COMMERCIAL BANKS AND BALANCE-OF-PAYMENTS FINANCING

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This paper summarises the role of the private commercial banks in the international financial system, with respect to their intermediary role in financing world balance-of-payments deficits. Six key aspects of this role are examined:

1. The relative responsibilities of private banks and official institutions.

2. Country credit risk appraisal.

3. Information gathering.

4. The quality of rescheduling techniques.

5. Regulatory issues.

6. Future developments.

The paper concentrates upon the experiences of the recent 2-3 years of growing debt crisis, and draws conclusions as to how future balance-of-payments financing needs might be met.

1. The Relative Responsibilities of Private Banks and Official Institutions

The crisis atmosphere of the last twelve months has resulted in a considerable blurring of responsibilities, both for private banks and official institutions. Most striking has been the degree to which the private banks and the IMF have been working side by side in arranging rescheduling agreements.

To a degree the role played by the IMF has been a necessary one: in order to marshall all the numerous lenders involved in the reschedulings,the Fund has made very pointed requests to banks to increase their exposures in particular countries alongside an IMF support/rescue package. At times,individual central banks, such as the Bank of England, have also made such requests.

Clearly, in a financial market system where private institutions have a particular responsibility to stand on their own feet, such a close relationship (with banks being instructed to increase exposures to countries they deem now to be uncreditworthy) cannot continue indefinitely. This dilemma is recognised on both sides, and for the time being official institutions, private banks, and borrowers probably are looking to a general economic recovery to ensure that this untenable situation need not last longer than is absolutely necessary.

It is important to make clear why the position is untenable. For many years the IMF, and outside observers, have bemoaned the fact that the IMF's influence on its members has been increasingly limited. Most striking was the period in the run up to the Mexican crisis, when many officials felt that the IMF was either unable to influence the banks (i.e. urge them to desist from increasing short-term lending) or to curb Mexico's enthusiasm for borrowing,especially in an election year. Furthermore,the willingness of private banks to lend to countries with large balance-of-payments difficulties has undoubtedly helped countries avoid going to the IMF when perhaps they should (or would) have undertaken a formal IMF-style programme.

Of course,the IMF's declining influence cannot be blamed entirely upon the banks' willingness to lend. The IMF's relatively small financial resources have always made the attraction of borrowing from banks much greater than borrowing (on conditional terms) from the IMF. Indeed it is the theme running through this paper that a key problem in the last ten years has been the absence of sufficiently large official financing facilities, given the size of world balance-of-payments dislocations.

But there is a more fundamental reason why the present situation is untenable. Private banks have a specific responsibility to their shareholders and to their depositors. Bankers take it upon themselves as their profession to offer a safe haven for depositors' funds and a profitable investment opportunity for shareholders, principally as a result of their own skill and expertise in on-lending such funds to borrowers with various risk profiles. Depositors and shareholders have to be confident that the bank can perform this central task of credit risk appraisal adequately. Therefore it follows that any interference (the word is not used pejoratively) to direct bank lending in any

particular direction impacts directly upon the central aspect of a banker's profession, i.e. on credit risk appraisal. The greater the direction given to banks as to whom they should lend to, the less can be banks' true responsibility for such loans and the greater the responsibility taken on by those issuing such directives.

Of course this dilemma is not confined to international lending. During domestic banking and credit crises, official action is often called for to stabilise the market. The degree of official intervention and support is always a key aspect and consideration (see for example the role of the Bank of England's so-called "lifeboat" in the 1974 UK secondary banking crisis). The debate has now shifted into the international arena, and is undoubtedly more complicated given the plurality of regulating institutions, and the plurality of sovereign entities involved.

There is a further aspect to this blurring of responsibilities, an aspect which requires us to make a clear distinction between the role of the IMF and that of the central banks during the rescheduling of the last twelve months.

When central banks issue directives to individual banks these directives pass along established lines. In the UK, for example, the Bank of England is responsible for both the specific regulation of banks and for the control, as the central monetary authority, of the financial markets. The Bank is thus long used to issuing instructions with varying degrees of force to those banks for which it is responsible. In the United States the position is somewhat less straightforward, given the existence of three official bodies (the Federal Reserve, the Comptroller of the Currency and the Federal Deposit Insurance Corporation). Nonetheless, all banks have a direct relationship with their regulators and central banks. There are therefore established channels for coping with any blurring of responsibilities which take place when official monetary institutions issue instructions to the private sector.

In contrast, private banks have no formal relationship with the International Monetary Fund. If private banks continue to lend new money in conjunction with an IMF programme, it is very unclear what private banks can do should the IMF withdraw its 'seal of approval' or end its programme. There is of course nothing to prevent the IMF from trying to cajole other lenders, or from refusing to lend its monies if other

lenders do not contribute. But the Fund/bank relationship must remain an arm's length relationship, albeit in a cooperative way.

As mentioned above, the dangers inherent in the IMF/central banks/private banks cooperation of 1982/3 are fully recognised by all participants. But if the hoped-for world economic recovery proves to be weak and/or delayed, then further blurring of responsibilities may take place. In which case it will become increasingly important that the central banks and regulators, if anyone, take the prime role in "instructing" private banks during any reschuduling as to how much additional funds they should lend. The central banks/regulators in their turn can clearly seek guidance from the International Monetary Fund through their own official channels. This does not solve the problem as to relative responsibilities of official and private institutions but at least it ensures that the signals, messages, nods and winks are passed along the correct channels. Recent practices have developed along this route.

2. Country Credit Risk Appraisal

During the crisis there has been a great deal of discussion of the quality of banks' country risk assessment. Implicit in such debate has been the assumption that banks' country risk assessments have been lacking and/or that bank lending decisions have not paid due attention to country risk factors. Undoubtedly, the enthusiasm for lending of the later years of the 1970s diluted the influence which bank economists have had on individual lending decisions. In contrast, many, lending officers now probably feel the economists' present warnings are given undue weight in comparison to their own market assessments.

A most serious problem for the credit risk analyst has been the lack of sufficient, up-to-date, information. Borrowers, in both developed and developing countries, are often reluctant to publish data on their external debt, often for domestic political reasons. Many countries have not had adequate debt reporting systems, so that with the best will in the world they have not been able to provide up-to-date information. Some countries have not had sufficient control over foreign borrowing by their own institutions.

The credit risk analyst has had to tackle this problem in several ways. First, there has never been anything to prevent country analysts from visiting

countries and gaining a good inside feel for the economic and political future of each country. Though credit risk appraisal will pay a great deal of attention to statistics, it must also pay a great deal of attention to an overall judgemental assessment of the future of the country. In the same way, while corporate credit risk analysis relies heavily upon the analysis of a borrowers' balance sheet, the art of credit risk assessment has always been in looking beyond the bald statistics into the viability of the enterprise itself and into its operating environment.

Where there has often been a glaring absence of statistics the correct action for the country risk analyst has been to point such absences out and assess the reasons for their absence. In some instances it may be justifiable to accept the reluctance of the country to publish data. For many countries, however, it has been appropriate to "mark down" the country if it proves unable to provide adequate data. It is perfectly valid to turn down a credit request on the grounds of insufficient information about the borrower: the doubt, of course, is that banks have not been sufficiently strict on this point.

A second problem which country risk analysts have faced is that, for many major borrowers, the standard yardsticks of credit appraisal have been broken. Many countries have long exceeded the classic 20 per cent debt service ratio "ceiling" suggested in the past by the World Bank. For some time many borrowers have been able to cope with a high debt service ratio, but as 1982 has revealed (with a vengeance) a high ratio is only acceptable and tenable if banks continue to lend new monies. This has placed the country risk analyst in a dilemma: he can point out that according to his appraisal a country is no longer creditworthy, yet has often had the riposte from the lending officer that the market continues to believe the borrower is creditworthy and therefore by definition the debt service burden is supportable (as it can be refinanced). At that point the correct response, on strict creditworthiness grounds, should be that the borrower is only creditworthy while the market has confidence in it, and that under any normal criteria the borrower should be treated with extreme caution.

The present contraction of credit reverses this position (again with a vengeance). With banks seeking to reduce short-term exposures, borrowers are finding it difficult even to raise trade financing requirements, which under normal market circumstances they might be expected to obtain easily. There is thus the risk that

even borrowers who are creditworthy according to economists' standard indicators will prove to be uncreditworthy if the market so judges.

In the context of our concern with the relative role of the private banks and official institutions, a comment also must be made on the importance of the IMF's seal of approval in credit risk decisions. In a private banking market where, as pointed out above, the key professional task of a banker is credit risk appraisal, it is surely totally unacceptable that this central role of a bank should be passed on to an outside institution. Thus reliance upon the IMF's "seal of approval" must be done cautiously. The bank must still judge the degree to which the IMF's programme will improve the credit risk, stabilise the market, and lead to satisfactory improvements in the country's long-term ability to honour its financial obligations. At present it can be justifiably said that banks have no option but to rely upon the IMF's seal of approval, and despite protests, banks have had to increase their exposures to difficult countries, to protect their own current exposure. There is a great deal of "can and mouse" in the present rescheduling arrangements. Banks undoubtedly want to put on record that they are relying heavily upon official institutions, such as the IMF, to police the economies of problem countries, even if the powers of that policeman are strictly limited.

Ultimately the fundamental limitations of country credit risk assessment must be recognised. However skillful the analyst, the task of forecasting the future economic and political developments of sovereign states, in themselves and within a global context, is a major one. There is no such thing as 20/20 foresight.

3. Information Gathering

A propos the discussion of credit risk, a number of proposals have been made recently to improve the information flow in international credit markets. The new Institute for International Finance (formerly known as "Ditchley II") embodies the private sector's attempt to improve the flow of information. There is no denying that better information can help towards achieving better credit risk appraisals, even though information is not the whole of the story.

In practice better information can come from two sources: either from the lenders or from the borrowers. At present limited information is provided by both. Borrowers publish their own debt statistics, sometimes

relatively quickly in their own publications or rather more slowly via the World Bank Debtor Reporting System. Lenders provide information to their own central banks on their exposures. This information is published separately by some central banks (the Federal Reserve, the Bank of England and now the Bundesbank) and is coordinated by the bank for International Settlements in its semi-annual and quarterly statistics on international banking.

So far,when considering the full range of countries, the private banks and central banks have come up with more timely information than the borrowers. Current data provide details on the major industrial countries' banks' exposures to LDCs as of June 1983, and as of December 1982 on a more detailed maturity basis. The 1982/83 World Bank World Debt Tables, in contrast, give external debts up to the end of 1981 only, although they do provide forecasts of debt servicing requirements over the next ten years (on term debts established as of the end of 1981).

The nub of the problem has been the monitoring of short-term debts. Not only have these been always absent from the World Bank's data system but also short-term debts can build up very rapidly and thus timely information on these debts is crucial. When a country's borrowing programme is sound the absence of short-term and up-to-date figures is a limited problem. It is precisely when a country is relying excessively on short-term debt that by definition a problem will arise and the crisis builds up almost undetected.

If a country is going to build excessive short-term debts, no amount of reporting will prevent such an occurrence. However more timely information might at least bring forward the "inevitable" crisis so that the amount of short-term debt built up would not grow too large. Thus the rescheduling and recovery programme could be of smaller magnitude. Appraisal of the BIS statistics has proved useful in giving a degree of early warning but the time lags are still too long. And perhaps more importantly for the credit risk appraiser the statistics could be more detailed. At present an analyst is unable to determine the quality of the assets which banks are reported to have and the degree to which they may relate to standard trade financing requirements can only be estimated.

In principle the effort to improve the information flow would be most efficiently performed by improving the present systems: speeding up the process of reporting to the World Bank Debtor Reporting System, and extending and accelerating the reporting of data through the BIS.

The World Bank, IMF and BIS are all working towards this objective. However the "Ditchley II" idea is that the banks themselves could provide more information to their own institution, on both their lending levels and planned leading activities.

As a means of coordinating current bank strategies such a system might be helpful, but it must he questioned how far a competitive banking industry can in practice be relied upon to share such critical information. Traditionally the private sector has always been loathe to provide official institutions with too much information, and is always loathe to add to the data reporting burden. In an ideal world the fastest way of obtaining good debt information would be from the borrowers themselves, on a country-by-country basis. This would involve fewer institutions in making reports and the process itself should encourage better debt management and control. If the IMF and the World Bank could encourage faster and standardised debt reporting by individual countries then this could improve the overall quality of the market's credit risk assessment.

4. The Quality of Rescheduling Techniques

The debt rescheduling process has been difficult, to say the least. Before mentioning the problems, however, it should be stated that debt rescheduling is not an operation which the market should regard as commonplace. Thus the setting up of automatic rescheduling arrangements is not something which can in the long run encourage good lending or good borrowing practices. Nonetheless, with a large number of ccuntries rescheduling their external debts, it would be foolish to think that the absence of any formal debt rescheduling arrangement can help very much in dissuading countries from rescheduling. Further, with a large number of countries now rescheduling it is in the interests of both lenders and borrowers to at least perform this task as efficiently as possible, however much lenders and borrowers regret the task has to be done at all.

Lenders will tend to operate on the short leash principle. A lender's power is greatest at the period prior to lending new or relending old money. Once any new loan agreement has been signed then the power quickly shifts across to the borrower: possession is 90 per cent of the law. Borrowers, on the other hand, will seek as long an extension as possible knowing full well that even reschedulings arranged in 1982/3 might have to be re-arranged again if the underlying economic positions do not change adequately.

Thus the parties will seek a compromise, giving both sides some room for maneouvre while trying to balance out the level of future negotiability over the credit. This will undoubtedly mean that banks will lend for shorter periods than would really be advisable given the time taken for a country to adjust. Borrowers will always seek to obtain as long a rescheduling as possible and at times even to overstate the extent of their financial problems. Just like the initial borrowing negotiations, reschedulings are a question of wheeling and dealing.

The most serious criticism that can be levelled at the rescheduling arrangements is that the delays in rearranging the credits, and the disruptions caused during the period of rescheduling, cause real economic hardship for the country concerned. If all banks are rapidly cutting short-term lines prior to a successful rescheduling then the country has difficulty in trading, its industries have to slow down even further and its prospects for early economic recovery are further reduced (thus making it even more difficult for it to repay future loans on time). In addition with a large number of banks involved (and particularly a large number of regional banks in the case of Mexico) negotiations have been tortuous and from time to time could have easily broken down if one or more of the participants had broken rank. The large lenders have been as active as the borrowers in seeking to coordinate reschedulings and to keep all players in the game. Hence the Ditchley II ideas might be regarded as very much part of the effort by the major money centre banks to encourage other lenders to maintain and even increase their exposures.

In practice various techniques and procedures have emerged as reschedulings have become more numerous. Each new rescheduling has raised the number of new negotiating ploys. One major problem is just keeping track of the status of negotiations and of the resulting debt obligations of the individual countries, a problem which is going to present country analysts with more and more difficulties as debts are rescheduled and data become rapidly out of date. However, a side benefit of the number of reschedulings has been that the major LDCs have had to publish more detailed payments estimates and forecasts, as reschedulings have required extensive economic analyses to be published.

An additional criticism has been made with respect to the terms of reschedulings, an issue which directly affects the countries' finances. Rescheduled loans have been usually priced at a higher spread than the original

loans and substantial fees often accompany the reschedulings. To some this seems illogical. The country, by the mere fact that it is rescheduling, clearly has a problem repaying its debts and to make the burden even greater by increasing the fees and spreads only adds to that problem. However, from the lender's point of view, given the higher risks now apparent, the rewards need to increase.

On balance, an increase in spreads is justifiable and if any real criticism was to be made with respect to risk and reward it would be that the spreads over the last few years have been too low. Thus reschedulings at least give the opportunity to correct this position. Bankers themselves can point to the 1978/79 period when countries took it upon themselves to renegotiate credits at the lower spreads obtainable when market conditions improved, to many bankers' chagrin.

Once again, reschedulings, no less than other loan negotiations, are a matter for bargaining. Price is set by the market and by the relative competitive positions of both lenders and borrowers. Furthermore, if banks are to make greater provisions against sovereign loans then such provisioning should also be reflected in the price charged for such loans. In practice, in a period of falling interest rates, spreads have themselves tended to rise (being a function of both the business cycle and banks willingness to lend.) Thus even for non-rescheduled loans the current climate should see rising margins for new business. If, through rescheduling, borrowers are seeking to refinance existing credits, then current market conditions must clearly prevail.

Nevertheless, these considerations are obviously not the whole story: insofar as the rescheduling process represents a loan "workout", so it is clear that "normal market conditions" are hardly operative (especially as lenders are largely obliged to relend). The eventual spread will need to be fixed in the light of both the desired return to the lender and the borrower's financial status. Naturally for lenders the spread is all-important, whereas for borrowers the same effect on servicing costs could come from either a fall in spreads (potentially small under any circumstances) or a fall in LIBOR itself (which potentially could be brought down considerably if inflation rates stay low). The latter condition would assist the borrower without reducing the lender's return.

5. Regulatory Issues

On Capitol Hill there are strong calls for the banks to pay the price for the support now being given by official institutions in the rescheduling process. This is not the place to discuss the relative responsibilities of governments and of private banks for causing and/or for resolving the present crisis. Clearly there are strong responsibilities on both sides. The extent to which there was no official route by which the large second oil shock could be recycled through official channels is now being reflected in the demands for governments to make amends for the absence of previcus action. Meanwhile, in the reschedulings,the banks, in total, are often putting in more new money than the official institutions, and thus are bearing a significant share of the burden.

Apportioning blame will always occur during crises but is not in the long run the most important issue: what is at issue is whether or not international banking should now be subject to greater scrutiny and control in order to prevent further crises occurring. If such regulation is imposed this does not mean that further financing flows will be done adequately through official institutions,but at least governments may feel that the ball is firmly in their court.

Ever since 1975 the BIS and central banks have sought to improve their monitoring of the international banking system as the first step towards possibly providing more controls on the system. One major practical hurdle has been that every central bank and every country has its own way of regulating its own financial institutions. The authorities in Japan,for example,have often given very explicit instructions to their own banks as to what proportion of syndicated credits Japanese banks may take (such restrictions are now being lifted). Regulations often relate as much to the general balance-of-payments objectives of the lending country concerned as to concern over the quality of bank's portfolios.

The regulatory issue is important in three main areas: first, should official institutions in some way seek to improve the credit appraisal techniques of banks; secondly, should more prudential controls be imposed upon banks' lending policies (e.g. greater and stricter limits on exposures as a percentage of capital); and thirdly, should different reserve requirements etc. be imposed on banks for their international lending, particularly to developing countries?

As mentioned in the second section there would seem to be little point in central monetary institutions' seeking to impose their own credit judgements on those of the private sector, without a major change in the way in which our international and domestic banking systems operate. Central monetary authorities may have somewhat better information on individual countries but in most cases private banks' credit risk assessment teams are better qualified than those of central banks. Furthermore, as mentioned above, using other official institutions' judgements (e.g. those of the IMF) would equally be of limited value.

Changes in prudential controls ought to offer greater scope for satisfactory progress, although again central banks have always had to rely upon the discretion of private banks to achieve appropriate mixes of risk in their portfolios. A classic example of the limitations of such controls was the so-called "means and purpose" test in the United States. Regulations can only seek to influence banks' decisions, not to replace them with official judgements.

Nevertheless, stricter adherence to risk exposures to capital may be necessary, as long as such single exposures can be adequately defined and policed. Imposing such limits at this point is like closing the stable door after the horse has bolted. Doubtless banks themselves are carefully re-appraising what potential limits they should impose upon individual country exposures. The market is probably performing this task adequately now, and may be being over-enthusiastic in imposing new prudential limits for future use.

The third aspect, of banks' reserve policy, etc., relates very much to government tax policies and accounting principles. It is traditional in banking that doubtful loans are written off even though over time perhaps as much as one third of such loans are finally written back. Where banks are allowed to write off loans against tax in the short term the taxpayer bears part of the burden of the loss. Where a debt has been rescheduled successfully, ostensibly restoring creditworthiness, it is not clear whether that loan should now be treated as doubtful, given that a rescheduling has been done successfully. A major difficulty would be in deciding what amount of earnings should be set aside against potentially doubtful loans. If a major developing country defaulted in total then the banks' real protection (whether reserves or capital) may not in all cases be adequate. It is extremely difficult

to access exactly what the potential losses are in sovereign loans. This has always been the problem in pricing the loans adequately in the first instance, and even now it is not clear exactly how much banks should be providing (except that provisions may be too low).

In practice it would seem advisable to give banks as much leeway as possible to adjust earnings targets and possibly raise new capital as they see fit, and to re-assess any further change once the situation has improved. No amount of regulatory changes at this point would alleviate the present crisis and any change would probably only complicate banks' current decisions.

6. Future Developments

A number of proposals have been made to improve the international financial system with respect to private bank lending to developing countries. Some relate to the restructuring of existing debts. Others relate to improvements required to prevent the need for restructuring in future. There is always a temptation during a major crisis to seek global solutions to solve the crisis. In practice the only solutions lie in a series of individual fire fighting exercises which leave their own mark, adjusting participants' expectations.

A common theme running through the various proposals is the idea that official institutions should provide some new underpinning to private bank lending, either by guaranteeing new loans or by taking off the banks' books existing loans in the form of discounted bonds, etc. Yet all these ideas fall into the trap which we originally identified, that of blurring the distinct responsiblities of the private and the official sectors. If the loans prove to be bad then the banks will undoubtedly suffer. If the loans prove to be good then the banks would be unwise to sell down such loans. Choosing the price at which to discount such loans would be an extremely arbitrary process carried out under very abnormal market conditions.

Of course, changing the system solely to account for past activities would be hardly progressive even though there might be some satisfaction that past errors may have been accounted for. All players (governments/ taxpayers, lenders, borrowers) will feel the effect of the inadequacies of past practices, and compensating for any inadequacies is a separate task from altering future structures. Naturally the mistakes of the past should highlight how future arrangements might be structured, but

it would seem most fruitful to return to the key development finance issue: how do LDCs obtain the financial capital for development, and indeed what proportion of LDCs' investment capital needs to come from international savings?

The only logical way to change the system significantly is to increase the direct role played by official institutions or governments in funding LDCs' current account balance-of-payments deficits or providing development capital. The International Monetary Fund and the World Bank are designed to help correct balance-of-payments deficits and to finance developing countries respectively. Neither institution has had sufficient financing support to perform these roles adequately.

The amount of resources allocated to these institutions naturally must be related to the financing need. And it is this latter concept which now warrants very close attention. Balance-of-payments deficits (on current account) do not just represent poor budgeting by LDCs. Their counterpart is the need for capital inflows, or foreign savings, to complement the domestic savings needed for investment in LDCs. If there is a long-term need for a large injection of foreign savings into the LDCs, it follows that there must therefore be a transfer of resources into LDCs.

In the 1970s this transfer escalated rapidly, on the financial side. But much of the required financial transfer was obviously directly offsetting the outward transfer of resources resulting from the deteriorating terms of trade (both higher oil prices and worsening non-oil terms of trade).

In the 1980s however, barring a third oil shock and barring a further serious terms-of-trade deterioration, the balance-of-payments deficits on current account (excluding debt interest payments) need not be particularly large. Hence the required transfer of financial resources to LDCs need not be extraordinarily high. Once the existing debt of the 1970s is adequately treated on its own merits, then there need not be any great need to establish a new system for future resource transfers. Equally, the need for such new transfers has to be identified before designing new transfer mechanisms.

Moreover, if a transfer is required, the experience of the past ten years suggests that private banks are not the best conduit for this transfer to LDCs to take place. The debate then, as suggested above, returns to the issue

of how LDCs obtain capital for development. Just because new mechanisms have not yet been devised other than letting the private banks take the strain (or finance the residual) we should surely not conclude that therefore banks can, and will, finance any significant transfer in the future.