INTERNATIONAL LENDERS OF LAST RESORT: ARE CHANGES REQUIRED?

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I. Introduction

"The widespread belief that, whatever the Bank [of England about 1860] might say, it would support the market in time of crisis, had no legislative foundation". (Fetter, 1965, p. 269)

"The rapid recovery after 1857 temporarily stilled controversy over money and banking among men of affairs". (*ibid*., p. 268)

"Theory suggests, and experience proves, that in a panic the holders of the ultimate Bank reserve (whether one bank or many) should lend to all that bring good securities,quickly, freely and readily. By that policy they allay a panic; by every other policy they intensify it". (Bagehot, 1873)

"... the most mischievous doctrine ever broached in the monetary or banking history of this country, viz. that it is the proper function of the Bank of England to keep money available at all times to satisfy the demands of bankers who have rendered their own assets unavailable". (Hankey, 1866, against the Bagehot doctrine)

"From the middle 1870s, the principle was no longer in doubt ... The Bank of England as a lender of last resort was ... accepted as the foundation of monetary and banking orthodoxy". (Fetter, 1965, p.275)

As the national LLR needed clear exposition in 1866-73, so international lender of last resort (ILLR) needs it now. Bank activities are much more complex, internationalised and interlocked. Not merely the welfare of depositors, but the capacity of sound firms at home and abroad to borrow - as well as the capacity of many developing countries to grow - depend on the maintenance of a liquid base for the banking system. We concur with Kindleberger (1978), IMF (1983) and others, that formalised, known international lender-of-last-resort arrangements are increasingly necessary not mainly to "allay a panic", but to prevent one.

However, to construct a proper ILLR requires an improved understanding of LLR functions, in two respects. First, while most observers appreciate that LLR's purpose is not "to bale out banks" - indeed, a major problem is to prevent banks from relying on this perception - neither does LLR exist mainly to protect depositors; its main purpose is to ensure a stable, and if possible steadily growing, flow of credit to sound borrowers. Second, in this task, reliable LLR and really adequate supervision are two sides of one coin, the latter acceptable to banks only with the former; as supervision should smoothen unswings, so LLR should buffer downswings of bank credit.

This paper tries to suggest ways in which ILLR arrangements can be achieved, without unacceptable increases in moral hazard, 1/ by changes in supervisory arrangements and other matters. First, however, we would stress the importance of confidence in ILLR for maintaining, despite recent shocks, the flow of capital to developing countries. This applies even to low-income countries, although they seldom borrow much from commercial banks. The present operations of the system, without clear ILLR facilities, may hurt the poorest countries in two ways. First, pressures to avoid default divert official flows from low-income to middle-income countries - and, recently, towards shorter-term and less concessional official lending. Second, as we shall explain, the inadequacies of ILLR, even without crisis and especially during early recovery, exercise steady deflationary pressure on growth, trade, and hence development prospects.

The lack of an appropriate ILLR - which can take account of the enormous complexity, scale and internationalisation of commercial banking - makes two undesirable developments more likely. Firstly, there remains a possibility that widespread financial distress now characterising the world economy may turn into a major financial crisis (see Kindleberger, 1982, on stages of financial crisis). Secondly, and more plausibly, the combination of actual reschedulings (reducing the banks' liquid base) and fear of defaults may continue to constrain private bank lending to developing countries. *Ad hoc* anticipatory contractions - by them or banks - are mutually deflationary, and further weaken the prospects of a sustained world economic recovery.

More generally, insufficient ILLR facilities give commercial banks scant reason to accept really effective supervision. This contributes to patterns of capital flows, especially of bank lending to developing countries, in which "euphoric" over-expansion (Kindleberger, 1978) alternates with over-contraction. Such swings tend to accompany, not to stabilise, business cycles, both at country level (Griffith-Jones, 1980) and world-wide. Adequate supervision would control, diversify, and when necessary limit, "euphoric" expansion. Moreover, such supervision relates each bank's behaviour to the total exposure, not just of that bank, but of the borrowing and lending country. It considerably transcends traditional supervision, 2/ and would be acceptable to commercial banks only if backed by reliable, even if potentially costly, ILLR facilities. With supervision moderating upswings and ILLR buffering downswings, private credit flows would be more regular. The package would produce much more desirable credit patterns - not just for developing countries but for the world economy, and ultimately for the banks also, even though some apparently profitable business would from time to time be frustrated.

The paper focuses on issues closely linked to the need, or otherwise, for ILLR. However, this problen cannot be treated in isolation from other major issues (covered in depth in other papers in this series). In particular, any ILLR facility is complementary to - and by no means a substitute for - measures to make its use less likely or less necessary. This covers, in general, measures to promote sustained world economic recovery, and, in particular, the expansion of official and private flows, which may be more appropriate to finance lending in some developing countries than is current short - or medium-term bank lending with floating interest rates (ICIDI, 1983). We share doubts about the genuine appropriateness of medium-term variable-interest bank loans for the finance of some developing countries. However, such flows remain essential, particularly while alternative mechanisms - either private or official - remain only as proposals.

In Section II, we define the role of a LLR, pointing to the key issue of how "onerous terms" for its use must deter imprudence by potential users. We then ask why a special ILLR is needed at all (Section III). Next - in the context of central bankers' decision to make ILLR deliberately uncertain and vague, so as to create a form of "onerous terms" - we outline existing ILLR facilities, and associated supervision procedures (Section IV). We then assess (Section V) whether they are - and are perceived to be - sufficient to contain a "crisis" that might be caused by various sorts of non-repayment of foreign debt. In that context, we also enquire how these uncertain ILLR facilities affect the level and stability of commercial bank lending and of world flows of credit. Do these facilities encourage banks and customers to distribute credit, among users, in ways that favour steady and sound economic expansion, especially by developing countries? Finally, in Section VI, we review our conclusions and make our proposal - to replace damaging uncertainty about ILLR by a revival, in a form that suits today's needs, of Bagehot's original conditions for "onerous terms".

II. Role of National LLR, and International Aspects

A LLR is a central bank, group of banks, or treasury that has the power, and accepts the responsibility, to lend without limit - or to the limit of plausible requirements - but on onerous terms, to institutions in trouble or crisis. "Institutions" were taken by Bagehot to mean "all comers" but nowadays are confined to banks, or, at most, institutions taking financial deposits against interest for onlending.

"Trouble" has normally been taken to mean a significant risk of not being able to repay depositors and creditors on request, either because the bank is unusually illiquid, or because depositors seem likely to ask for their money in unusually large numbers (a run); if depositors are confident of LLR facilities they will, it is assumed, be prepared to restrain withdrawals. In fact, "trouble" could be more broadly defined as incapacity by a bank, even well short of any risk of collapse, to carry on with normal lending operations. For instance, when British commercial banks recalled money from discount houses and forced them into the Bank of England at the "penal" Bank Rate, this was often conventionally taken as a first-stage LLR operation, though nobody suggested that either commercial banks or discount houses were in danger of not meeting obligations; recourse to the central bank is had in order not to forfeit normal, profitable business. Similarly, recent "liability management" by US banks implies that" even borrowing from the Fed should be considered a source of funds" (Cargill, 1979, p. 92).

It is crucial, in understanding the case for LLR (or ILLR) as a "social good" like health or roads to be provided by the State, to realise that this case depends not only, nor mainly, on the wish to rescue depositors. The main basis is the need to maintain the capacity of the banking system to lend: to prevent "trouble" facing one bank, especially if it threatens to degenerate into a "crisis" of confidence in many banks, from stifling the flow of credit to countries and enterprises. Of course, panic transfers of cash among banks by depositors, or rushes by them into cash (or foreign currency, or physical or financial assets bought with foreign currency), would make it even harder for firms to borrow, as banks became more cautious and less liquid. But the principal reason for a LLR to commercial banks is not to safeguard depositors (which can be achieved by other mechanisms - see below). It is to preserve and stabilise productive activity, by underpinning the capacity of the banking system to lend to enterprises and countries.

Before we define "onerous terms", we should build on these points to clarify what a LLR is not. "LLR"is sometimes vaguely or inexactly used to describe three entirely different sorts of operation. The first is deposit insurance. This covers, for example, US deposits below $100,000 - about two-thirds of the total, but excluding almost all major foreign deposits. Since 1934, deposit insurance through FDIC* has been dramatically successful in reducing US bank failures (Cargill, 1979, especially p. 168) and since 1967 Canada, France, Germany, Japan, Netherlands, Switzerland and the UK have set up similar schemes. Coverage is usually incomplete or small (e.g. 75% of deposits up to £10,000 in Britain) and foreign-currency or company deposits are sometimes excluded (IMF, 1983, p. 21). These schemes provide valuable safeguards for small depositors, but their extension would probably create larger and less predictable burdens for central banks (and ultimately taxpayers). More fundamentally, deposit insurance may not fulfil the prime function of LLR as a social good - maintenance of the commercial banks' capacity to lend in support of economic activity. Institutions whose depositors have just been baled out are normally compelled - by prudence, by central bankers, by depositors themselves - to contract advances; and there is no clear guarantee that other institutions will replace them, especially in a climate of impaired confidence.

Support for depositors is different from LLR. So is support for borrowers. We share the widespread fear (cf. ICIDI, 1983) that the recently agreed enlargement of IMF resources is insufficient. We share, too, the fear that IMF conditionality can be inappropriate; although aimed

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*Federal Deposit Insurance Corporation (FDIC) administers the federal deposit insurance fund. Banks which participate in the fund have their deposits insured against loss up to $100,000 for each depositor. The fund obtains its resources through annual assessments on participating banks. All members of the Federal Reserve System are required to insure their deposits through the Corporation and non-member banks, normally organised under laws of various states, may apply and qualify for insurance. Ed.

at financial realism for <u>each</u> borrower, it involves - when simultaneously applied to many countries - contractions of demand, including mutual export demand, that will make it harder for the borrowing community <u>as a whole</u> to meet its new and old obligations. Countries with repayment problems, if there are many countries and large problems, certainly need new funds conditional on their adjustment in a manner that does not induce general and mutual deflation. However - while additional provision of such funds (and new modalities for conditionality) may reduce the risk of calls upon ILLR - provision of such funds to borrowers is distinct from LLR facilities for banks.

Both depositors and borrowers, if their activities have not been speculative, may be provided with emergency facilities through some sort of safety net. Such help for <u>customers,</u> while it may ease the strain on a LLR, is not truly a substitute for LLR to the banking or near-banking <u>intermediaries.</u> Nor, third, are general open-market operations a true form of LLR in near-crisis. Generalised new liquidity will not - unless enormous - go to distressed banks, or their clients.

To advocate provision of LLR proper, as Bagehot did - and to deny the adequacy of substitutes - is not to express general lack of trust in the operation of financial markets. A series of bank troubles, leading to a crisis that feeds on itself for want of a LLR, is not a market, but a gap, a discontinuity, between two sets of situations, in each of which market forces can operate, but between which they can no more mediate than people can see round sharp corners. LLR is not a substitute for financial markets, but a necessary condition for their contribution to stable growth.

However, if a LLR is not to be transferred into a mechanism to "bale out the banks", and if LLR facilities are not to encourage reckless lending in the belief that there is no lender's risk, then a precise content must be given to the concept of "onerous terms". Three different methods for applying the concept of "onerous terms" today seem possible. (a) Bagehot did this with a twin condition: lending had to be on "good collateral", and there should be "a very high rate of interest" (Fetter, 1965).
(b) Another approach is to define clearly conditions where LLR will not be available, e.g. if there is good reason to suspect fraud, or if there has been gross breach of banking practice and/or explicit supervisory conditions. (c) A final approach is to maintain uncertainty about the nature, duration, entitlement or cost of LLR facilities. We shall argue that current reliance on (c) in ILLR has

gone too far for the health and stability of the banking system - but that (a) and (b) can be revived only with supervision, redefined, as the counterpart to a more assured ILLR.

III. The Internationalisation of Banking and of its Risks

Why cannot the requirements of ILLR facilities simply be met by national authorities? Six trends in international banking since the early 1970s have increased the need for an ILLR, and for new forms of international central-bank co-ordination and supervision. These are well known, and have been analysed in depth elsewhere, we sketch them very briefly here.

1. Private bank lending to oil-importing developing countries grew at 19.7% annually at constant prices between 1970 and 1980 (World Bank, 1981, Table 5-3). Recently a very high proportion of such countries' current-account deficits has been financed by borrowing - and very recently by short term borrowing - from international banks. Of all such deficits, in 1977-81, 53% was financed on average, by increases in international bank claims. (For the large borrowers, the ratios were much higher). Thus, by end-1981, the total obligations of non-oil developing countries to banks reached on average 3.56 times the level of their official international reserves (this ratio being higher than 10 for Mexico, Philippines and South Africa). Furthermore, an increasing proportion of this borrowing had short maturities; as a result, by end-1981, 45% of the bank debt of the non-oil developing countries was due in less than one year (IMF, 1983, pp.6-7). Under-reporting of much military, short-term, and non-publicly-guaranteed debt-while less serious than hitherto - still means that the truth is even more worrying than such official estimates suggest.

2. Non-oil LDCs' current-account deficits (of which banks covered a rising proportion) themselves grew dramatically - from $11.3 bn. in 1973 to $107.7 bn. in 1981.* This added to fears that an ILLR might be needed, and perhaps found wanting.

3. The speed at which debt service, especially and increasingly to banks, has been expanded and internationalised has involved more and more dangerous strains. By

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* The current account deficit declined, however, to $86 billion in 1982 and is projected to decline further to $68 billion in 1983, principally because bank lending contracted sharply from $53 billion in 1981 to $25 billion in 1982 and is expected to contract further to $15-20 billion in 1983. (IMF, World Economic Outlook, 1983) Ed.

1982, the debt service "ratio" (DSR) to annual exports of goods and services was24% for non-oil developing countries, as a group.* Yet, even for any one LDC, the risk of serious debt repayment difficulty rises sharply as DSR increases; even in 1965-74, when risks were far smaller, difficulties arose in 38 of the 102 cases where an LDC had a DSR above 20% in a particular year, but only in 2 of the 478 cases with DSR below 20% (Feder, 1979; Lipton, 1981, fn.10). Even the alarming recent DSRs exclude servicing of much unreported debt (see para. 1), and the position of several Comecon countries increases the dangers further. Nor, on past evidence, need "recovery" - especially if patchy - reduce the risk; for some debtors, it could even worsen terms of trade and/or raise interest-rates. Hence there is no validity whatever in popular, and populist, claims that the internationalised threat to financial stability is somehow unreal, or no greater than before (Lal, 1981, p. 17), or that urgent demands for ILLR or other action constitute some sort of "banker's ramp". There has been an explosion of demonstrably risky credit, in forms for which there is, as we shall see, no clearly demonstrable LLR (McNamara, 1982). Morgan Guaranty (1983) has estimated that almost half of LDC debt is in arrears, was being rescheduled or had been rescheduled at the time!

4. The debts - and risks - are the more alarming for being very concentrated on a few big debtors and banks. At end-June, 1982, of $347.5 bn. owed by the hundred-plus developing countries to BIS reporting banks (excluding offshore centres), some 49.6% was owed by Argentina, Brazil, Mexico and Venezuela (Morgan Guaranty, 1983, p. 3). In early 1983 Argentina, Mexico, Venezuela, Brazil, Chile and Colombia had reported debt service ratios well over 100%. Exposure to the first three alone by the 10 leading US banks was $38 bn. - over 40% of the countries' bank debt, and over 140% of the banks' total equity! (Economist, April 1983, pp. 13, 18.) The Federal Reserve estimated that about 70% of total US banks' exposure to the 12 largest LDC borrowers was with the 9 largest US banks.

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* This compares with a ratio of 14-16 per cent in 1973-1977. In 1983, the debt service ratio is expected to fall to about 19 per cent, reflecting a combination of three factors: lower average interest rates, reversal of the 1982 decline in export earnings and debt rescheduling (IMF, World Economic Outlook, 1983). Ed.

5. Banking was further internationalised as Euro-dollars and other "Euro-currencies" were placed in overseas banks, subsidiaries and offshore centres. "Recycling" of OPEC funds meant that, by December 1981, 16% of total deposits of private banks in the BIS reporting area (which includes Group of Ten countries plus the offshore branches of US banks in the Bahamas, the Cayman Islands, Hong Kong, Panama, and Singapore) originated from the oil-exporting countries; and about 38% of these banks' net external resources (deposits minus credits) came from oil-exporting countries, mainly Saudi Arabia, Kuwait and the UAE (BIS, 1981, 1983). The 1982 oil price fall somewhat reduced inflows from major oil exporters; however, their deposits - and current-account surpluses - are seriously understated by published data (IMF, 1982, pp. 142).

Finally, lending and banking increasingly involve agents of several nationalities in single transactions - so that responsibility for both supervision and ILLR is unclear. This means, for example, (a) syndicated lending, with the participation of banks from different countries, to finance developing-country and Comecon borrowing; (b) the rapid growth of a much larger, international, surprisingly vulnerable, interbank market; (c) a growing search by banks for legal means to avoid exposure limits and to reduce tax liability. All this means a great variety of foreign branches, subsidiaries, affiliates, so-called holding companies, etc., largely in offshore centres with parent banks based in other countries. Furthermore, the main depositors are often from yet other countries - as are the currencies in which the bank is operating. As a result of this internationalisation, a large proportion of operations and flows do not <u>clearly</u> fall within the purview of any national supervisory or LLR authorities.

IV. Existing Provisions for ILLR Facilities

There is now, as we have stressed (p. 7), uncertainty about LLR for foreign activities. Central bank representatives repeatedly aver that even indications of the possible provisions of their support as ILLRs, or any apparent generalisation from past cases where their services were provided, may reduce bank prudence. Governor Wallich (1978, pp. 95-6), of the US Federal Reserve Board, stated:

> "There are dangers in trying to define and publicise specific rules for emergency assistance to troubled banks, notably the possibility of causing undue reliance on such facilities and possible relaxation of caution ... The Federal Reserve has always avoided comprehensive

statements of conditions for its assistance to member banks. Emergency assistance is indirectly a process of negotiation and judgement, with a range of possible actions varying with certain circumstances and need. Therefore, a predetermined set of conditions for emergency lending would be inappropriate".

Bank of England Executive Director (now Deputy Governor) MacMahon expressed a very similar view (1978, pp. 108-109):

"... close consideration and cooperation among the central banks most concerned with the security of the international banking markets is essential. By the same token, however, it is not possible for them to define in advance with any precision the circumstances in which last resort finance might be forthcoming. Indeed, if they tried to do so, banks might be tempted to sail too close to the wind with the presumption that support would automatically be forthcoming if they got into difficulties. The primary purpose of agreement among central banks on the provision of last resort finance is to safeguard the international banking systems on which that is founded. The provision of such a safeguard does not - indeed cannot - entail automatic support to any bank facing difficulties regardless of the particular circumstances".

Central bankers, therefore, deliberately do not make explicit existing ILLR arrangements. Thus the major official statement, the September 1974 Communiqué, issued by the Central Bank Governors of the Group of 10 and Switzerland, a few months after the collapse of Bankhaus Herstatt, is kept brief and unspecific (IMF, 1983, p. 34):

"... The Governors also had an exchange of views on the problem of the lender of last resort in the Euromarkets. They recognised that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary". 3/

Note that this leaves open the possibility that "temporary liquidity" may be supplied to borrowers, to lenders, or through open-market operations. It is not explicitly assured to the troubled bank.

In April 1980, the same Group - in a further communique, mainly about supervision - referred even less explicity to ILLR issues:

> "In view of the present volume of international bank lending and of its prospective future role the Governors are agreed on the importance of maintaining the soundness and stability of the international banking system and of seeking to avoid any undesirable effects either worldwide or on the conduct of policy in particular countries".

This 1980 Communique announced the creation of the Standing Committee on the Euromarkets. This has been interpreted (IMF, 1983, p.34) as a responsibility for "coordination of responsibilities of lenders of last resort". It has also been suggested that the BIS "bridging loans" in 1982 and 1983 represented a sort of ILLR facility; and that, behind the 1974 Communique, there lay "an agreed plan with respect both to the allocation of responsibilities of lender of last resort and the circumstances under which such support would be provided to banks experiencing difficulties" (IMF, 1983, p.34). However, supervisory authorities (in conversations with us) questioned all this; they suggested BIS functioned, in respect of ILLR, not independently but as a monthly meeting-place for central bank Governors of the Group of Ten and Switzerland. Moreover, as the IMF document (1983, p. 34) itself points out, "subsequent developments with respect to individual banks, as in the case of Banco Ambrosiano, have cast doubts on whether such firm commitments exist". 3/

Some indirect evidence on the distribution of ILLR responsibilities can be extracted from the actions of central banks following the few recent failures of individual banks with significant international operations: Bankhaus Herstatt, the Franklin National Bank, the Israel-British Bank and Banco Ambrosiano. 4/ Except for Franklin, all four cases revealed important ambiguities as to final responsibilities in case of bank failures. With Herstatt and Israel-British, there was prolonged uncertainty as to whether all creditors would recover their funds. 5/.

The ambiguities were much greater in the case of Ambrosiano, leading (so far) to the loss of money by creditors of Banco Ambrosiano Holdings of Luxembourg, though the parent bank's creditors were granted full protection. The Luxembourg authorities and naturally the creditors of Banco Ambrosiano Holdings, objected. The issue was made more difficult by technical questions; 6/

and it has also been put to us that the problem arose from open fraud, not from international over-exposure as such. However, we are unconvinced that existing ILLR - overview facilities would prevent even a perfectly "innocent" bank from failing, if its overseas operations were overstretched. The Ambrosiano failure clearly points to gaps in the coverage of both supervisory and ILLR facilities. Luxembourg lacked an indigenous central bank, or any other LLR capacity for Euro-banks; while Italy did not supervise adequately Ambrosiano's consolidated accounts. These elements could surely be repeated in other cases - Italy and Luxembourg are relatively sophisticated financial centres, after all. More generally, the problems of non-banking (and other) subsidiaries, etc., without clear supervision from their parent country, particularly in centres with no LLR obligations, do reveal a more serious gap, both in supervisory and ILLR facilities. 7/ It is not clear whether this case has led to adaptations of these facilities.

A recent authoritative report confirms our fears that major deficiencies and gaps exist in supervision and ILLR facilities, both brought more clearly into focus by the (admittedly special) case of Ambrosiano (Dale, 1982):

> "It is a matter for concern that lender of last resort facilities differ considerably from country to country. A few financial centres have no LLR capacity. Some national authorities can provide only temporary liquidity assistance on a secure basis, while others are able and willing to sustain even insolvent institutions in order to protect depositors. These disparities apart, there is a danger that some authorities may be prevented from extending collaterallized assistance to banks' foreign branches where national laws confer on branch depositors preferential claims to branch assets".

International bank failures since 1973 have been at fairly long intervals, and each has been relatively small. It has been reasonable, therefore, to see the main ILLR task as being to safeguard the interests of depositors and other creditors. If a major international bank - or a closely-spaced sequence of minor banks - were to be "in trouble" or to fail, the main issue would not be to safeguard those interests, but to sustain that bank's (and others') lending capacity. It is in this context that true ILLR - not just deposit insurance, which in essence is what was applied to these four cases - acquires fundamental importance. (Even deposit insurance may require international coordination, if it is not to cut across and

and destabilize ILLR operations. 8/) Reliance on ad hoc solutions, however brilliantly managed, may be acceptable for a Herstatt case, or even an Ambrosiano case, but the prospect of open default by LDC or Comecon creditors requires formal ILLR safeguards.

The inadequacy of existing safeguards is well summarised by the Group of Thirty report (Dale, 1982). The main disparities and gaps in LLR operations at a national level, which create problems at an international level, are in their view (we follow closely Dale, 1982, pp. 16-17):

i) When monetary authorities provide financial assistance to commercial banks experiencing temporary liquidity difficulties, there are varying national distinctions made between formalised routine use of the official discount window, and longer-term support operations undertaken on a discretionary basis.
ii) Although emergency assistance is typically extended directly by the central bank, there are different alternative methods of support in different countries (e.g. special joint facility of the authorities and the banks; lending below market rates to institutions prepared to acquire or assist the problem bank; general support, with or without official encouragement, by one or more large domestic banks).
iii) Crucially, several financial centres - notably Luxembourg, Hong Kong and Singapore - have no indigenous central banks. (Luxembourg has no LLR at all.) This (and other problems) would appear even more widespread and serious among financial centres not included in the Group of Thirty study (e.g. Cayman Islands, Bahamas).
iv) Frequently emergency support can be offered only on a secured basis to solvent institutions. Some countries have broader powers of intervention where insolvency is threatened; elsewhere, the deposit insurance agency has LLR powers which - for potentially insolvent institutions - may exceed those of a central bank.
v) Some central banks are permitted to act as LLR in domestic currency only, although these funds may in principal be converted. Elsewhere, the capacity to provide foreign currency assistance has specific limits.
vi) To varying degrees, countries conceal the precise scope of LLR, as a matter of policy. In general, they expect foreign parent banks to provide all necessary assistance to their local subsidiaries, although the threat of shareholders' actions could in theory limit their commitment.
vii) Finally, where banks do fail, national liquidation proceedings sometimes favour local depositors. (US and many other deposit insurance schemes, too, leave big and/or foreign depositors virtually unprotected.) For this, several

countries treat branches of foreign banks as separate entities requiring their own liquidators; such creditors may also enjoy a preferential claim to branch assets.

In Appendix A we sketch the national supervision practices for international bank lending. These have national differences and international gaps, as do LLR facilities. But does it matter? In practice, can real harm be done by any shortcoming of current practice in ILLR facilities?

V. ILLR and International Expansion: Acute and Chronic Problems

Are ILLR facilities - and the accompanying supervision - adequate to limit damage in times of crisis or widespread distress? Perhaps even more important, in less "abnormal times", do existing arrangements encourage the right scale of lending; do they avoid "euphoric" lending, followed by panicky curtailment of lending; and do they promote, without over-centralist "hands-on" intervention (McMahon, 1983, p.8), an appropriate structure (by types of loan) and distribution (amongst developing countries) of bank lending?

A first conclusion of this study - shared by many other analysts - is that current arrangements, based on general uncertainty and attempted ex post coordination of ILLR in cases of distress, are dangerously insufficient.

There are a number of reasons - some familiar from the historical literature, others arising from the current situation - which make a reliable, predictable ILLR essential amid complexities of international banking today.

As Kindleberger (1978, 1982) has pointed out, responsibility for international banking stability (like health and welfare) is a public good, even if public provision of it may somewhat diminish private self-reliance. The good is too risky, and fraught with externalities to be provided by one, or even several, private agents acting alone. This approach does not necessarily rest on the perception of some analysts that the U.S. and other banking systems are inherently fragile, but on the possibility that the international capital market is mostly resilient but can very occasionally break down, with huge, unpredictable, lasting, and maldistributed costs.

National LLRs cannot cope with the problems of an international bank. As central banks or other national authorities represent their own national interests, they will be unlikely to take a cosmopolitan view of their responsibility in a crisis - unless, implausibly, potential loss from absence of ILLR, and potential cost of ILLR rescue, are in the same ratio for all creditor countries involved. It may be feared that as a consequence no single lender of last resort may be willing to save a given bank (whose activities transcend its frontiers) from a liquidity crisis, because the domestic effects of inaction do not seem to be larger than the cost of support, even though the world consequences may be. Inevitable conflicts of interest will arise where parent banks, subsidiaries, holding companies, depositors and borrowers have varying nationalities. Each central bank will try to minimise its proportion of the costs of any ILLR operation. Delays and disputes about responsiblity can themselves reduce confidence and deepen crisis. We repeat: the world can put up with such costs in the event of a Herstatt or an Ambrosiano; but in the event that overt default, in one or several developing countries, threatens the liquid base of major banks? We should perhaps thank the Ambrosianos, for alerting us, in time, to the crucial need for a formal, transparent, swift ILLR. But are we in fact alerted?

The review of existing national LLR facilities, and more importantly the recent experience of international bank troubles - with interlocking, multiple losers and unclear responsibilities - raised concerns that the financial crises of the 1870s and 1930s may be repeated, and showed that these concerns are not merely theoretical and historical. Furthermore, even if a national LLR had - and if it was willing to commit - unlimited resources in domestic currency, the fact that international deposits and loans may be denominated in foreign currencies could cause it serious problems and lead to its unwillingness to provide foreign currency to support commercial banks' international operators. Such a balance-of-payments constraint may have been one factor in Argentina's partial denial of its responsibility to foreign creditors in the failure of Banco Intercambio Regional (IMF, 1983).

Amongst industrial countries' central banks, this problem has so far been overcome by mutual balance-of-payments support operations. Such operations, however, could be much more clearly and swiftly handled in the framework of an ILLR. The role of the US Federal Reserve would necessarily be crucial, as such a large proportion of international banking operations is still in dollars. Therefore, the position of the US Government and of the US Federal Reserve Board in these matter will inevitably have a great influence on arrangements agreed.

Guttentag and Herring (1981) also stress special characteristics of international banking that make a transparent ILLR essential. Inter-bank credit lines may cause one bank's failure to damage the solvency of other banks. Furthermore, several of the largest international banks hold similar assets in their portfolios. Here, one bank's weakness may raise suspicions about other banks. On either ground, failure of one bank may result in deposit outflows from other banks. Thus uncertainties about ILLR may make uninsured depositors more prone to abrupt reassessments of the creditworthiness of banks. This creates, under current conditions, unacceptable risks to the stability of the international banks.

Such authors as Guttentag and Herring recognise the problem of moral hazard, but attempt to overcome it by mechanisms which they percieve as far more efficient (i.e. effective bank supervision). Moreoever, if uncertainty is used to control moral hazard, private banks may not know what behaviour would disqualify them from support; they will therefore not know what activities they should avoid (Shafer, 1982). Most important, "uncertainty" in time of crisis must involve delay, speculation and dangers of further destabilisation - especially if uncertainty is combined with unclear division of responsibility among central banks.

So much for the problems of ILLR in time of fear of crisis. Even in more normal times, the lack of clear ILLR protection, and of appropriate supervision, not just of the prudence of individual bank lending but of the adequacy and stability of the structure of total bank credits especially to LDCs, has serious disadvantages. Great swings of expansion and contraction, e.g. in lending by banks to Mexico or Brazil, indicate several things. First, each bank, initially lending in hope of a sound return, continues to do so to defend its previous lending, or to avoid admitting past errors. Then, when a country's balance of payments deteriorates, the withdrawal of some banks imperils the position of others, and they too withdraw. Finally, in the downswing, erosion of the cash base - and measures, by banks and borrowers, to anticipate it - reduce the volume of sound lending and delay recovery (McNamara, 1982; Lipton, 1981).

VI. Towards a Solution

Neither more lending nor less lending - only more appropriate lending, with better structure, distribution, steadiness and insurance (e.g. via ILLR) - can remedy this recurrent, deepening, and more and more destabilising sequence. Recovery alone cannot. If it turns out to be sustained and ideal for debtors - pushing up oil prices for Mexico, and commodity prices and general export demand (but not interest rates) for other LDC and Comecon lenders - "men of affairs" may, as in Britain in 1858-65, conclude all is well; credit will again be blown hard into the balloon marked "sovereign risk". But more lending on the same pattern as before will only mean bigger problems later. As for *less* lending as such, that either destroys recovery or precipitates default; national and international authorities realise this, as the recent frenzied, brilliant, and partly successful attempts to ensure that large numbers of banks continued to lend to Brazil, Mexico and other countries, show.

What does "more appropriate lending" mean, and how could a more clearly defined ILLR help? More appropriate lending involves three things: better information; sustained, counter-cyclical flows; and diversification.

Commercial banks considering loans to country X, which is likely to have a given production structure implying a particular set of foreign-exchange flows to and from X, would ideally know (a) what, in total, other banks and official institutions propose to lend to X, and have already lent to X - and what are the maturity structures; (b) what X's customers, suppliers and competitors plan to do in respect of the commodities to and from which X's foreign exchange is expected to flow. That sounds a frightening requirement, almost a world economic model, and if taken too far would choke off all credit; but what is needed is something much more modest. Unless a loan is secured very firmly, a commercial bank needs to know - from its own sources, and from the central bank and perhaps indirectly from BIS/IMF - something about the applicant's total credit position, actual and potential, as affected by the commodities and manufactures he proposes to trade in. Surer access to ILLR could well be a "carrot, persuading commercial banks to supply, and to seek, more such information.

Secondly, stricter supervision and surer ILLR, respectively, should stabilise the growth of lending in the "euphoric" stage and minimise its contraction during more critical times. Sustained, possibly counter-cyclical flows would seem to be one of the most crucial likely achievements of those mechanisms - if they can be properly specified. However, an ILLR with "uncertainty" cannot be relied on to stabilise credit flows.

The third aspect of better lending, diversification, is also intimately linked to the availability of ILLR. We have pointed to the extreme concentration of bank credit expansion to developing countries in the 1970s on a handful of Latin American and Far Eastern countries. At the time, this concentration on a few apparently credit-worthy middle-income lenders, plus neglect of almost all really poor countries, seemed prudential to each bank and each syndicate. Each, however, by its own prudent concentration of extra lending, produced a somewhat imprudent concentration of the rapidly expanded volume of total lending. Prolonged recession, high interest and oil price gyrations then turned what was sound for each lender, and mildly imprudent for all lenders *ex ante*, into what seemed like disastrous imprudence after the event.

However, almost nobody was in 1973-4, or even 1978-80, pressing the banks not to recycle, or urging them to diversify their portfolios towards, say, Bangladesh or Mali. Probably it was felt that absolute risk (and lack of banking information) about low-income countries was so high, and their reliance on official flows (especially aid) so well-established, that the dangers and doubts about bank lending to these countries - not all of whom wanted bank money anyway - outweighed any possible gains from a better spread of risks.

Nevertheless, in retrospect (and for future reference), greater diversity of customers among LDCs, to take in some LICs, could have improved the safety of many banks' asset structures. So, perhaps, would a larger share of project lending, as against balance-of-payments lending. However, the gains from such shifts are available to bankers *as a whole,* if they move together; for any *one* bank, the shifts in some cases could increase risks, and would certainly increase information costs. In such circumstances, how can the authorities nudge banks in these directions? If ILLR obligations were made explicit by some group of central bankers, they could include - in the supervisory package that must be (as it is nationally) part of the quid pro quo for LLR support - appropriate pressures to induce *all* banks, participating in an assured ILLR facility, to move gradually towards such restructurings, as well as to obtain better information about creditor countries' *total* debt position and prospects, and to stabilise credit (including interbank) flows towards each borrowing country over time.

All this - even the last proposal - should not amount to pressure on individual banks to support particular countries. *This* "interference with the market", indeed, has come, in practice, not from a carefully conceived ILLR/ supervision package, but from the hasty cobbling together of rescheduling and new loan packages to specific countries half-forced on numerous reluctant banks since late 1982 precisely because ILLR is and was inadequate.

How could improvements be brought about? In abandoning uncertainty as a way to raise costs of ILLR - because it defeats ILLR's very purposes - authorities can and should, we believe, replace it by adapting to the needs of today Bagehot's original concept of "onerous terms": good collateral and the penal rate.

At first glance, this seems difficult. The only "collateral" for sovereign debt is the willingness and ability of the governments to repay and service it, or to guarantee that the private sector does so. This collateral is by definition not very "good" in hard times. Thus, if net capital inflows become severely negative alongside large trade deficits - as in much of Eastern Europe and Latin American since 1982 - the need to reschedule, even to go into arrears, merges imperceptibly into a temptation to default outright, as is now under active discussion at semi-official levels in Brazil and Mexico (The Economist, May 1983, p. 28; Whitley, 1983, p.4). Indeed, leading bankers argue that "Poland, Mexico, Argentina, Brazil and now Romania have all unilaterally defaulted on their debts" already (Rohatyn, 1983, p.17). What, then, can "quality collateral" mean? And how high (and how self-defeating) would "penal rates" be? There is not, as yet, a clear consensus among bankers about proposals for "debt restructuring" (Avramovic, 1983; Guth, 1983; Rohatyn, 1982; ICIDI, 1983; compare, however, Lal, 1983, p. 17; Taylor, 1983, p.10; MacMahon, 1983, p. 8).

Our suggestion is that such proposals be prepared in the form of a contingency plan, for use as part of an ILLR call when needed by a bank. Then, and only then, the ILLR would purchase some or all of the bank's claims upon sovereign debt at a substantial discount. This would impose a de facto "penal rate", and turn large but doubtful claims on now insecure "sovereign debt" into a smaller amount of "good collateral" a la Bagehot. The private bank would thus suffer "onerous terms" for using ILLR; but the private bank, its deposits, above all its capacity to lend, would survive.

Afterwards, the ILLR would negotiate with borrowers (e.g. developing countries) to recover the debt - presumably at a considerably lengthened maturity - at a rate above that implicit in the discount price paid to the commercial bank for the claim, but somewhat below the original rate due. The better maturity and perhaps rate, reduce constraints on the borrowing country's development; this would be "traded in" by the new owner of the claim - the ILLR - against a firmer commitment by the borrowing country to ensure repayment. The more favourable conditions for LDCs would imply a less severe constraint on their future growth as well as a greater willingness by their governments to repay the debts.

Thus - 110 years later - Bagehot's proposals would again come into their own. Their two components for onerous terms - penal interest and good (in a sense) collateral - would have merged into one.

This proposal obviously raises problems, too complex to consider in detail here. Valuing the discounted collateral could be difficult, where no markets are functioning at the time. Other holders of sovereign debt, who are not in need of LLR facilities, must be considered (though presumably they would, on balance, welcome a valuation). Terms must encourage neither debtor countries to seek them, nor banks to seek ILLR facilities. International arrangements - the role of IMF and BIS, the extent to which commercial banks pay a fee or contribute funds for ILLR access, the treatment of lending institutions that "contract out" - need to be specified. The question of funding the operations of such an ILLR is of course crucial. However, we believe that these problems though difficult, are soluble; and that the proposal provides, by reviving truly "onerous terms", a much better way than "uncertainty" to overcome the moral hazard created by existing inadequate and crisis-prone ILLR arrangements.

The proposal would be complementary to the strengthening of international supervisory functions. Although much progress has been made, particularly since the 1975 Concordat, it is difficult to establish complementary and tightly coordinated international supervision. How can one resolve problems about differences in supervision procedures (Appendix A) amongst industrialised countries, and - even more - problems with supervising banks in developing countries and offshore centres? Even if such "piecemeal" difficulties can be overcome, what does an ILLR system with a supervision quid pro quo do about banks that opt out, and then hope that the authorities will allow them to free-ride on the ILLR facility, and will regard the cost of not doing so, in an interlocked financial system, as socially unacceptable? Finally, how does one strike a balance which assures adequate supervision and control, but which does not imply excessive centralised overview or impose unacceptable quasi-governmental controls on private lending? In any case, the existence of a clearer ILLR must increase the leverage of existing supervisory authorities, allowing them more timely and appropriate control of lending, insofar as a condition for access to ILLR functions would be to have respected the rules agreed with the supervisory authorities.

We feel that our proposal does not create the problems; it merely makes them explicit. In fact they have become serious partly because - in the interests of using "uncertainty" to police commercial-bank lending and to reduce moral hazard - the authorities have never clearly outlined and divided ILLR and supervisory responsibility, nor acquired the leverage to enforce what provisions do exist. Fundamentally such problems are always latent because of the complexity and internationalisation which now characterise banking.

As for the problem of "free riders", if closer supervision accompanies clear-cut ILLR arrangements, both will reinforce each other. Rigorous supervision should become more acceptable to commercial banks especially big international lenders, if accompanied by an explicit ILLR facility. On the other hand, an ILLR can work without excessive costs - whether from imprudent lending, or from the use of uncertainty to deter it - only with previous effective supervision. Both sides of the coin are currently somewhat tarnished (see below). They need to be etched clearly - and simultaneously.

As we have discussed, the establishment (or otherwise) of an ILLR, together with more stringent supervision of bank lending - would affect the nature, level and distribution of private credit flows to different categories of developing countries. We have for example argued that the supervisory component could be used to improve the distribution, among LDCs, of commercial bank lending; it could be linked to achieving a more appropriate balance of different types of private loans (e.g. different maturities; project vs. country loans; fixed vs. variable interest) to LDCs. Such matters inevitably have a major impact on the prospects of growth and development of the so-called Third World countries, who would borrow - or wish to do so - from the private capital markets; it would naturally also have a large impact on the interests of those developing-country Governments who are major depositors in the private capital markets, such as the capital surplus oil-exporters. It would therefore seem appropriate that LDC Governments should somehow be represented in the debate on the establishment of an ILLR and appropriate supervision. We are by no means suggesting incorporation of all or even many LDCs, as this would make any agreement infinitely more difficult; merely that the interests and concerns of the middle income and the poorest borrowers from - as well as the capital surplus lenders to - the international capital markets be clearly represented and considered.

APPENDIX A

Supervision of International Banking

As we have seen, the issue of appropriate international supervision is clearly separate from - though intimately linked to - that of an ILLR. As it is not absolutely central to our concern, and as it has been amply and adequately recently discussed elsewhere - in particular in IMF (1983), Dale (1982), as well as in several of Mr. Cooke's recent speeches, published in the Bank of England Quarterly Bulletins - we will discuss these issues only very briefly here.

As is widely recognised, the techniques of bank supervision lagged behind the internationalisation of banking through the early 1970s. The financial problems of 1974 highlighted this lag in a dramatic way. They led to the establishment by the governors of the central banks of the Group of Ten, plus representatives of Luxembourg and Switzerland, of a committee of bank supervising authorities. One of the earliest and most important achievements of this Committee (now called the "Cooke Committee" after its Chairman) was to develop broad guidelines for the division of responsibilities between national supervising authorities in respect of international banking activities undertaken in their territories. These guidelines - approved by the Central Bank Governors of the Group of Ten in December 1975 - are known as the "Basle Concordat". Cooke (1983) summarises thus the Concordat's priorities: "Supervision was deemed to be the joint responsibility of parent and host authorities...The supervision of liquidity was seen as the responsibility of host authorities in the first instance...The solvency of branches, which are an integral part of the parent bank, was seen as primarily a matter for parent authorities, while that of subsidiaries fell rather to the host, though it was recognised that parent supervisors, in their supervision of the parent bank, needed to take accounts of its foreign subsidiaries and joint ventures in view of its moral commitments in their regard".

A later important recommendation of the Cooke Committee (currently being implemented in some countries), was the consolidation of the data in banks' international business, so as to provide a global picture of banks' activities. A number of other initiatives have been taken, by the Cooke Committee and other bodies, within OECD and EEC, to improve coordination of supervision; these include contacts with banking supervisors in offshore centres, not initially subscribing to the 1975 Concordat.

Many problems for coordinated international supervision still remain. Some of them result from different national traditions of supervision, in crucial aspects such as formality of the methods of control; the relative importance attached by supervisors to quantitative limits on banks, as against adequacy of bank management; the nature of "acceptable" business activities; definitions of appropriate methods to evaluate country risk exposure; and the role of on-site bank examination. Others result from different interpretations of the key principle of parental responsibility, the need to regulate liquidity in the Eurocurrency market and the limited application of the principle of coordination. As a result of several of these factors, it seems that certain banks may, for some purposes at least, be largely unsupervised. A revised Concordat, to be published shortly,* emphasises "that the central bank in the parent bank's home country has supervisory responsibility for the solvency of the parent bank and its subsidiaries", whenever "central banks of the countries in which foreign subsidiaries operate will be responsible for those units' liquidity" (Hughes, 1983, p.2).

However, Cooke rightly stresses that there is no "unsupervised horde" of international lenders. The real problem, as we indicate, is the inadequate <u>scope</u> of supervision - its concentration on the exposure of particular banks, rather than of the total system and of borrowers from it - and the lack of leverage, such as the grant or denial of ILLR facilities that may be needed later to enforce supervision rules.

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* Since published. For the text, see <u>IMF Survey</u>, July 11, 1983, p.202-204. <u>Ed</u>.

Footnotes

1. Grubel (1971) derived the concept of "moral hazard" from the economics of commerce, where it initially referred to the danger that persons would take greater risks because they were insured. Now it has acquired the more general definition used here and elsewhere (see IMF, 1983).

2. Viz. control of each bank: for fraud; for overall lending, relative to cash and to capital; and for exposure to particular borrowers, or in particular countries or sectors.

3. The 1975 Concordat - sometimes wrongly thought to apply to ILLR - deals only with the separate, though linked, issue of bank supervision (Appendix A).

4. Such cases have been examined in some detail (e.g. Spero, 1980).

5. The issues were later clarified. The German authorities granted favourable treatment to the creditors of Herstatt. The Israeli authorities accepted responsibility for the Israel British Bank - even though the Bank of England contributed as a compromise, but not as a precedent, £3 million to the bank's pool of assets.

6. Banco Ambrosiano Holdings was technically, in the view of the Luxembourg and the Italian authorities, a holding company and not a bank, for whom neither authorities had accepted supervision or LLR responsibilities.

7. Ambrosiano's failure, however, is one of the main factors leading to a revision of the Basle Condordat on banking supervision (Hughes, 1983, p.2)

8. "Not all countries have deposit insurance schemes and those that do offer widely differing coverage with respect to the size, type, currency denomination and status of deposits. In order to avert the danger that perceived differences in national protective arrangements could provoke destabilising capital movements in times of uncertainty, greater co-ordination in this area is desirable" (Dale, 1982, pp. 3-4; see also pp. 14-16, and IMF, 1983, p. 21).

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