, because average price was paid for marginal debt reduction.43

43 See Bulow and Rogoff (1988); op. cit.
### Table 5.6

**Debt Prices Before and After Debt Reduction Agreements**

<table>
<thead>
<tr>
<th>Country</th>
<th>Pre-deal price</th>
<th>Post-deal price</th>
<th>Average price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>0.36</td>
<td>0.52</td>
<td>0.41</td>
</tr>
<tr>
<td>Philippines</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Phase I)</td>
<td>0.40</td>
<td>0.61</td>
<td>0.50</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>0.12</td>
<td>0.12</td>
<td>0.24</td>
</tr>
<tr>
<td>Venezuela</td>
<td>0.37</td>
<td>0.56</td>
<td>0.45</td>
</tr>
<tr>
<td>Uruguay</td>
<td>0.56</td>
<td>0.74</td>
<td>0.60</td>
</tr>
<tr>
<td>Nigeria</td>
<td>0.21</td>
<td>0.45</td>
<td>0.40</td>
</tr>
<tr>
<td>Philippines</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Phase II)</td>
<td>0.52</td>
<td>0.76</td>
<td>0.52</td>
</tr>
<tr>
<td>Argentina</td>
<td>0.18</td>
<td>0.63</td>
<td>0.50</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>0.32</strong></td>
<td><strong>0.60</strong></td>
<td><strong>0.45</strong></td>
</tr>
</tbody>
</table>

**Source:** World Debt Tables (1993-94): vol. 1.

**Note:**

(a) Pre-deal price is the average price in the month before the Brady plan was announced except for Philippines (phase II) for which it is the post-Phase I price.

(b) Post-deal price is estimated as the market value of post-deal claims (inclusive of enhancements) minus the prepayment equivalent of collaterals, divided by the face value of commercial bank debt minus the debt reduction as measured by debt-reduction equivalent.

(c) Average price is defined as the post-deal value of the new portfolio, comprising post-deal debt claims (inclusive of enhancements) and payments applicable in connection with buy-backs, net of new money provided, as a fraction of the face value of the debt before the operation.

Secondly, the Brady deals were tailored to the differing needs of the commercial banks substantially. Different exit and relending instruments were offered to the banks out of which they were to choose depending upon their balance-sheet needs, and also, the tax and regulatory requirements of the home country. It, thereby, enabled banks to sell their old claims for cash, or swap them for exit bonds, or swap them for some minimum commitments of some new lending. Old debts with a lower contractual obligation were exchanged for new instruments.

Thirdly, a higher security was generally granted to the exit
bonds offered to the banks by pledging a secure third party asset (usually US Treasury bills or bonds) against (specific or general) payments.

Fourthly, the Brady deals, also, adopted measures to stop free-riding by small as well as regional banks. This was done by creation of new claims which were senior to the old ones and, also delinking the prices of debts from their post-deal prices.

All these point out the benefits of market-based approaches accruing to the creditors. Debtors benefitted by the amount their debt stock and interest payments were reduced. As the evidence suggests, debt and debt services reduction till 1992 through market-based approaches amounted to only $19.8 billion - 17% of the total debt eligible for such kind of conversion. Commercial banks' debt exposures in the third world economies were basically reduced by restricting gross as well as flows in the direction of the developing countries.

In effecting such a meagre debt reduction the debtors paid a high price in terms of their costly internal adjustment efforts resulting in huge transfers of financial transfers from their economies. Gross flows which were advanced actually went to meet the shortfalls in debt charges due to the creditors. With interests of the private creditors waning off by end of eighties, possibilities of pick up in the volume of gross advances

44 See Appendix 5.E at the end of the chapter.
45 See World Debt Tables (1993-94).
exceeding the debtor's debt payments or debt reduction requirements became quite remote. As a result, net private flows of credits went down continuously. Till 1992 net flows from banks in the direction of the developing countries remained negative. The recent increase in direct foreign investment flows and other portfolio investments is restricted only to a few Latin American and Asian countries and has so far remained inadequate to ensure a rise in the net flows of private finance to the other indebted countries of the world. This continuous decline in net flows from private sources along with net flows from the official sources entering to leave the economy to meet the shortfalls in debt charges caused net transfer of financial resources in the direction of the debtor countries to remain negative throughout the decade. Debtors were forced to rely upon their contractionary domestic adjustment efforts to meet their debt obligations. As a result, the real economic growth in the debtor economies suffered for a decade which proved to be harmful for the industrialised nations, as well, reeling under the longest recessionary bouts in the post war era, in terms of a lost opportunity for expansion in their market areas in the developing world. It seems that the interests of the finance held sway over the real economic interests of the industrialised nations, leading to "debt explosion" because of unmatched economic transactions in the real economy. And, the debt management policies including the market-based approaches were deployed to serve the interests of the private finances in the industrialised nations.

46 See World Debt Tables (1993-94).
5.4 : Banking Regulations and Change in Banks' Attitude:

Creditor country's tax and regulatory environment and loan loss provisioning played an important role in the evolution of commercial bank debt restructuring. First, let us take note of the conceptual issues involved with a bank's capital structure vis-a-vis their lendings to the developing world.

5.4.1 : Theoretical Issues Involved in Bank's Capital Structure:

A bank is like a microeconomic firm whose objective is to maximise profits. It may be an expected value maximiser or a risk averse investor. An individual bank optimises its profit subject to its capital structure. That level of capital structure is said to be optimum which maximises the bank's objective function. In this respect, the implications that a regulation can have on bank's capital structure are of great significance. For example, the US deposit-insurance system provided the banks, therein, with an incentive to increase risks and leverage. As a result of this, riskier portfolios and additional leverage became attractive to the US banks. Since the additional losses accrued to the insurer, with declines in its capital, the bank - in order to maximise profits -- starts getting involved in more and more riskier

47 For an excellent survey of the theoretical literature on optimal bank capital and regulation see Demirgüç-Kunt, A. (1992), Creditor Country Regulations and Commercial Bank Lending to Developing Countries, (The World Bank, June 1992, WPS 917).
ventures. In such an event, the probability of success for the bank in terms of generating additional profits is quite low. Hence a regulation is a tax which actually, as perceived by the theoretical literature, prevents banks from attaining their optimal capital structure and portfolio compositions. 

An individual bank's capital structure measures how much risks it can bear. A higher (lower) capital-asset ratio or a lower (higher) leverage decreases (increases) the bank's risk exposure and the probability that it would fail. Capital regulation is a method of coinsurance. Higher capital levels require the bank to absorb higher losses in the event of failure. Because then the bank is less likely to be insolvent, and hence, insurers are likely to suffer less losses. Therefore, in simple logic, more capital is preferred to less.

Now the pertinent question is whether capital regulation will be effective enough to induce banks not to undertake more risky ventures relative to their capital bases. The question is especially set in the context of large scale developing country exposures of the commercial banks in seventies relative to their capital. The effectiveness of a capital regulation actually depends on the nature of the objective function of the banks. If the bank is a risk averting profit maximiser then higher capital regulation may lead to a rise in asset risk to offset the former and thereby, may enhance the probability of bank failure. On the

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other hand, if the bank is risk neutral maximising agent then a higher capital regulation may reduce the probability of failure. Therefore, for capital regulation to succeed in reducing the probability of bank failure it must take into account the portfolio risks in determining capital requirements. Otherwise, "some banks may always circumvent the intent of regulation, increasing the overall risk of bankruptcy for the industry"⁴⁹. Risk-related capital regulation came into existence as a result of this possible circumvention. It takes into account the quality of assets and off balance sheet exposure in calculation of a bank’s required capital.

Now the pertinent question is what would be the possible impacts of capital adequacy norms on lending by the commercial banks to the developing countries. According to the capital adequacy norm an individual bank is required to have a risk weighted capital-asset ratio of 8%. Suppose the bank’s assets consist of cash, developing country loans and developed country loans with risk weights of 0, 1 and 0 respectively. The liability of the bank includes deposits, loan loss reserves (LLRs) and retained earnings (RE) and stockholders’ equity (EQ). With risk weighted assets of $10 billion and capital of $0.08 billion the bank meets the capital adequacy ratio of 8%. Suppose its cash asset is $2 billion and developed country loan asset is $10 billion; deposit liability is $2.1 billion and LLR is $0.02 billion and RE and EQ is $0.08 billion. Now if it decides to extend a loan of $1 billion to a developing country then its

risk weighted assets increase to $11 billion and risk weighted capital-asset ratio drops to 7.2% which is less than the required ratio of 8%. If the regulations of the country in which the bank is situated require 50% provisioning against such kind of new loan extension then LLR will move up to $0.07 billion, and then its retained earnings (RE) will come down by $0.05 billion unless it sells $1 billion loan with equal risk weights which require 50% mandatory provisioning. As a result, its risk weighted capital-asset ratio comes down to 2.7%. On the other hand, suppose there is no provisioning costs, and this $1 billion face value of new loans sells for $0.8 billion. Then $0.2 billion differential would come from cash and will be written off from loan-loss reserves. In that case, the required capital adequacy of 8% is maintained while the bank size shrinks to $21.8 billion from $22 billion. But if there exists provisioning requirement for new loan, or if the loss realised on the sold loan is greater than the available loss provisions of $0.2 billion the bank will have to raise additional capital to maintain the required capital adequacy ratio of 8%. One option for the bank is to go to the equity market and raise $0.58 billion of capital so that 8% mandatory risk weighted capital asset ratio is achieved once again. Now the question is if the bank will, at all, invest in developing country portfolio judging the cost associated with it. It will invest in such a risk weighted asset if and only if return from such investment outweighs the cost of raising capital. Otherwise, a zero risk weighted developed country loan will be more profitable for the bank. The decision ultimately depends on the cost of capital which may vary from bank to bank.
and across countries.

The cost of capital of a bank for its financial product is the net spread between bank borrowing and lending rates which has to be generated so that the market value of the banks’ assets is maintained. In our example, the cost of capital of the bank will be equal to the expected return from the new loan investment if issuing new shares of equity does not reduce the bank’s share price in the market. For this to happen the return on the new equity has to be at least as great as the profit rate on the bank’s existing equity. In order to make an estimate of the required return on the new developing country loan the bank has to deduct other expenses like labour costs, physical capital costs, expected default losses etc. from the gross return on the loan.

As mentioned above, cost of capital varies across nations owing to differing national savings pattern, national economic policies, tax policies and rules and regulations. A cross country study for the period 1984-90 reveals that the cost of capital was least for the Japanese banks, moderate for the German banks, and highest for the US, UK and Canadian banks.50

The analysis in this section reveals that international capital adequacy requirements and differences in loan loss provisioning might have discouraged banks from lending to

developing countries. But one point to note is that all kinds of developing country lending are not treated similarly. Lending to private sector, government sector and banks are treated differently under the norms set up for risk weights by the BIS.

5.4.2: Banking Regulation and Banking Practices in Eighties:

The BIS capital adequacy regulation of 1988 had a significant impact on the banks' balance sheets. During 1988-89 the international banks replenished their capital through retained earnings, and the raising of equity. The "financial fragility" of the banking system increased during the late eighties with the slowdown of economic growth in the OECD areas and also due to declining trend of the interest income of the banks. In view of the competitive challenges from the non-bank financial intermediaries which accounted for a large share of gross bank income and growing funding costs banks' interest margin was squeezed substantially during eighties. As a result, the share of non-interest income grew rapidly while that of the interest income fell continuously over the decade. Table 5.7 gives an account of the rising trend of the non-interest income of the international banks as share of their annual gross income in the six major developed countries in eighties.

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51 See Appendix 5.F at the end of the chapter.
52 See OECD (1992); op. cit.
53 Financial fragility is defined as the deterioration of the banks' balance sheets owing to lower asset quality and lower net earnings. See OECD (1992); op. cit.; pp. 127-138.
54 During 1991 share of non-bank financial intermediaries of the gross bank income was 41.1% in UK, 38.0% in US and 35.9% in Japan. See BIS (1990); op. cit.
Table 5.7

Net Non-interest income
as a share of banks' annual gross income

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>16.0</td>
<td>16.2</td>
<td>16.8</td>
<td>13.2</td>
<td>14.1</td>
<td>14.4</td>
<td>14.4</td>
<td>17.0</td>
<td>17.0</td>
<td>21.2</td>
</tr>
<tr>
<td>Germany</td>
<td>29.1</td>
<td>26.8</td>
<td>24.8</td>
<td>25.9</td>
<td>20.1</td>
<td>29.5</td>
<td>29.8</td>
<td>30.4</td>
<td>36.0</td>
<td>35.7</td>
</tr>
<tr>
<td>Japan</td>
<td>17.8</td>
<td>13.9</td>
<td>14.7</td>
<td>17.7</td>
<td>21.1</td>
<td>19.7</td>
<td>25.1</td>
<td>25.8</td>
<td>33.8</td>
<td>24.1</td>
</tr>
<tr>
<td>Switzerland</td>
<td>47.7</td>
<td>44.2</td>
<td>46.5</td>
<td>45.7</td>
<td>47.4</td>
<td>49.4</td>
<td>51.6</td>
<td>47.1</td>
<td>50.9</td>
<td>49.1</td>
</tr>
<tr>
<td>U.K.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>35.6</td>
<td>34.5</td>
<td>36.3</td>
<td>38.1</td>
<td>37.6</td>
<td>39.2</td>
<td>40.1</td>
</tr>
<tr>
<td>U.S.A.</td>
<td>24.0</td>
<td>24.6</td>
<td>28.5</td>
<td>24.7</td>
<td>26.6</td>
<td>29.8</td>
<td>30.2</td>
<td>30.1</td>
<td>31.8</td>
<td>33.8</td>
</tr>
</tbody>
</table>

Source: OECD (1992); pp. 125.

One of the basic reasons behind the rise in the non-interest income of the banks was that in eighties the banks increasingly got involved in activities other than the normal banking activities of deposit taking and credit extension owing to deregulation of finance in the major industrial countries.\(^{55}\) These included underwriting services, provision of back-up facilities and other advisory services which earned them fee income. Also, interest rate margins were sometimes adversely affected because of mismatches. Long term loans were often matched by short term deposits. This was the case with the US money centre and small regional banks which had its severe repercussion on the US loan and investment industry in eighties. As a result of this, the pre tax profits of the US banks came down from $ 6 billion in 1985 to $ -11.6 billion in 1988.\(^{56}\)

In the six major financial centres, noted in table 5.7, the pre tax profits declined as proportion of the banks' gross income

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\(^{55}\) See OECD (1992); op. cit.

\(^{56}\) See OECD (1992); op. cit.; Table 11, pp. 125.
over the decade with a notable exception of the Japanese banks.\textsuperscript{57} Operating costs absorbed the major portion of the banks' gross income - Switzerland being the only exception. However, the Japanese banks could maintain their profit level because of their low loan loss provisions. German and French banks were better off than their counterparts in USA and UK as they had already made substantial loan loss provisions, although the cost efficiency of the German and the French banks deteriorated during eighties. The US and UK banks were compelled to step up their provisions in late eighties which sharply cut back into their net earnings. In Japan the actual fear was with regard to the potential financial fragility, rather than actual one, following the steep drop in stock and real estate prices\textsuperscript{58} in the end of 1989. Earlier Japan experienced a strong "asset inflation". Thus it was expected that the growth of foreign assets of Japanese banks would be reduced in the aftermath of the stock market plunge of 1990, which had made them to lose an estimated $200 billion of their aggregate capital.

The perception that banks had become more vulnerable had provoked regulatory responses across the countries and also called for a harmonised system of bank supervision internationally in the late eighties. The US and UK banks were more vulnerable, as noted above, than their European counterparts

\textsuperscript{57} The empirical facts about bank profitability and gross income are based on OECD (1991), Bank Profitability: Statistical Supplement, Financial Statements of Banks 1981-89.

\textsuperscript{58} Real estate prices are important for real estate is and important collateral for Japanese bank loan. A sharp drop in real estate price could lead banks to demand higher collateral or a repayment of credit, resulting in higher bankruptcies. See Salomon Brothers (1991a), Bank Asset Quality: A Global Profile, (International Equity Research, Commercial Banks, October 1991).
in terms of deterioration of their asset quality. By 1990-91, therefore, as a result of this and also, as a result of BIS norms most of the international banks cutting across regions reduced their external asset profile substantially including their third world debt assets. Rather, more emphasis was laid upon risk-sensitive pricing, which reflected higher margins on corporate loans. Different debt conversion instruments helped the banks in reducing their developing country debt exposures and simultaneously allowed them to diversify their asset portfolio.

The developing country loan asset profile of the international banks was greatly reduced by 1990. The proportion of non-performing to gross loans declined substantially. The banks rather got involved in corporate lending including arranging mergers and acquisition for the corporate sector, real estate transactions and equity business. De-regulation of finance in major creditor countries gave fillip to the off-balance sheet activities of the commercial banks since mid-eighties. Banks started using derivative over the counter instruments (OTC) including warrants, asset-based securities (ABS) etc. These operations were no less risky than their lending business.

In 1990 the size of the international equity market swelled to $2315.1 billion as a result of a near 50% surge in the value

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59 See Salomon Brothers (1991a); op. cit.


of cross-exchange trading. The early nineties witnessed a shift in the pattern of cross-border equity flows from within the OECD countries to emerging markets outside OECD, mainly in East Asia and Latin America. Major investing institutions, such as pension and insurance funds in Europe and other countries in OECD, are the key intermediaries of these cross-border capital flows, not banks or multinational industrial companies. Net equity flows rose from $4 billion in 1987 to $51 billion in 1991, while cross-exchange trading rose from $508.6 billion in 1987 to $873.9 billion in 1990. Cross-exchange trading as per cent of total foreign share trading increased from 27.4% in 1987 to 37.7% in 1990. If in seventies the non-securitised assets, mainly bank deposits, were the main source of global capital flows the same can be said about the securitised assets since the late eighties.

In the context of financial deregulation in the major developed countries in eighties the distinctions between banking, insurance, investment management trusts and securities have become blurred. Profitability became a problem among all the financial firms stretching from securities firms to banking and insurance. As a result of financial deregulation the credit cycle of rapid expansion and contraction has been deepened and broadened and now has penetrated into all areas of financial services. Deregulation has heightened volatility. Banking franchises were lost and banks entered into markets with products they hardly understood. Reserve requirements changed. Business

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See Salomon Brothers (1991b); op. cit.
became more risky. The volatility has increased tremendously because of short term nature of the global capital flows - the junk bond market in US, the equity warrant market in Japan, and short term bank loans in UK and Australia have soured. From the late eighties there appeared moves away from the highly competitive, low margin areas towards specialisation. In international banking there is a return to "relationship" business.  

On the other hand, by the late eighties international policy makers, such as the IMF and BIS, started their efforts to slow down the effects of deregulation. Global regulation has been strengthened to counter the risks stemming from more intense domestic financial competition.

By 1982, there was a demand for prudential regulation from the banks with high third world debt exposures, and the major creditor governments acted promptly to protect the troubled banks. In 1983, International Lending Supervisory Act (ILSA) was approved by the US monetary authority, which we as we have noted earlier, in effect introduced a creditors' cartel, one where the individual debtor had very little scope of negotiations with the respective creditors at a direct level. Simultaneously, the move warded off the threats of an immediate debt collapse.

In 1991 most of the banks met the BIS capital adequacy requirements.  

The improvement in capital ratios of the US money centre banks was attained through decreasing the high risk

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64 See OECD (1992); op. cit.

weighted assets of developing country and real estate loans. The US banks' capital asset ratio rose from 10.17% in the first quarter of 1991 to 10.78% in the third quarter of 1991. Japanese banks' capital ratio during the same period rose from 8.32% to 8.58%. This was largely attributed to an increase in the amount of subordinated debt raised and the rise in the stock and bond markets.

To a large extent international banking regulation and, also, creditor country regulation provided a protective umbrella to banks holding risky asset portfolio. De-regulation of finance at home had led to the banks' involvement in non-bank activities and at the same time it increased the competition from non-bank intermediaries. Third world debt crisis, also, raised the potential inter-bank rivalry and competition among banks (especially between large and small banks) for receiving shares of debt payments. Banking regulation came into force to meet these imminent needs of the banking sector. De-regulation of finance at home led to an end to the creditors' cartel of early eighties as the inter-bank fierce competition increased (for example, between Japanese and US banks). The impact of all these was felt through the declining profits by the banks and rising proportion of riskier ventures which aroused the demand from the financial intermediaries including the banks to seek re-regulation at the international level, leading to the initiation of capital adequacy norms for the BIS regulated banks.

These regulations including the BIS norms aided the banks
in reducing their third world debt exposures and, also, helped their interests in lending to the third world waning off.

5.4.3: Loan Loss Provisioning:

As far as tapering off in the gross as well as net flows of third world credit was concerned, loan loss provisionings\(^6^6\) contributed to the banks' reluctance in extending new credits to the third world countries.

Creditors intend to reduce their risk exposure by provisioning. But they pay a price in terms of reduced short-term profits as reserves are generally held in low earning assets. Neither writing down the book value of an asset nor provisioning against it reduces the debtor's contractual obligations. Such relief is forthcoming only when the lending institution translates the write down into a reduction in debt and debt service payments from the debtor.

Table 5.8 shows the percentages of the developing country exposures of the commercial banks which are reserved against by loan loss provisionings. It reveals important differences among banks even within the same country.\(^6^7\) For a commercial bank with, say an overall provision of 25%, the reserve against one Latin American country may be as low as 5% while that against another

\(^6^6\) See Appendix 5.G at the end of the chapter.

\(^6^7\) Most provisioning by banks is generally presented to the public as being against a group of, say, 35 countries. Actually, the banks arrive at the overall provision by aggregating notional provisions against individual debtor countries.
may be as high as 35%. Japanese banks held much less reserves against their developing country exposures which is explained by their large holdings of hidden reserves.68

Table 5.8
Loan Loss Reserves as per cent of developing countries' exposures

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Money Centre Banks</td>
<td>2-5</td>
<td>25</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Regional Banks</td>
<td>5</td>
<td>5-15</td>
<td>30-35</td>
<td>50-60</td>
</tr>
<tr>
<td>UK</td>
<td>30-50</td>
<td>25-30</td>
<td>25-33</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>8</td>
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<td>Japan</td>
<td>16</td>
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<tr>
<td>Canada</td>
<td>20-30</td>
<td>30-50</td>
<td>35</td>
<td></td>
</tr>
</tbody>
</table>


Traditionally different attitudes of bankers across the major creditor countries to the optimum point of any return/risk trade-off might have attributed to the varying standards and levels of provisioning. For example, German bankers during seventies quite often took critical concern about the rapid expansion of US bank loans to developing countries because of their own more prudent approach to lending to these countries.69

A range of factors might have impinged on the banks' decision to set aside provision against expected loan losses. Banks are profit maximising agents. In the conduit of realisation

68 See Appendix 5.G at the end of the chapter.
69 See Appendix 5.G at the end of the chapter.
of their profits, they have to consider both return and risk associated with their lending activities. The utility of their lending activities is a positive function of return and a negative function of risk. Banks' decisions in general and decisions relating to loan loss provisioning in particular can then be interpreted as attempts to move toward a preferred combination of return and risk.

Provisioning requirements, by and large, across the creditor countries indicated that after the emergence of third world debt problem banks sought to protect themselves from the potential losses of their third world debt exposures. This was, also, because of banks' attempt to restore investors' confidence in them. Inter-bank rivalries (between money centre and small and regional banks in US; between US and Japanese or European banks) and fierce competition, too, demanded the adoption of rules and regulations in each creditor country, favouring the banks to set aside some reserve assets to protect them from possible losses due to these factors. Regulatory authorities in the creditor countries responding to the needs of the banking sector came up with different loan loss provisioning criteria. As table 5.G.1 indicates, Japanese banks were probably in a position to take more risks than their American or European counterparts. On the other hand, German banks from the very beginning maintained a high reserve level and adopted a prudential approach towards asset holding. In fact, German banks' third world debt exposures were relatively lower than the other banks. On the whole, provisioning helped the creditor banks in adopting a cautious and
prudential approach towards holdings of risky assets which include third world loan assets.

The implications of loan loss provisioning on third world debt process in terms of commercial banks' involvement in the post-debt crisis years can be broadly identified as follows:

(i) Events since 1982 which include the debt servicing problem of the third world countries have made the banks more averse to risk than ever before. There is now a changing perception of risk among the banking community following the debt crisis of eighties.

(ii) For some time banks were engaged in the process of internal adjustment by strengthening their capital bases and looking for new and more secure lines of business. Consequently, there was a general feeling among the banks that they were strong enough to bear the cost of provisioning.

(iii) In a competitive environment an individual bank would be inclined to take actions they deem to be relatively advantageous. Provisioning affected banks' earnings, profits and share prices. The more profitable a bank was and the greater its ability to foster and develop other lines of business, the more inclined it was to set aside relatively large provisions. See Bird G. (1989); Loan Loss Provisions and Third World Debt, (Essays in International Finance, No. 176), Princeton University, November 1989.
inclined to set aside the larger than proportional provisions against these loans (for example, US small and regional banks tended to have larger provisions than the US money centre banks).  

Provisioning might have indulged banks in debt-trading business, which led to the emergence of market-based menu-driven approaches. A potential advantage, emanated from loan loss provisioning, led the banks to off-load some of their third world loan assets in the secondary market. Particularly, it aided in debt-equity swapping and debt-securitisation.

Provisioning represented one component in an ongoing set of negotiations and relationships between debtor countries and creditor banks. Banks' decision to increase their provisioning against their third world debt exposures aided them in adopting a tougher position in debt negotiations with the debtors.

Provisioning rendered banks more reluctant to lend new money to the developing countries as additional lending implied increases in costs to be incurred in terms of additional provisioning for the new loans. Provisioning was thus a tax on new lending to the banks and hence, dissuaded

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71 See Appendix S.G at the end of the chapter.
72 See Bird (1989); op. cit.
them not to lend new money.

Banks’ balance sheets were brought more in line with market perceptions by provisioning which might have helped the banks to restore investors' confidence in them. Provisioning, as evidence suggests, had a positive short term effect on its share prices.

Banks with relatively large provisions were generally expected to favour some form of debt relief to developing countries over the injection of new money. In the past differences in the extent of provisioning were used to explain the different attitude of US and German banks towards third world debt. US banks held relatively low reserves and they favoured new money over any form of debt relief. With greater provisioning, prospect for new money was doomed but did not result in debt reduction either. The latter depended upon the demand for third world debts in the secondary market. As Salomon Brothers (1991 a & b) pointed out, the multinational demand and official demand for debt-equity swaps and direct buy-backs at a discount together provided very little filling to the stagnating demand for debt which in the year 1988 was at its record low at its 20 cents and 11 1/2 cents for Argentina. In general, risky trade and a low spread caused a low dealer profile in the secondary market.73 A sudden and large dose of off-loading also turned out to be capable of asset contamination, especially for the major US and UK banks74, which explained the official initiative in the form

of Brady Plan in order to boost market-based approaches.

In sum, provisioning provided the banks the extra flexibility in managing their balance sheets. Apart from this it seems to have rather marginal implication for debt relief or debt reduction strategies.

5.5 : An Evaluation of the Commercial Banks' Debt Restructuring Efforts:

From the preceding discussion on commercial bank debt restructuring efforts in eighties following the outbreak of the severe debt servicing problems in several debtor developing countries it can be asserted that debt management strategies which include the case-by-case and market-based approach were evolved basically to protect the interests of the active partners involved in the third world debt process, the creditor commercial banks. The interests of the private finances lay (i) in preventing a debt collapse of the financial system due potential threat of defaults and also, (ii) in reducing the international commercial banks' developing country exposures substantially. It seems that these two-fold interests dominated the third world commercial bank debt restructuring scenario. Domination of the creditors' interests over those of the debtors was evidenced in the formation of creditors' cartel as soon as the crisis broke out. Barring few short term moratorium announcements by some Latin American countries no major debt default took place over the decade. The debt relief operations and the concerted lending
by the banks at the insistence of the IMF played a major role in this regard. But more importantly, prevailing global political and economic order dissuaded a debtor country to unilaterally repudiate on its debt obligations. Apart from one futile attempt by the Latin American countries to form a debtors' cartel in early eighties, which is known as the Cartagena attempt, no initiative was undertaken by the debtor countries collectively to that effect in the rest of the period. Even the Cartagena attempt did not succeed. On the other hand, the creditors always acted collectively in dealing with their developing country loan exposures. The creditor country interventions through different initiatives including the Baker and Brady Plans, and formulations of new acts at home (for example, ILSA in US) aided the collective efforts of the private creditors in reducing their debt exposures while protecting them from a debt collapse.

By the mid eighties it was clear that immediate danger of debt collapse had already been averted. The major concern which remained was the reduction in the banks' developing country exposures. Different market-based debt reduction schemes and also, the Baker and Brady formulations served the purpose in that regard.

The tax and regulatory environment in the major creditor countries coupled with the BIS capital adequacy norms and loan loss provisioning attempted to set limits to the banks' risk weighted assets - which include the developing country loan assets. As a result, banks' asset structure underwent significant
changes over the period. Developing country lending came to a standstill by the end of the decade.

Banks' exposures were reduced not due to off-loading of substantial amount of their loan portfolios in the secondary market, as we have seen, but because of drying up gross as well as net credit flows in the direction of the third world. The burden of debt repayments and also, debt reduction thus was shouldered by the internal adjustment efforts of the debtor governments which were politically unpalatable for them. The size of these adjustment efforts, spelt out through export generation and import restraints, was determined by these countries' past debt obligations to the banks. Third party flows, including those from multilateral and bilateral sources, went to compensate the shortfalls in debt payments but not for any effective use to reactivate the debtors' economies. The latter flows, used otherwise for productive purposes, could have propelled debtors' investment expenditure, in turn fuelling demand for real resources from the creditor economies which could have created expanded market areas for the latter economies, hit by severe recession. Even in the industrialised countries due to deregulation of finance private financial flows went to support speculative activities including real estate transactions or to finance mergers and take-overs to tap short run profit and these flows were not matched by any real economic transactions there. As a result of this, credit cycle of expansion and contraction became more rapid and broadened to the all sectors of the financial services, injecting more uncertainty and volatality in
the system. Third world debt management policies along with international banking regulation sought to protect banks from uncertainty and financial fragility, stemmed from their developing country loan exposures. The banks were successfully bailed out in terms of their risky third world loan portfolios but debtors paid the cost for that in terms of their foregone real economic growth.

The question of debtors' foregone real economic growth due to overdoses of contractionary internal adjustment efforts was crucially linked with the financial fragility in the industrialised countries. Like other sectors of the market economy the main driving force of the financial sector is the realisation of profits which is generated by creation of debt by the other sectors of the economy. When real growth in the economy stagnates debts of the other sectors create problem for the entire economy including the financial sector which experiences decline in their profitability due to "debt explosion" in the economy. The problem becomes acute unless adequate doses of real economic transactions are stirred up in the economy to back the financial flows.75

In eighties, therefore, survival of the financial sector in the industrialised economies, reeling under stagnating output demand and falling employment, largely hang upon the third world debt management policies in terms of bailing the commercial banks

out of a debt-led collapse. Debt management policies, thus evolved, were heavily weighed by the concerns of finance in the industrialised economies and of little use in restoring real economic growth in the debtor economies. Seen in this context, it is not difficult to understand the creditors including the multilateral and bilateral creditors have always displayed disproportionate concern for debtors' internal adjustment efforts. As the World Bank has put it: "...despite new money and financial support from multilateral and bilateral sources, these countries (the debtors) also had to provide sizable funds to successfully conclude these operations (debt and debt services reduction). The progress made in recent years on middle-income countries' commercial bank debt depends ......on debtor countries' persistence in pursuing economic stabilization policies and reform programs. Besides improved creditworthiness, these policies also resulted in a strengthened external position, allowing countries to accumulate sufficient reserves to be used in DDSR (debt and debt services reduction) operations." (italics ours).

It was thus not unexpected that the third world debt management policies could do little in restoring voluntary flows of private credit in the direction of the developing countries. Sea changes took place in global financial market over the decade. It found its reflection in the changes in the attitude and activities of the banks. Private credit market got replaced by international equity and securities market. Gross equity

portfolio flows increased in recent years to some developing countries as well, especially those which are located in East Asia and Latin America." The 'fictitious' nature of these capital flows, most of which are occurring in the direction of few Latin American countries, raises the doubt to what extent these flows will get translated into real economic activities therein. A large proportion of these flows is believed to be the flight capital which departed the home countries during early eighties. As the past experiences of capital flight from this region suggests these flows may not take much time in leaving the region if there occurs any change in factors, governing these capital flows. During 1983-90 estimated capital flight from five large countries of the region amounted to $ -21.3 billion. The highest capital flight took place in 1983 when debt servicing problem came out in the open. Globalisation of finance has made capital more mobile and, thereby, has increased the risks of volatile short-term capital movements along with transmission of shocks across the border. A special concern arises for the developing countries since their capital markets are more volatile than those of the industrialised countries.80

These recent reverse flows of private capital so far has

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79 See Griffith-Jones (1992); op. cit.
80 The standard deviations of developing countries' monthly share price indexes indicate that they are more volatile for Latin America, with standard deviation of 14, than for Asia, with standard deviation of 8. The volatility of the developed country stock markets, measured in terms of standard deviation, is much less - with US, UK and Japan having standard deviation of 5 each. See International Financial Corporation, Emerging Stockmarkets Factbook. Also, cited in Griffith-Jones (1992); op. cit.
remained very skewed, reaching out only a few countries of Latin America and Asia. Despite these flows, constraints on debtor economies in terms of net outward transfers of financial resources from there still persist, adversely affecting growth recovery in many third world economies. The debtors' interests in restoring economic growth viably needed adequate attention to this problem of transfer which the third world debt management policies hardly attended. This problem is not only linked with the debtors' internal adjustment efforts but also has a crucial global link in terms of uses of overall global savings - their composition, direction of their flows and the particular uses they are put into.81

Financial development is not a gain in itself. Unless put into productive use, private finances will create its own turbulatutory circulur flow for its own survival as the history of the commercial bank debt restructuring strategies in the context of third world debt crisis tends to suggest.

5.6 : Summary:
The major findings of the chapter can be summarised as follows:

(i) Commercial bank debt restructuring strategies were evolved to bail the commercial banks out of an imminent collapse, fuelled by the threats of potential debt defaults of the third world countries.

(ii) Two different approaches, including the case-by-case

approach of debt financing and rescheduling, and the
market-based menu approaches of debt and sebt services
reduction were effective in terms of reducing banks' third world debt exposures. In the case-by-case approach a systam rational was followed to deal with the third world debt exposures of the banks and a creditors' cartel was emerged. In the market-based approach market perception of the banks' loan exposures was taken into account to reduce the latter through debt sales in the secondary market.

(iii) Actually, banks' third world exposure reduction was effected through continuous tapering off in gross as well net flows in the direction of developing countries.

(iv) Restoration of voluntary flows of private capital in the direction of third world economies did not take place in eighties as was suggested by the different debt management policies.

(v) Third party flows including those from the multilateral and bilateral sources mainly went to compensate the shortfalls in debt payments of the third world debtors.

(vi) Vulnerability of the banking system in major creditor countries triggered regulatory supervision both at home and at the international level. Also, incentives were given to banks for loan loss provisionings. These discouraged banks further in lending to the third world countries.

(vii) Debtors were forced to rely on their internal
adjustment efforts to meet their debt payment obligations. These adjustment efforts were contractionary and helped them to generate trade surpluses by enhancing exports and restraining imports. The foreign exchange reserves, thus accumulated, went to either service their debt payments or to finance the debt reduction ventures.

(viii) The dominance of finance remained overwhelming over the real sectors of the world economy. Third world debt management policies were instrumental in safeguarding the interests of the active partners of the financial sector - the private financial intermediaries. As a result, debtor economies missed a decade of growth and real economic development.

(ix) At the heart of the debtors' concern remained the problem of net transfers of financial resources abroad which was not paid heed to by any debt management policies.

(x) Since the beginning of nineties reverse flows of private capital have started in the direction of few Latin American countries. These flows are mainly portfolio investments including bond and equities. It remains to be seen whether these capital flows add to the real economic growth therein. Given the nature of these flows and also, the globalisation of financial market any small change in any parameter affecting these flows may produce explosive capital flight from these economies and may render them vulnerable.
APPENDIX

5.A : Debt Rescheduling:

(i) The essence of a rescheduling exercise was to stretch out the period of capital repayments falling due in the years covered by negotiations (initially only one or two years) between individual debtors and creditor banks.

(ii) Targets of adjustment were generally spelt out in a Letter of Intent, which provided the pre-conditions for availing a Fund stand-by credit.\(^{82}\)

(iii) For carrying out rescheduling negotiations, the commercial banks adopted a case-by-case approach. Each individual debtor country was dealt with separately by the banks through their debt negotiation forum, popularly known as London Club.\(^{83}\) In each case, a steering committee comprising of individual banks, who were highly exposed in the country concerned, was set up together with an economic sub-committee to monitor the detailed facts and figures produced by the debtor. The committee, acting in liaison with the exposed banks and coordinating the process of reaching an agreement

\(^{82}\) See Lomax, David F., (1987); op. cit.; pp. 91.

\(^{83}\) The framework for negotiating commercial bank debt restructuring was developed in tandem with the Paris Club framework for official debt restructuring. In the late sixties Philippines faced debt servicing problem with its large chunk of private debts. Negotiations that took place between Philippines government and the private creditors established a broad forum in which commercial bank debts could be negotiated. During the late seventies when Argentina, Peru and Zaire held negotiations with their commercial bank creditors the forum became popular and came to be known as London Club as dubbed by the press. It has no permanent secretariat or chairman. For negotiations to take place a Bank Advisory Committee (henceforth, BAC), represented by a dozen or so people from the major banks and chaired by the biggest creditor, is formed. BAC negotiates an agreement in principle with an individual debtor country. When all the creditor banks involved in the concerned debtor country give their approvals, a final agreement is arrived at. It may take months together to reach at the final agreement. Representatives from the IMF may be invited to BAC meetings but their participation is not as essential as it is at the Paris Club. See Lomax (1987); op. cit.
with the debtor, set about the task of obtaining the necessary informations in order to formulate its own negotiating position.

(iv) In 1983-84, 47 agreements were negotiated covering $130 billion of debt, compared to 14 agreements covering $10 billion in 1981 and 1982. Table 5.A.1 gives a detailed account of countrywise debt rescheduling exercises during 1982-84 while table 5.A.2 provides an aggregate account of debt restructuring till 1992.

(v) Between 1983 and 1984 principals falling due over 1-2 years were rescheduled. Typically, the terms included 8 year maturity with 4 year grace, while the margins on rescheduled debt were 1.75-2.50%. During the period debt restructuring arrangements involving new money and short term credit maintenance were made with Brazil, Chile, Costa Rica, Cuba, Ecuador, Mexico, Peru, Uruguay and former Yugoslavia. Rescheduling arrangement without new money or credit line extension were entered with Bolivia, Dominican Republic, Jamaica, Liberia, Malawi, Nicaragua, Poland, Romania, Senegal, Sudan and Zaire. Argentina negotiated a 12-month deferment and new money agreement in 1983 while Madagascar succeeded in restructuring its entire stock of debt with commercial banks in 1984.
## Table 5.A.1

Countrywise Debt Rescheduling by Banks  
(1982-1984)  
(in billion US $)

<table>
<thead>
<tr>
<th>Country</th>
<th>Consolidation Period (in months)</th>
<th>Amount Rescheduled</th>
<th>Deferment</th>
<th>New Money</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>12</td>
<td>0</td>
<td>0</td>
<td>1.8</td>
</tr>
<tr>
<td>Bolivia</td>
<td>36</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Brazil</td>
<td>24</td>
<td>10.7</td>
<td>0</td>
<td>11.7</td>
</tr>
<tr>
<td>Chile</td>
<td>24</td>
<td>3.3</td>
<td>0</td>
<td>1.2</td>
</tr>
<tr>
<td>Costa Rica</td>
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<td>0.7</td>
<td>0</td>
<td>0.2</td>
</tr>
<tr>
<td>Cuba</td>
<td>40</td>
<td>0.2</td>
<td>0</td>
<td>0</td>
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<td>Dom. Rep.</td>
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<td>Ecuador</td>
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<td>2.7</td>
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<td>Guyana</td>
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<td>0</td>
<td>0.3</td>
<td>0</td>
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<td>Honduras</td>
<td>72</td>
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<tr>
<td>Jamaica</td>
<td>21</td>
<td>0.1</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Liberia</td>
<td>--</td>
<td>0.0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Madagascar</td>
<td>--</td>
<td>0.3</td>
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<td>Malawi</td>
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<td>0.1</td>
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<td>Mexico</td>
<td>28</td>
<td>23.2</td>
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<td>8.8</td>
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<td>Nicaragua</td>
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<td>Niger</td>
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<td>0.1</td>
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<td>Panama</td>
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<td>0</td>
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<td>Poland</td>
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<td>Romania</td>
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<td>Senegal</td>
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<td>Turkey</td>
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<td>Uruguay</td>
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<td>0.5</td>
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<td>2.6</td>
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<td>0.6</td>
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<td>Zaire</td>
<td>28</td>
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<td>0.1</td>
<td>0</td>
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<td>Zambia</td>
<td>--</td>
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Source: World Debt Tables (various issues)
Table 5.A.2
Debt Restructuring by Commercial Banks
(1980-92)
(in billion US $)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Restructuring</th>
<th>Deferment</th>
<th>Rescheduling</th>
<th>New Long Term Money</th>
<th>Short Term Credit Maintenance</th>
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<td>1980</td>
<td>15.93</td>
<td>2.00</td>
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<tr>
<td>1981</td>
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<td>--</td>
<td>15.43</td>
<td>0.89</td>
<td>--</td>
</tr>
<tr>
<td>1982</td>
<td>82.45</td>
<td>0.14</td>
<td>82.31</td>
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</tr>
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<td>1983</td>
<td>384.01</td>
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<td>380.51</td>
<td>157.01</td>
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<td>1984</td>
<td>134.98</td>
<td>2.20</td>
<td>132.78</td>
<td>112.80</td>
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<td>1985</td>
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<td>10.07</td>
<td>737.96</td>
<td>59.24</td>
<td>61.90</td>
</tr>
<tr>
<td>1986</td>
<td>548.66</td>
<td>96.00</td>
<td>452.66</td>
<td>13.04</td>
<td>183.34</td>
</tr>
<tr>
<td>1987</td>
<td>1295.57</td>
<td>--</td>
<td>1295.57</td>
<td>122.15</td>
<td>65.98</td>
</tr>
<tr>
<td>1988</td>
<td>984.24</td>
<td>0.08</td>
<td>984.16</td>
<td>52.00</td>
<td>161.33</td>
</tr>
<tr>
<td>1989</td>
<td>88.77</td>
<td>4.12</td>
<td>84.65</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>1990</td>
<td>759.52</td>
<td>--</td>
<td>759.52</td>
<td>33.37</td>
<td>--</td>
</tr>
<tr>
<td>1991</td>
<td>15.15</td>
<td>--</td>
<td>15.15</td>
<td>18.57</td>
<td>--</td>
</tr>
<tr>
<td>1992</td>
<td>310.29</td>
<td>--</td>
<td>310.29</td>
<td>19.91</td>
<td>--</td>
</tr>
</tbody>
</table>

Source: World Debt Tables (various issues).
Multi-Year Restructuring Agreements (MYRAs):

(i) To reach a MYRA with a debtor country creditor banks considered the involvement of the IMF in the debtor economy as a safeguard. It was thus agreed at the London economic summit of June 1984 that a kind of enhanced Article IV consultation would take place between the IMF and the borrowing country when a MYRA would be reached between a debtor and its creditors. On the basis of the Fund report on the performance of a particular country, banks would decide if the rescheduling of the debt payments, which were falling due, was to be continued or not.

(ii) The MYRA, in essence, was prospective and it rescheduled the debt falling due in future peak years. Principal repayments falling due over 3 to 5 years were consolidated, which was seen as a way to eliminate uncertainties associated with year by year rescheduling. Maturities for MYRAs signed between 1984 and 1986, ranged from 9 to 14 years, compared to 5 to 8 years for most rescheduling agreements previously negotiated. Interest rate margins were substantially lowered. Table 5.B.1 depicts the actual scenario of the MYRAs reached during the period 1985-87.

(iii) One of the major aims of the MYRA was to restrict the
number of negotiations between banks and a debtor country in future. Banks, therefore, wanted to put into the agenda of a MYRA negotiation as many outstanding issues as possible. For example, in 1985 in the Venezuelan case a MYRA was held up due to substantial arrears in dealing with Venezuela’s private sector debt.
Table 5.B.1
Multi-Year Rescheduling Agreements (MYRAs) during 1985-87

(in US $ billion)

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Consolidation Period (in months)</th>
<th>Total Debt Restructuring</th>
<th>New Money</th>
<th>Short Term Credit Maintenance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Congo</td>
<td>1986</td>
<td>36</td>
<td>2.17</td>
<td>0.6</td>
<td>0</td>
</tr>
<tr>
<td>Cote d'Ivoire</td>
<td>1986</td>
<td>48</td>
<td>6.91</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Cote d'Ivoire</td>
<td>1986</td>
<td>36</td>
<td>3.7</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Dom. Republic</td>
<td>1986</td>
<td>60</td>
<td>7.87</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Ecuador</td>
<td>1985</td>
<td>60</td>
<td>44</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>Ecuador</td>
<td>1985</td>
<td>36</td>
<td>4.12</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Mexico</td>
<td>1985</td>
<td>48</td>
<td>236</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Mexico</td>
<td>1985</td>
<td>72</td>
<td>201</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Philippines</td>
<td>1987</td>
<td>72</td>
<td>93.56</td>
<td>29.65</td>
<td>0</td>
</tr>
<tr>
<td>Poland</td>
<td>1987</td>
<td>72</td>
<td>82.5</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>Uruguay</td>
<td>1986</td>
<td>60</td>
<td>17</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Venezuela</td>
<td>1986</td>
<td>72</td>
<td>211.72</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Former Yugoslavia</td>
<td>1985</td>
<td>48</td>
<td>36</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

5.C : The Baker Initiative:

(i) The Baker Plan comprised of the following three interlocking elements:
(a) a debtor country adjustment programme;
(b) increased bank lending to support these policy efforts;
(c) continued monitoring by the IMF and enhanced lending by multilateral development banks to the highly indebted countries.

(ii) The Baker Initiative envisaged a $20 billion net commercial bank lending in 1986-88 and $9 billion on a net basis from multilateral development banks. In other words, it asked the banks to extend new lending amounting to approximately $7 billion annually over 3 years or 2.5% of existing exposure each year to fifteen major borrowing countries with debt problems. This target was set as net disbursements above and beyond amortisation of principal but not to cover interest payments. In addition, an increase in net loan disbursements amounting to $3 billion annually by the multilateral banks was targeted. Debtor nations were asked to undertake structural reforms of their economies. Three areas were specified in this regard: trade liberalisation, policies to facilitate direct foreign investment flows in these countries, and reform of the public sector, including privatisation.
Table 5.C.1
Annual Average Capital Flows
to the Highly Indebted Countries
(1983-1991)
(in US $ billion)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Official:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Multinational</td>
<td>3.9</td>
<td>4.2</td>
<td>8.0</td>
</tr>
<tr>
<td>Banks</td>
<td>1.6</td>
<td>1.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Bilateral</td>
<td>3.8</td>
<td>-0.9</td>
<td>2.0</td>
</tr>
<tr>
<td>IMF</td>
<td>9.3</td>
<td>5.2</td>
<td>14.0</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Private:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banks</td>
<td>9.8</td>
<td>4.6</td>
<td>9.0</td>
</tr>
<tr>
<td>Direct Investment</td>
<td>14.5</td>
<td>8.1</td>
<td>10.0</td>
</tr>
<tr>
<td>Total</td>
<td>33.6</td>
<td>17.9</td>
<td>33.0</td>
</tr>
</tbody>
</table>

Source: World Economic Outlook (various issues).
Table 5.C.2

Countrywise Capital Flows Under the Baker Plan
1986-1988

(in billion US $)

<table>
<thead>
<tr>
<th>Country</th>
<th>Banks</th>
<th>Multilateral</th>
<th>Bilateral</th>
<th>IMF</th>
<th>Total Official Credit</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>2.6</td>
<td>1.6</td>
<td>0.7</td>
<td>0.8</td>
<td>3.2</td>
<td>5.8</td>
</tr>
<tr>
<td>Bolivia</td>
<td>0</td>
<td>0.5</td>
<td>0.2</td>
<td>0.1</td>
<td>0.9</td>
<td>0.9</td>
</tr>
<tr>
<td>Brazil</td>
<td>4.0</td>
<td>1.5</td>
<td>0.3</td>
<td>-2.3</td>
<td>-0.8</td>
<td>3.1</td>
</tr>
<tr>
<td>Chile</td>
<td>0.2</td>
<td>1.1</td>
<td>0.1</td>
<td>0.1</td>
<td>1.2</td>
<td>1.4</td>
</tr>
<tr>
<td>Colombia</td>
<td>1.9</td>
<td>0.9</td>
<td>0.2</td>
<td>0</td>
<td>1.2</td>
<td>2.2</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>0</td>
<td>0.1</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.0</td>
</tr>
<tr>
<td>Cote d'Ivoire</td>
<td>0</td>
<td>0.5</td>
<td>0.3</td>
<td>-0.2</td>
<td>0.6</td>
<td>0.6</td>
</tr>
<tr>
<td>Ecuador</td>
<td>0</td>
<td>0.8</td>
<td>0.2</td>
<td>-0.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Jamaica</td>
<td>0</td>
<td>0.1</td>
<td>0.1</td>
<td>-0.3</td>
<td>-0.6</td>
<td>-0.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>5.4</td>
<td>2.1</td>
<td>2.3</td>
<td>1.1</td>
<td>5.6</td>
<td>11.1</td>
</tr>
<tr>
<td>Morocco</td>
<td>0</td>
<td>0.9</td>
<td>0.5</td>
<td>-0.5</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Nigeria</td>
<td>0</td>
<td>1.0</td>
<td>0.7</td>
<td>0</td>
<td>1.7</td>
<td>1.7</td>
</tr>
<tr>
<td>Peru</td>
<td>0</td>
<td>0.3</td>
<td>0.1</td>
<td>-0.1</td>
<td>0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>Philippines</td>
<td>0.5</td>
<td>0.3</td>
<td>0.9</td>
<td>-0.1</td>
<td>1.1</td>
<td>1.6</td>
</tr>
<tr>
<td>Uruguay</td>
<td>0</td>
<td>0.1</td>
<td>-0.1</td>
<td>-0.1</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Venezuela</td>
<td>0</td>
<td>0.1</td>
<td>-0.2</td>
<td>0</td>
<td>-0.1</td>
<td>-0.0</td>
</tr>
<tr>
<td>Former Yugoslavia</td>
<td>0</td>
<td>-0.6</td>
<td>-0.2</td>
<td>-1.1</td>
<td>-1.5</td>
<td>-1.5</td>
</tr>
</tbody>
</table>

Note: * - Total official debt consists of multilateral and bilateral debts.
5.D : Market-based Approaches:

(i) Enthusiasm about market-based menu approaches was derived from the experience of Chile’s debt-equity swap operation in 1985. By 1987, such kind of debt conversion programmes were institutionalised in many highly indebted countries. The Brazilian package of 1988 was the first formal market-based menu approach with regard to the restructuring of debts owed to the commercial banks.

(ii) In early 1987 Brazil declared moratorium on its debt service payments which triggered widespread loan loss provisions by the US banks. These eroded the market psychology that drove secondary market prices for the debt of major Latin American countries from the range of 60-80 cents on the dollar to the 40-60 cents level. A large number of banks, especially regional banks, who were highly exposed in Latin America opted for reducing their portfolios of loans to debtor countries. Moreover, in late 1986 long delays in mobilisation of $ 7.7 billion new money package for Mexico aroused doubt about further new lendings.

(iii) The menu approach consisted of vehicles for new money-bond to confer implicit seniority, rights to convert new loans into equity and alternative options for banks. The major menu options included debt buy-backs, debt securitisation, debt-equity swaps and
Menu options offered by Mexico is noteworthy for its use of third party bonds as collateral. Mexico offered exit bonds to its creditors, namely Morgan Guaranty, who used Mexican reserves to purchase zero-coupon US Treasury bonds as collateral for 20 year bonds paying a spread of 1.625% over the LIBOR. However, the total volume, thus exchanged, was limited to only $3 billion. The discount offered was 30%, not 50% which was close to the prevailing secondary market prices. This was because the bonds had a guarantee only for distant maturity and none for ongoing interest payments. Despite its limited success Mexican debt conversion package in 1988 was a preview of things to come for the Brady Plan in 1989.†

See Section 4.3 of Chapter 4 for the definitions of the different debt conversion instruments.

In March 1989, the US Treasury Secretary Nicholas Brady announced that his government would support voluntary debt and debt service reduction (DDSR) financed by official sources. As a result, the Executive Boards of the IMF, the World Bank and the Inter-American Development Bank agreed to provide funds for voluntary debt reduction schemes. The success of the DDSR depended upon the cooperation of debtor countries, international financial institutions (IFIs), creditor governments and commercial banks. Each had a specific role:

(a) Debtor countries must undertake growth-oriented adjustment programmes and encourage repatriation of flight capital;

(b) IFIs, namely the IMF and the World Bank, would provide funds for three years. A quarter of the Bank's policy-based lending and 25% of an IMF extended or stand-by agreement could be reallocated or set aside to help reduce the principals of the debts outstanding, through buy-backs and collateralised reductions of principals. Moreover, additional resources could be used to support interest payments on reduced interest bonds traded for commercial bank debts. The IMF and the World Bank were prepared to provide up to $20 billion, divided between set-asides and new resources.

(c) Commercial banks would provide debt reduction and new
money, and support the accelerated reduction of debt and debt services through temporary (and conditional) relaxation of conditions on current debts.

(d) Creditor governments would continue to reschedule or restructure their loans to the developing countries through the Paris Club and maintain their export credit lines for the countries with sound reform programmes. Tax, accounting and regulatory impediments to debt reduction would be eliminated. Japan could provide roughly $10 billion in additional funding in the next few years.

(ii) Till September 30, 1992 seven agreements have been signed. Table 5.E.1 summarises the terms of these agreements.

(iii) Buy-backs at a discount were an important feature of the most agreements, with the discount ranging from as high as 84% (in Costa Rica) to as low as 44% (in Uruguay). The Argentine, Mexican and Brazilian agreements did not include buy-backs. Discount bonds were used in half of the agreements. The discount was 30% for Venezuela and 35% for the other accords.

(iv) Except in Philippines-I agreement interest reduction bonds were used in all agreements. There were three modalities to these bonds. One type offered a below-market fixed rate for the life of the bonds. This was used by Mexico, Venezuela and Uruguay. There were four agreements which featured step down/step up arrangements. Under this arrangement, in the first year
of the agreement interest rate would be very low and, then it would be stepped up to a fixed rate which would continue for the remaining life of the bonds. This option was included in the Argentine, the Brazilian, the Nigerian and the Philippines-II agreements. The third modality was the temporary, front-loaded interest reduction agreement, first used in the Venezuelan agreement of December 1990. Like the step down/step up arrangements, it featured below-market fixed interest rates that would rise gradually (typically over five years), but then would revert to a floating rate (LIBOR plus a margin) until maturity. This option was used in the Philippines-II, Venezuelan and Brazilian accords. In Mexican, Philippine-II, Venezuelan, Uruguayan and Brazilian accords, providing new money was an option. This option differed from the new money offers of concerted approach. The Brady new money option was not mandatory for banks and they could select from different options. New money bonds (not loans) were extended under this option except in the Mexican case. These bonds were extended in tandem with the conversion of existing claims into bonds at an agreed ratio, ranging from 4:1 to 5:1.
Table 5.E.1

DDSR Agreements, January 1990 - September 1992
DDSR Instruments and New Money

(in billion US $)

<table>
<thead>
<tr>
<th>Country</th>
<th>Debt Reduction</th>
<th>Debt Service Reduction</th>
<th>New Money</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>20.5 (43%)</td>
<td>22.4 (37%)</td>
<td>4.3 (11%)</td>
<td>48.0 (100%)</td>
</tr>
<tr>
<td>Philippines - I</td>
<td>1.3 (100%)</td>
<td></td>
<td></td>
<td>1.3 (100%)</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>0.9 (68%)</td>
<td>0.4 (32%)</td>
<td>6.0 (31%)</td>
<td>1.4 (100%)</td>
</tr>
<tr>
<td>Venezuela</td>
<td>3.2 (7%)</td>
<td>104.3 (53%)</td>
<td>0.3 (31%)</td>
<td>19.5 (100%)</td>
</tr>
<tr>
<td>Uruguay</td>
<td>0.5 (39%)</td>
<td>0.3 (30%)</td>
<td>0.5 (12%)</td>
<td>1.2 (100%)</td>
</tr>
<tr>
<td>Philippines - II</td>
<td>1.2 (28%)</td>
<td>2.6 (57%)</td>
<td></td>
<td>4.4 (100%)</td>
</tr>
<tr>
<td>Nigeria</td>
<td>3.3 (62%)</td>
<td>2.0 (38%)</td>
<td></td>
<td>5.3 (100%)</td>
</tr>
</tbody>
</table>

Table 5.E.2
Buy-Backs Financed by the IDA Debt Reduction Facility,
(January 1991-September 1992)
(in billion US $)

<table>
<thead>
<tr>
<th></th>
<th>Niger (Mar-91)</th>
<th>Mozambique (Dec-91)</th>
<th>Guyana (Nov-92)</th>
<th>Bolivia (July-92)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buybacks (Commitment)</td>
<td>0.11</td>
<td>0.12</td>
<td>0.09</td>
<td>0.03</td>
</tr>
<tr>
<td>Discount (per cent)</td>
<td>0.08</td>
<td>0.09</td>
<td>0.09</td>
<td>0.08</td>
</tr>
<tr>
<td>Financing required</td>
<td>0.02</td>
<td>0.02</td>
<td>0.01</td>
<td>n.a.</td>
</tr>
<tr>
<td>IDA Reduction Facility</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
<td>0.01</td>
</tr>
<tr>
<td>Bilateral assistance</td>
<td>0.01</td>
<td>0.01</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Own Resources</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

5.F: BIS Capital Adequacy Norms, 1988:

(i) The Basle Committee on Banking Regulations and Supervision Practices, which includes bank regulatory agencies from twelve developed countries, reached an agreement in July 1988 on a framework for measuring capital adequacy and setting up minimum standard for international banks in order to minimise the risks associated with the international banking system and to reduce the differences in international bank supervisory practices. It has set a minimum ratio of capital to risk weighted assets at 8% to be achieved by April 1993. Assets are assigned relative risk weights ranging from 0 to 100%. These include both on-balance-sheet and off-balance-sheet exposures.

(ii) Capital is classified into two categories: "core" or "Tier 1" capital consisting of equity capital and general reserves from post-tax earnings; and "supplementary" or "Tier 2" capital consisting of undisclosed reserves, revaluation reserves, general loan loss reserves, hybrid capital instruments and subordinated debt. The gross Tier 2 capital is limited up to 100% of Tier 1 capital. Loan loss reserves can be included in Tier 2 capital only up to 1.25% of risky assets. The minimum capital requirement under the Tier 1 category is set at 4% of risk weighted assets and off-

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87 The countries are Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, UK, USA, Switzerland and Luxembourg. The Committee was founded in 1974. It reached an agreement in 1975 on the so called Basle Concordat, which was substantially revised in 1983. It outlines the principles for supervision of banks' foreign establishments on a consolidated basis. The Concordat stipulated that home and host country authorities have a joint responsibility in the supervision of solvency and liquidity of the banks. See OECD (1992), Banks Under Stress, (Paris, 1992).

88 See BIS (1988); op. cit.
balance-sheet exposures, and for the total Tier 1 and Tier 2 capital it is set at 8% of the total risk weighted assets and off-balance-sheet exposures.
5.G: Loan loss provisioning:

(i) Loan loss provisioning implies 'provision' against certain loans by putting aside reserves in low earning but risk free assets in order to cover the possibility that repayments of principal or interest payments may not be made by the debtors in future. These reserves represent the normal business practice of allowing for the statistical probability that a certain proportion of loans will encounter problems. Specific provisions by contract are set aside against loans to a particular country or group of countries where a specific risk has been identified.

(ii) The different tax and regulatory environments across the major creditor countries are as follows:

US: The Federal Reserve Board or the Office of the Comptroller of Currency regulates most large US banks. Provisioning regulations as well as rules relating to capital adequacy are determined by these two authorities with the help of Federal Deposit Insurance Corporation (FDIC). Inter-Agency Country Exposure Review Committee (ICERC) coordinates the regulators' attitudes to provisioning. It also sets standards for bank treatment of loans to countries that are not servicing their debts.

There are three types of loan loss provisions:

specific provisions mandated by the Federal Regulators; (2) provisions against specific identifiable risks; and, (3) provisions against general estimated losses.

The last two types are established by the bank management.

Before 1983 US banks were subject to a legal lending limit of 10% of their capital to any single borrower. It has been raised to 15% thereafter. Under existing regulations US banks must hold reserves equal to at least 5.5% of total assets, and capital equal to at least 6% of total assets. No further regulation relating to general provision is mentioned. However, the regulatory bodies can require banks to make specific provisions against individual countries in the form of allocated transfer risk reserves (ATRRs). In the first year after the imposition of such a requirement ATRRs must cover 10% of the loans, rising to 15% in subsequent years. Such reserves are tax deductible. But they have not been much used. The ICERC may classify debts as sub-standard, value-impaired, or a loss. For a debt to be value-impaired, the debtor must fulfill more than one of the following four conditions -

(a) non-payment of interest for more than six months;
(b) failure to comply with an IMF-aided programme;
(c) failure to meet the rescheduling terms for a year;
(d) little prospect for an orderly restoration of debt service in the near future.
While tax deductibility was not there for general provisions, prior to BIS regulation, they were counted as part of the banks' primary capital base and therefore did not harm the banks' position with respect to capital adequacy. Tax allowance can be claimed for actual write downs against general provisions. Now they are included in the Tier 2 capital up to 1.25% of risk weighted assets. Specific reserves allocated against identified losses are not included in the capital and are tax deductible.

**Germany:** German banks create three types of reserves against their loans:

1. specific reserves,
2. general reserves, and
3. hidden or undisclosed reserves.

German tax laws remained particularly favourable to provisioning and permit reserves to be deductible from taxable profits. General and specific reserves are excluded from the regulatory capital. Specific reserves are tax deductible whereas the general reserves are not. Hidden reserves are established against special risks pertaining to banking and are disclosed only in audit reports. They are excluded from the capital but are not generally tax deductible. Under BIS norms banks are allowed to include their hidden reserves in Tier 2 capital provided they are accepted by the relevant banking supervisor. German authorities also have encouraged banks to be prudent in the valuation of
their claims on developing countries.

**France**: French banks are allowed to make two types of provisions:

1. specific provisions; and,
2. general provisions.

Specific provision is made against individual assets whose recovery is doubtful. French regulations allow provisions against sovereign debt tax deductible only if the debtor country is on a list of 41 countries compiled by France’s Banking Commission. For such countries provisions are deductible from taxable profits up to 100% of the face value of the loan.

**Japan**: The Japanese banks are allowed to create three types of reserves:

1. specified overseas receivables against sovereign risks which are used to be included in regulatory capital except 1% of exposure and tax deductible up to 1% of exposures;
2. general provisions against estimated losses in the overall loan portfolio which are used to be included in capital and are tax deductible up to 0.3% of total loans or total loans outstanding multiplied by the average loan loss ratio for the preceding three years;
3. special reserves established for loans which are
not likely to be paid which are not included in capital and tax deductible up to 50% of the face value of a specific loan.

In Japan banks may not deduct more than 20% of their provisions from taxable profits. In the Japanese case average reserves for developing country loans were only 5% of the total asset. This may probably be attributed to the large hidden reserves that Japanese banks possess in the form of undervalued securities. The difference between book and market values of these securities are included in Tier 2 capital with a discount of 55%. Reserves against developing countries (SORs) is designed for potential losses due to transfer risks from loans to foreign borrowers. SOR is applied to all commercial bank loans to a particular country. Earlier SORs were included in the regulatory capital. Now they are not. The Japanese Ministry of Finance has an undisclosed list of countries against which it allows SORs. In 1991 major Japanese banks had reserves of 40% of developing country exposures.

UK: In U.K. banks can create general and specific provisions against potential loan losses. Banks were encouraged by the regulators to appraise the adequacy of their provisions with respect to their developing country loans, without setting formal minimum or maximum values. General provisions were included in regulatory capital prior to BIS regulations and were
not tax deductible. Specific provisions were always excluded from the regulatory capital and are tax deductible up to established limits. In 1987 the Bank of England developed a framework or matrix, designed to measure the extent to which the chances of full recovery had deteriorated, and therefore the extent to which the provisions were justified. This was to be used as a basis for discussion between the Bank and each individual institution. The matrix was similar in many respects to those used by commercial banks in assessing country risk. Much would depend upon the particular negotiation between an individual bank and the tax authority.

Table 5.G.1 summarises the tax and accounting treatment of loan loss reserves as on 1991.

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Table 5.G.1
Tax and Accounting Treatment of Loan Loss Reserves
(1991)

<table>
<thead>
<tr>
<th>Country</th>
<th>Reserve Level</th>
<th>Capital Inclusion</th>
<th>Tax Deductibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>45%</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>France</td>
<td>52%</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Germany</td>
<td>58%</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Japan</td>
<td>15% Up to 14%</td>
<td></td>
<td>only 1%</td>
</tr>
<tr>
<td>UK</td>
<td>35% No</td>
<td></td>
<td>Up to matrix level</td>
</tr>
<tr>
<td>USA Money</td>
<td>30% Yes</td>
<td></td>
<td>No</td>
</tr>
<tr>
<td>Centers Regional</td>
<td>55% Yes</td>
<td></td>
<td>No</td>
</tr>
</tbody>
</table>


5.H : International Lending and Supervisory Act (ILSA):

ILSA made use of the prevailing US 90-days non-accrual asset rule in terms of which interest earning assets were rendered non-performing if interest remained unpaid beyond the stipulated period. A steering committee was led by nine US money centre banks which suggested involuntary lendings by banks to borrowers approved of by the IMF on a case-by-case basis. Simultaneously, pre-payments by any debtor was to be shared by all creditor banks, ruling out inter-bank rivalry and competition in receiving payments.91