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A Regional Bank's Perspective: An Analysis of the Differences and Similarities in the U.S. Banking Community's Approach to and Participation in the Mexican Restructuring

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While the billion dollar Mexican loan portfolios of the largest U.S. banks have received substantial media attention, there is little public notice that an estimated 180 U.S. state and national banks are involved in the restructuring of Mexico's foreign debt.[1] Although the nine largest single U.S. bank creditors held slightly more than 50% of the $27 billion-plus owed in August 1982 by the Mexican public and private sector to U.S. banking institutions, $13.5 billion was held by at least 160 U.S. banks, with exposures ranging from approximately $625 million to less than $10,000.[2] While no single bank can be representative of this large and diverse group, the perspective of a regional bank highlights some of the differences and similarities within the U.S. banking community in its reaction and approach to the many issues and problems presented by the Mexican situation.

The differences and similarities have not been a simple function

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1. Although the number of U.S. banks with exposure to Mexico has been placed as high as 400, Deputy Treasury Secretary R.T. McNamar reported at a press briefing on August 23, 1982 that the number of U.S. banks was 180, which more closely coincides with the number which signed the March 1983 new credit facility.

2. The approximate amounts owed to the nine largest U.S. bank creditors have been frequently reported. *See Mexican Loan Agreement Reached*, AM. BANKER, Aug. 23, 1982, at 1, col. 3, *Latin American Exposure of the Top Ten Banking Companies*, AM. BANKER, Dec. 5, 1983, at 3, col. 1. The reported amounts for the debt owed to all U.S. banks range as widely as the reported number of banks. The most commonly reported figure of $27 billion most closely coincides with the U.S. bank commitments to the March 1983 new credit facility since the expected commitment was to be based on 7% of total outstandings. The August 1982 debt figures, however, have since increased largely by reason of the 1983 and 1984 new credit facilities extended to the United Mexican States as part of the restructuring effort.

of relative gross dollar exposure. Notwithstanding the fairly straight-line relationship between a bank's gross dollar exposure and the degree of direct participation allowed the bank in debt restructuring negotiations, relative exposure of any bank is much more meaningful when expressed as a percentage of the bank's capital and surplus. Contrary to the popular conception that lesser-dollar amounts extended by the regional and smaller banks are more easily absorbed or written off, a significant number of the regional bank Mexican loan portfolios reflect debt-as-percentage of capital and surplus at levels comparable to those of the large money-center banks.

In a regional bank's Mexican loan portfolio, the aspect which has most affected the regional bank's response in the restructuring is the amount extended to the private sector. Differences between creditors arising from different characteristics of their respective portfolios of public sector debt have been relatively minimal, for the sheer magnitude and complexity of the public sector debt structure has mandated with few exceptions identical treatment of debt as the only feasible restructuring approach.[3] The stereotype of the regional and smaller bank Mexican loan portfolio as being oriented primarily to trade finance or purchases of participations in short-term public sector debt is not entirely accurate. While there is a tendency toward such orientation by the regional and smaller banks, all U.S. banks tend to have greater private sector exposure than foreign banks. Indeed, many regional banks have substantial private sector exposure, and, in a few cases, their ratios of private sector to public sector debt are higher than those of the money center banks.

Another significant aspect affecting a smaller bank's response to the situation is the degree of the bank's physical presence in Mexico and the resources available to the bank within Mexico to deal directly with the borrowers, particularly private sector borrowers. Although many of the regional banks have representative offices in Mexico, most do not have the staff necessary to conduct the constant negotiations and legwork required to monitor the situation on a daily, sometimes hourly, basis as do their larger bank counterparts.

Several aspects that have arisen during the formulation of the restructuring relate to the U.S. banking laws and regulations. While national banks often are unified in their response to issues because they are all subject to the same legal and regulatory system, these

3. Although differences in loan currencies and cost of funds were addressed with the object of attaining functional identity of treatment, the few exceptions to identical treatment simply were removed from the basic negotiations as excluded debt.

same laws also have provoked differences. For example, since the U.S. banks as a whole have a much higher ratio of private to public sector debt in Mexico than the other foreign banks, the U.S. banking community usually has been unified in its insistence that attention be given to the private sector debt as part of the restructuring. On the other hand, U.S. national banks have polarized on issues such as the early suggestion by some banks that the private sector debt be nationalized. A given bank's position on this issue depended primarily on the size of its portfolio in terms of capital and surplus, and on the effect of this suggestion on its legal lending limit to the United Mexican States.

The reaction of the U.S. banking community to the new financing principles, which were announced September 8, 1984, for the long-term restructuring of the 1985-90 maturities of Mexican public sector debt to foreign commercial banks is not known at the time of this writing. It is the premise of this writer, however, that most of the differences between U.S. banks surfaced in connection with the announcement in December 1982 of the first restructuring principles for the public sector debt maturing through December 31, 1984 and the concomitant request for the 1983 $5 billion new money facility. Comparatively, the 1984 $3.8 billion new money facility provoked little interbank controversy. Accordingly, this article addresses primarily the context in which the December 1982 restructuring principles were negotiated and the U.S. banking community's response thereto.

I. Backround of the Restructuring Problem

The particular circumstances surrounding the Mexican restructuring effort not only affected the reaction of virtually all banks with outstanding Mexican loan exposure, but largely dictated the manner in which the restructuring was undertaken. The banking community was caught unprepared for the gravity of Mexico's foreign exchange position, which surfaced abruptly on August 5, 1982, when the Mexican government announced it was running out of foreign exchange and could no longer support the peso on foreign exchange markets.[4]

4. Foreign credit to Mexico which had slowed down beginning in the last half of 1981, reached a virtual standstill in the first half of 1982 in response to the substantial deterioration of the Mexican economy as oil prices weakened. In December of 1981, the largest private sector conglomerate controlled by Grupo Industrial Alfa, S.A., had announced the need to restructure its $2.2 billion foreign debt. Shortly thereafter, on February 17, 1982, the Central Bank, Banco de Mexico, allowed the value of the peso to float against the dollar resulting in a 45% devaluation before the Central Bank again intervened to stabilize the peso. The devaluation had immediate serious ramifications, especially for the private sector,

The peso, which had already fallen from 27 pesos to the dollar in February to 49 pesos to the dollar, plunged almost immediately to 70 pesos at the floating rate. Only one week later, as holders of U.S. dollar bank accounts in Mexico began withdrawing their accounts, the government announced that the approximately $12 billion in foreign currency accounts with Mexican banks could only be withdrawn in pesos. The foreign exchange markets were closed the following day. Since Mexican banks were required to maintain reserves with the Central Bank of 70% for foreign currency accounts, this action reflected the true gravity of the Central Bank's liquidity crisis.[5]

On August 17, the magnitude of the problem was revealed in a live television presentation during which Treasury Secretary Jesus Silva Herzog announced a $1 billion emergency loan from the U.S. Treasury, tied to a complex arrangement for future oil purchases from Mexico and plans for a $1.5 billion bridge loan from the Bank for International Settlements (BIS). He announced Mexico would need a total of $5 billion in new loans from international agencies and commercial banks before the end of the year, including an estimated $3.8 billion from the International Monetary Fund (IMF), and $1 billion from the commercial banks. It also would be necessary to reschedule large amounts of Mexico's $81 billion in foreign debt, about 75% of which was owed to foreign banks. The 1981 rescheduling of the $4.3 billion Polish debt paled in comparison.

When the foreign exchange markets opened the next day, the rate to buy dollars was 120 pesos to the dollar. On August 19 and 20, Secretary Herzog met in New York with repesentatives of Mexico's foreign bank creditors to request a 90-day moratorium on the repayment of public sector debt principal until November 23. Inter-

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as borrowers tried to cope with the virtually instantaneous doubling of their dollar denominated liabilities. Following the devaluation, several more companies also requested a restructuring of their foreign debt. Others, such as Mexicana Airlines, were purchased by the Mexican government. Pressure for government support or protection against devaluation for the private sector foreign debt mounted. Inflation was rampant, yet the Mexican government continued to deny there was any need for exchange controls or other such measures. Attention was focused on the July presidential election. On August 5, however, the government announced that except for certain essential imports and other priority transactions for which a preferential exchange rate would be maintained, the value of the peso would be allowed to float.

5. The foreign exchange markets remained closed for a week, and the black market rate soared to 150 pesos to the dollar. Private sector Mexican companies were battered further as the liability side of their balance sheets increased at rates which technically rendered insolvent even the best companies. With the exchange markets closed, only the few companies with dollars in hand could maintain foreign loan payments. The situation was already critical for the U.S. banks with private sector exposure, and it was clear there was serious trouble ahead for the public sector debt.

est on public sector debt would continue to be paid, although the rate was not announced until August 26: ¾ over prime and ⅞ over the London Interbank Offered Rate (LIBOR). At the same time, he announced the appointment of an Advisory Bank Group consisting of 14 foreign banks including the seven largest U.S. bank creditors as advisors to the Mexican government in its restructuring effort.[6]

For the next several months, until President Miguel de la Madrid assumed office on December 1, 1982, complete uncertainty best describes the atmosphere within which most of the U.S. banking community sought to assess and respond to the Mexican debt situation. The Mexican government had waited until after the July elections to make any frank disclosures of its liquidity condition, and it was not clear to what extent it had made a full disclosure in August. The lame duck administration of President Jose Lopez Portillo was reluctant to be the administration to formalize any arrangement with the IMF, a critical element for the restructuring effort.

Although officially no moratorium had been placed on the repayment of private sector debt, and dollars theoretically were available for the repayment of interest on private sector debt at the preferential rate of 49 pesos to the dollar, there actually were no preferential rate dollars and few dollars to be purchased at any rate. Given the general lack of foreign exchange, even companies with dollars in hand were loathe to use them for interest payments, especially when preferential rate dollars were supposedly available for this purpose.

The unavailability of dollars for the private sector debt was not immediately apparent, however, but disguised for several months by confusion over the regulations and over precisely what was necessary to register the debt to qualify for the preferential rate. There also was confusion as to the scope of the official moratorium on the repayment of public sector debt principal. The massive government involvement of various forms in the private sector made it difficult to determine what constituted public sector debt.

A common response of the foreign banks to avoid the official moratorium was to argue that the official moratorium did not apply to a given borrower. As the unavailability of dollar exchange at any rate for both principal and interest on private sector debt became apparent, however, the response of the U.S. banks with substantial

6. The members of the Bank Advisory Group were Banamex, Bank of America, N.T. and S.A., Bank of Montreal, The Bank of Tokyo, Ltd., Bankers Trust Company, The Chase Manhattan Bank, N.A., Chemical Bank, Citibank, N.A., Deutsche Bank, A.G., Lloyds Bank International Limited, Manufacturers Hanover Trust Company of New York, Morgan Guaranty Trust Company of New York, Societe Generale and Swiss Bank Corporation.

private sector exposure shifted. Moreover, by late September and early October, interest on private sector debt rapidly was approaching being 90 days overdue, a major problem for U.S. banks under the Federal Financial Institutions Examination Council Call Report (FFIEC Call Report) instructions for nonaccrual of interest on nonperforming loans.

The situation further was complicated by President Portillo's decrees of September 1, 1982, nationalizing the Mexican banks and establishing rigid foreign exchange controls which essentially tied up the last few dollars on hand in the private sector by requiring all dollar revenues to be immediately converted to pesos. The new exchange controls created an even more complicated three-tiered fixed exchange rate system with new regulations following two weeks later to further confuse the situation. The head of Banco de Mexico, the Central Bank, resigned and was replaced immediately by Carlos Tello Macias, a known opponent to the types of belt-tightening loan conditions normally imposed by the IMF. The banks and foreign exchange markets were closed for a week until September 6. Thereafter negotiations with the IMF mired. One of the last acts of the Portillo administration was to request a further extension of the moratorium on the repayment of public sector debt principal for 120 days until March 23, 1983.

II. The Response to the Problem

By October 1982, differences in response and approach to the Mexican situation within the U.S. banking community began to emerge depending upon the relative amounts extended to the private sector. The large money center banks, particularly the seven U.S. banks which were members of the Advisory Bank Group, and which had large exposures to both the public and private sectors, had the responsibility for the direct negotiations with the Mexican government for the restructuring of the public sector debt. These banks were taxed to the limits of their resources trying to cope with both the official negotiations with the lame duck Portillo administration and the unofficial negotiations with the incoming de la Madrid administration in formalizing what was the largest restructuring effort in history, as well as with the problems affecting the private sector portions of their portfolios. Excluded from the direct negotiations for the restructuring of the public sector debt, the regional and smaller banks with small amounts extended to the private sector were concerned primarily with what appeared to be lack of progress in these negotiations, especially those between the Mexi-

can government and the IMF which were critical to the negotiations with the Advisory Bank Group. Likewise excluded from the direct negotiations, the regional banks, with large amounts extended to the private sector, focused their attention on the effects of the massive devaluation and exchange controls on their private sector borrowers. By October and November, the unpaid private sector interest became the primary focus of these banks' attention.

After many conferences with Mexican attorneys and initial disjointed approaches, the efforts of the banks with private sector exposure concentrated on the creation of trust accounts with Mexican banks. The Mexican borrower would pay the equivalent of the accrued interest in pesos into the trust as security for the obligation to pay the interest in dollars to the foreign bank, which was to be the beneficiary of the trust. Whether this approach would satisfy sufficiently the U.S. regulatory authorities and avoid having to place the loans on a nonaccrual basis was not entirely clear. Regardless, the approach was frustrated by the failure of the Central Bank to approve the trust, a prerequisite under Mexican law when creating any trust in which a foreigner holds the beneficial interest.

With the assumption of office by President de la Madrid on December 1, 1982, order was returned to the process. Progress was made in the negotiations with the IMF after submission of the 1983 Mexican budget to the Congress by the new President his first week in office. On December 8, the general principles for the rescheduling of public sector debt falling due prior to December 31, 1984, were announced. Included were assurances that dollars would be made available for the repayment of the private sector debt and under new exchange controls to be forthcoming there would be some protection against devaluation. Also, a mechanism was proposed for the settlement of the approximately $900 million of unpaid interest on private sector debt which had accrued since August 1, 1982. As proposed, the borrower could pay the accrued interest in pesos at the preferential rate. The dollar equivalent of the interest so paid was to be credited to an interest-bearing dollar denominated account established with Banco de Mexico for the foreign bank creditor which Banco de Mexico agreed to remit to the foreign bank in monthly installments as dollars were available. If the account could not be fully remitted by September 30, 1983, the balance would be a debt of the Mexican government to be financed by the foreign bank as a term debt on conditions to be determined.

Within one week, the new exchange control decree was published. The new decree, to be effective December 20, was similar to

the original August 1982 decree in that it provided for both a controlled rate of exchange for certain limited purposes and for a free floating exchange rate for all other purposes. The decree expressly provided that the controlled rate of exchange would be available even for the limited specified purposes only to the extent foreign exchange actually was available in accordance with established priorities. Accordingly, even though both principal and interest on preexisting registered private sector debt to foreign banks qualified for the controlled rate, priority only was accorded to interest unless the borrower generated the foreign exchange from its own exports, in which case 20% of the export proceeds could be applied to the repayment of principal. A major improvement, however, was the high priority afforded private sector interest under the new decree. The preferential or controlled rate of exchange, moreover, was intended to be adjusted periodically to eventually coincide with the free floating exchange rate. The decree did, however, direct Banco de Mexico to establish a system intended to protect the private sector from devaluation for the payment of preexisting private sector debt principal, provided, the debt was long-term or rescheduled to be long-term. On December 20, there was an almost immediate further 50% devaluation of the peso at the free floating rate.

What drew the most immediate attention, however, was the inclusion in the December 8 announcement of the general restructuring principles of a request for a new credit facility to which foreign banks were expected to commit pro rata in accordance with their outstandings as of August 23, 1982. Instead of the $1 billion facility forecast by Secretary Herzog in August, the request was for a $5 billion facility. Moreover, the commitment to the facility was to be based on both public and private sector outstandings. For the U.S. national banks with high exposures in terms of percentages of capital and surplus, this request presented yet another problem — the single borrower lending limit under 12 U.S.C. § 84.

Following the announcement of the general restructuring principles and the new credit facility, differences between U.S. banks developed depending upon relative exposure and ratio of public to private sector debt. Some of the banks with very small exposures were reluctant to increase their exposure by a penny even if it meant writing off their existing portfolios. The banks with medium exposures were equivocal, and within this group many banks with significant private sector exposure were reluctant to commit more funds without more definitive assurances for the repayment of the private sector debt. Although the banks with very large exposures in terms of capital and surplus were most prone to commit in order to pre-

serve their existing portfolios, in many cases these banks had the same concerns about the private sector debt and also were faced with lending limit problems.

Both the IMF and the U.S. regulatory authorities made it clear that their respective approvals of the $3.9 billion IMF loan and of the mechanism for settlement of the accrued private sector interest would depend upon the foreign commercial banks' full commitment to the new money facility.

The combined pressure of the Advisory Bank Group, the IMF and the U.S. regulating authorities was sufficient to convince the majority of the banks to commit. On December 23, 1982, $4.3 billion of the total facility had been committed and the IMF loan was approved and signed. Disbursement of the IMF loan, however, still was conditioned upon the foreign banks' full commitment to the new credit facility. On January 18, 1983, the U.S. Comptroller of the Currency, Federal Reserve Board and Federal Deposit Insurance Corporation issued a joint statement approving the deposit arrangement for the accrued unpaid private sector interest for purposes of the year end 1982 FFIEC Call Report. Again, the approval expressly was subject to the conclusion of the restructuring as then planned, i.e. full commitment to the new credit facility. Obtaining the balance of the total $5 billion in commitments, however, took a couple of months. Some banks with very small exposures never did commit, other banks were refusing to commit until, or conditioned their commitment on, announcement of a satisfactory plan for the repayment of the private sector debt, and yet other banks with lending limit problems could commit only up to their lending limit.

Throughout January and February, attention was focused on obtaining the balance of the $5 billion commitments and formalizing the terms and conditions of the new credit facility. The Advisory Bank Group, which was negotiating the terms and conditions of the new credit facility, had hoped to complete the new credit facility by the middle of January. The facility, however, was not executed until March 3, 1983. As a result, the members of the Advisory Bank Group needed to make an interim loan of approximately $450 million on February 25, 1983. Another consequence was that the rescheduling agreements for the existing public sector debt could not be completed before the expiration on March 23, 1983, of the 120-day extension of the moratorium on the repayment of the public sector debt.

In many respects the new credit facility was the heart of the

restructuring effort as the banks recognized that it provided their primary leverage in the negotiations to shape the terms and conditions of the overall restructuring. From the perspective of the regional and smaller banks who were not directly participating in the negotiations with the Mexican government, it was the only opportunity for any significant influence. Once the new credit facility was signed, the basic framework was established for the rescheduling over eight years of the $20 billion in public sector debt which fell due between August 23, 1982 and December 31, 1984.

Since the problems in finalizing the new credit facility until March 3 precluded the execution of the rescheduling agreements for the existing public debt, yet another extension of the moratorium was requested to August 15. The ensuing rescheduling of the $6 billion owed by Petroleos Mexicanos (PEMEX), which was the largest public sector borrower, presented yet further problems, testing in one case a regional bank's ability as the holder of a participation to prevent the extension of maturity of not only the participated portion but the nonparticipated portion as well. Another lending limit consideration was raised by the extension of the $4 billion bankers' acceptance line to PEMEX within the parameters of eligibility of bankers' acceptances. It was not until August 26, 1983, a little more than a year to the day after the establishment of the public sector debt moratorium, that the first rescheduling agreements were signed. These agreements with the three largest public sector debtors, the United Mexican States itself, PEMEX and Nacional Financera (Nafinca), covered $11 billion of the $20 billion to be rescheduled. They also set the precedent for the rescheduling agreements with the other public sector borrowers which were signed September 29 and October 26, 1983.

The new credit facility, likewise, was the primary leverage for forcing the Mexican government to address the problem of the repayment of private sector debt. Although the December 20, 1982 regulations had directed the Central Bank to establish a mechanism to afford the private sector some protection against further foreign exchange loss, no definitive proposal had been announced before the signing of the new money facility on March 3. Nonetheless, because of the pressure mounted by the banks for solution of the private sector debt problem, the new credit facility included as conditions for disbursement that the deposit arrangement with Banco de Mexico for the payment of the past due and accrued private sector interest through January 31, 1983 be implemented reasonably to the satisfaction of the banks, that foreign exchange generally be available at prevailing rates to private sector borrowers

for payment of interest accruing after January 31, 1983, and, for all but the first disbursement, the implementation of the Mexican government's commitment to take measures to assist the private sector to repay its foreign debt, including specifically the implementation of a program for the purchase of foreign currency for forward delivery at a preestablished exchange rate for the payment of "restructured" foreign debt.

Accordingly, even though the specific program to assist repayment of the private sector debt had not been announced by the signing of the new credit facility on March 3, 1983, the basic format of the program as a contract for forward delivery of foreign exchange for the repayment of long term or rescheduled private sector debt principal had been established.

The actual announcement of the program was made by Banco de Mexico on April 6, 1983. As announced, the program provided for the establishment of a trust fund or Fideicomiso para la Cobertura de Reisgos Cambiarios (FICORCA). While voluntary, and providing several options, the complex FICORCA program was designed to encourage the rescheduling of the private sector foreign debt on terms parallel to the rescheduling of the public sector debt by providing the most favorable fixed forward exchange rate for debt rescheduled over eight years with four years' grace.

Therefore, with the signing of the new credit facility on March 3, 1983, followed shortly by the establishment of the FICORCA program in April and the signing of the public sector rescheduling agreements in August, September and October, the primary elements of the initial short-term restructuring of the foreign bank debt were in place.

Notwithstanding the subsequent $3.8 billion new credit facility in 1984 and the presently pending proposal for a long-term restructuring, the initial restructuring was successful. It stabilized and moved the situation out of the crisis conditions existing in 1982. Although most banks would have been loathe at that time to have recognized it as such, the initial restructuring served much the same purpose as the automatic stay in a Chapter 11 reorganization. It allowed the borrower time to adjust its economic policies, stabilize its economy and reduce its dependence on foreign credit. Likewise, the foreign banks have had time to write down and realign their portfolios, build loan loss reserves and increase their capitalization. Accordingly, both the borrower and its creditors now are much better prepared, not only financially but psychologically, to address the long-term restructuring proposal.

III. Relative Roles in the Negotiations Leading to the Restructuring

There is little point debating the relative roles played by the money center banks versus the regional banks in the negotiations with the Mexican government, the U.S. governmental regulating authorities and the international financial community. With the announcement by the Mexican government of the formation of the 14-member Advisory Bank Group in August 1982, it was understood that the role of the regional banks would be largely one of reaction to the restructuring principles proposed by the Mexican government after negotiation with the Advisory Bank Group rather than an active role in the initial formulation of the restructuring principles.

Mexico's foreign exchange position in the summer of 1982 was far too grave to permit an attempted solution by a committee of the whole foreign banking community. Moreover, the regional banks, despite their relative exposure in terms of capital and surplus, simply did not have the experience or the resources necessary to devote to the restructuring effort on the scale required. Further, many of the regional banks with high Mexican exposures already had experienced some of the problems and frustrations of large group restructuring efforts in connection with Grupo Industrial Alfa, S.A. which had announced the need to restructure its debt more than six months previously in December of 1981.

Nonetheless, from the perspective of a regional bank, especially one with high exposure in terms of capital surplus, the greatest frustration with a small group of large money center banks being responsible for direct negotiations with the borrower was difficulty in obtaining information, especially in the very fast moving situation which was occurring in Mexico.

This is not to say that the Advisory Group Banks were withholding information, but their resources were being taxed to their limits. Recognizing they could not both address the basic problem and act as a general clearing house for all of the banks' inquiries, the Advisory Bank Group made an effort to establish a network of Area Contact banks. Each of the 14 members of the Advisory Bank Group was assigned as the Advisory Group contact for all banks within a specific geographic area of the world, generally coinciding with the location of the respective member. Each of the seven U.S. bank members thus was assigned a specific multi-state area of the United States which was further divided generally along state lines. A bank was designated within each such smaller area as the Area Contact Bank for all other banks within that area. As so estab-

lished, the network provided each U.S. bank with two contacts, an Advisory Bank Group Contact and an Area Contact Bank which was not a member of the Advisory Bank Group.

Little more, probably, could have been done to facilitate the dissemination of information. Unfortunately, the situation in Mexico in 1982 was so complex and large in scope, and events were occurring so rapidly, particularly during the last months of President Lopez Portillo's administration, that it is doubtful the members of the Advisory Bank Group were even able to keep abreast of all developments. Certainly, the network was not capable of disseminating the information sought by all of the U.S. banks which were involved.

By forming the Advisory Bank Group, the Mexican government intended to limit its contacts with foreign banks as much as possible to the members of the Advisory Bank Group. Therefore, even the regional banks with offices in Mexico were not in a significantly better position to obtain accurate information directly from the government. If anything, particularly during the initial months following the August 23, 1982 moratorium request, the banks without local offices had the advantage of being spared the flood of inaccurate information circulating in Mexico City.

The information gap, however, provided the members of the Advisory Bank Group with an additional power base at least as formidable as the size of their loan portfolios from which to direct the shape of the restructuring of the debt owed to the foreign banks.

It is doubtful many of the other U.S. banks recognized in August of 1982 how much their ability to respond to the initial restructuring negotiated by the Advisory Bank Group would be affected by the unusually large information gap created by the emergency and complexity of the situation. As it happened, the other U.S. banks had little time and information on which to respond except in very broad terms.

In retrospect, because of the circumstances that created the information gap, it was probably not inappropriate that the gap had the effects that it did. Not only did it force the regional banks to respond in broad terms about basic principles and concerns, but it eliminated the possibility of 530 foreign banks each commenting on the drafting style and punctuation of the new credit agreement.

Nonetheless, from the perspective of a regional bank, "cram down" is not an unduly harsh description of what in fact occurred. By way of illustration, the banks were sent a telex on December 8, 1982 which was over twenty feet long announcing the general prin-

ciples for the entire restructuring. Included was a request that each bank commit seven percent of its total August 23, 1982 outstandings, both public and private sector, to the $5 billion new credit facility which the telex only outlined in the most basic terms. The commitment was requested to be made within one week.

Although it was known that a new money facility would be included in the restructuring package, neither the basis for computation of a bank's share in the facility (reflecting both private and public sector interests), nor the $5 billion size of the facility was generally anticipated.

Moreover, when the draft of the actual agreement for the facility was forwarded to the banks it was a three-fourths of an inch thick "final" draft dated February 18, 1983. The closing was expected the week of February 28. Comments were not solicited even though the new credit facility as previously stated was in many respects the heart of the restructuring effort. The Advisory Bank Group perhaps best summarized the respective roles of the banks in its telex of February 18 advising that the final draft was being delivered as follows:

> The draft results from the extensive negotiations between the Borrower and the Advisory Group. In the course of those negotiations the Advisory Group has considered the many comments received from you (the foreign banks) in your commitment telexes, and every effort has been made to prepare a document responsive to the concerns of the Banks.

Perhaps some would argue that the regional banks have had no influence on the restucturing. Yet, for at least the intense two-month period following the December 8, 1982 telex, by conditional commitments, or refusals to commit without adequate assurances with respect to the repayment of private sector debt, particularly by the Mexican government, the regional banks focused greater attention on private sector debt.

The influence, if any, of the regional and smaller banks in shaping the long-term restructuring remains to be seen, but the climate in which the recently announced long-term restructuring principles have been negotiated is significantly different from that in 1982. The crisis has abated and all parties have learned from the two-year experience. While fears have been significantly reduced, so too have expectations. The Advisory Bank Group's negotiations have been more open. There has been more time to provide the banks with interim reports, and ac-

cordingly the regional and smaller banks have had opportunity to provide input on the issues prior to announcement of the principles. The information gap also has been largely reduced by the detailed economic reports provided by the Mexican government to the international financial community. The role of the commercial banks in general (and hence even of the Advisory Bank Group itself), however, has been reduced by the intervening involvement of the supervising agencies, official lending agencies and multilateral financial organizations. As bilateral financings have increased, the relative participation of foreign banks in the total debt structure has decreased. Similarly, as no new credit facility is included in the pending proposal, the leverage of the commercial banks in general is less.

IV. Relative Exposure as the Crux of a Bank's Response

Notwithstanding the fact that the U.S. bank members of the Advisory Bank Group have represented all U.S. banks in the restructuring negotiations, and have taken the lead both with the U.S. regulatory authorities and with the Mexican government in structuring solutions to the many problems encountered during the restructuring effort, the regional banks have not been immune from either the effects of the liquidity crises which necessitated the restructuring or the terms of the restructuring as proposed and ultimately implemented. Not all U.S. banks have been presented with the same problems, and each bank has had to deal with the particularities of its own loan portfolio in reacting either to the problem presented or to its proposed solution.

As premised at the beginning of this article, similarity or difference in response has been more a function of relative exposure in terms of percentage of capital and surplus than of relative gross dollar exposure. This premise includes consideration of relative private sector exposure insofar as comparability of a bank's total exposure of capital and surplus to the exposures of the U.S. members of the Advisory Bank Group presupposes substantial private sector exposure.

The problems presented by the national bank lending limit, 12 U.S.C. § 84, illustrate the point. Although state bank lending limits generally were higher than the national bank limit, most foreign creditor banks had yet a higher limit or were not subject to any lending limit. Accordingly, the lending limit has been of far greater concern to the U.S. banks than to the other foreign banks. For the U.S. banking community the lending limit was a factor in determining the structuring of the whole initial restructuring package. For

example, the mechanism for the settlement of the over $750 million in accrued private sector interest in part was structured as a deposit because then the obligation of the Central Bank to remit the deposit balance to the foreign bank was outside the coverage of the lending limit. Accordingly, as confirmed by the Office of the Comptroller of the Currency on December 15, 1982, it was not necessary to aggregate the deposit of accrued private sector interest with the loans to the Mexican government. Similarly the FICORCA program was structured as a forward delivery of foreign exchange undertaking by the Central Bank. The rescheduling of existing debt owed by public sector borrowers in accordance with the general restructuring principles did not involve any extension of new credit and hence did not present any lending limit problems.

The 1983 new credit facility, which did present lending limit questions for a number of the U.S. banks, was structured so that only 34% of a bank's commitment could be drawn before April 15, 1983, when the increase of the lending limit from 10 to 15% of capital and surplus under the Garn-St. Germain Depository Institutions Act of 1982 became effective. The lending limit applies when a loan is made and not when a commitment is made.[7]

While the total exposures of many U.S. banks were small enough that the lending limit never presented a problem, for others the lending limit problem was serious enough to require that the commitment to the new credit facility be made at least in part by the bank's holding company or to require loan swapping with other banks. The lending limit issue most commonly encountered by the national banks was the question of aggregation and reexamination of the various public sector borrowers for continued compliance with the means and purpose test under 12 C.F.R. 32.5(d) which was superseded on April 12, 1983 12 C.F.R. 7.1330.[8]

Since the initial restructuring included a request for the $5 billion new credit facility, the question presented was to what extent did the events occurring since August 1982, including the nationalization of the banks of September 2, 1982, require a reexamination of public sector borrowers for continued compliance with the means

7. Although under 12 U.S.C. § 84, as amended by the Garn-St. Germain Depository Institutions Act of 1982, the Comptroller of the Currency is authorized to determine when a contractual commitment to advance funds is to be included within the lending limit, the Comptroller has not used this authority to expand significantly the historical position of the office beyond standby letters of credit. 12 C.F.R. 32.2(d)(1984).

8. The new 1983 regulation is more lenient than the original 1979 Comptroller Interpretive Ruling 7.1330. As revised, loans are to be aggregated "only if" the borrower fails to meet the means and purpose test.

and purpose test. Failure of continued compliance by such an entity required aggregation of all outstanding loans to that entity with all outstanding loans to the government itself to determine whether the new money could be advanced to the government within the lending limit. On December 15, 1982 the U.S. Office of the Comptroller of the Currency issued a letter advising that if a bank was aware of a borrower's change in circumstances which gave the bank reason to believe the borrower may no longer pass the means and purpose tests, the U.S. national bank had to reexamine the borrower for compliance with the tests before advancing any new money. The letter clarified, however, that the most significant events which had occurred — the request for rescheduling, the imposition of exchange controls and the government's guarantee of the rescheduled public sector debt — did not by themselves constitute such a change of circumstances to require reexamination.

The lending limit concerns were reduced significantly by the increase of the lending limit under the Garn-St. Germain Depository Institutions Act of 1982 and the efforts of the Advisory Bank Group members in obtaining the U.S. regulatory approvals. Without such U.S. governmental action, many U.S. national banks, including some members of the Advisory Bank Group, would have been precluded by the lending limit from fully commiting to the new credit facility. Even with such action, however, inclusion of private sector exposure within the base for computation of the banks' expected pro rata commitment to the new credit facility aggravated the lending limit problem. From the perspective of counsel to one regional bank, not speaking for any others, the lending limit with all of the attendant aggregation issues under the means and purpose tests presented the paramount concern with the 1983 new credit facility.

There have been many more legal and business issues encountered by the U.S. banks during the course of the restructuring than could possibly be addressed in this article. With respect to each of these issues banks have differed in their approach and response. Nonetheless, it is this writer's perspective that in overview the circumstances of the unexpected gravity of Mexico's liquidity crisis determined the process and form of the restructuring to a much more significant degree than interbank differences. Aside from whatever differences there may have been between the members of the Advisory Bank Group, the perspective of a regional bank is that for the most part the differences within the U.S. banking community, as illustrated by the lending limit example, have been more internal concerns with the effects of the crisis and/or of a proposed solution

on the particularities of the bank's own portfolio than external expressions of interbank conflict. The primary exception has been the pressure for attention to the private sector debt problems.

It will be interesting to compare the reaction and response of the U.S. banking community to the presently pending multi-year, long-term restructuring proposal with the reaction and response to the 1982 and 1983 initial restructuring proposal. The new proposal is a bold digression from the historical pattern. Interest margins are to be reduced rather than increased (especially during the first several years); the U.S. prime rate has been eliminated as a reference rate and no mention is made of a restructuring fee. Similar in approach to some of the new types of home mortgages which have appeared domestically for much the same reason (high interest rates), the proposal is weighted heavily toward the end of the up-to-14-year term, both as to principal amortization and interest rates, which initially are low but increase over time. Nonetheless, for the reasons discussed above — the lessons learned from the experience of the last two years, the more open negotiations, the availability of detailed, reliable economic information, the increased involvement in the restructuring by official lending agencies, multilateral financial organizations and supervisory agencies, and the precedential value of the restructuring principles already in place — the proposal should be accepted with comparatively little interbank controversy.[9]

In conclusion the experience has been one that few would want to repeat, although events in Brazil, Argentina and the Philippines imply that destiny may prove otherwise. As said at the beginning, no single bank's experience was representative of the large and diverse group of U.S. banks involved; one perspective is but one perspective, yet being from a different viewpoint, hopefully it adds dimension to a better understanding of the whole restructuring effort.

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9. An issue not likely to receive much notoriety, but which is likely to be raised by those money center and large regional banks who are not members of the Advisory Bank Group, but who are presently acting as agent for syndicated public sector loans, is the selection of the servicing banks. Similar to the 1983 restructurings, it is proposed that all of the bank debt owed by a given public sector borrower is to be restructured under a single agreement for that borrower. Hence, as in 1983, the servicing bank under the restructuring agreement for a given borrower will displace the agent banks for the syndicated loans to that borrower. Given today's significance of fee income, it did not escape notice that in the 1983 restructurings the members of the Advisory Bank Group were selected as the respective servicing banks and hence received the servicing bank fees. A similar selection of servicing banks for the proposed agreements is likely to be seriously challenged.

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Advising Sovereign Clients on the Renegotiation of their External Indebtedness

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Advising Sovereign Clients on the Renegotiation of their External Indebtedness

JAMES B. HURLOCK*

Over the past decade, relief for the severe debt problems of sovereign states, especially developing countries, generally has been provided through a combination of multilateral and bilateral loans, technical assistance and performance programs administered by the International Monetary Fund (IMF), and renegotiation of all or some portion of the countries' external indebtedness.[1] The debt renegotiation process between sovereign debtors and their creditors has evolved into a highly specialized and complex practice, grounded on the experience of previous renegotiations but responsive to current developments in the volatile international financial system.

This article examines the process of debt renegotiation from the perspective of the legal counsel retained to assist a sovereign in the renegotiation of its external indebtedness. The discussion first considers the internal analysis that a sovereign, in conjunction with its legal advisers, must undertake before deciding whether to renegotiate its debts, and what form such a renegotiation should take. The

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1. Prior to 1973, sovereign states obtained most of their credit from multilateral institutions such as the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank), from bilateral loans from other states, or from the sale of bonds. Dod, *Bank Lending to Developing Countries*, 67 FED. RESERVE BULL. 647, 648 (1981). For a brief historical account of the relationship between international lenders and sovereign borrowers and some of the problems they have encountered, see A. SAMPSON, THE MONEY LENDERS 33-55 (1981). The 1973 oil embargo triggered a dramatic shift in the nature and the level of borrowing by sovereign states and in the relationships among developing countries, multilateral financial institutions and private commercial banks.

As a result, there has been a fourfold increase in the outstanding medium- and long-term indebtedness of developing countries from 1972 to 1982, with the share of the debt owed to private creditors rising from approximately one-half to two-thirds of the total amount. *A Nightmare of Debt: A Survey of International Banking*, ECONOMIST, Mar. 20, 1982, at 99 (separately numbered) (hereinafter cited as *International Banking Survey*); Nowzad & Williams, *External Indebtedness of Developing Countries*, 8 International Monetary Fund, Occasional Paper No. 3 (May 1981).

article then focuses on the process of planning and negotiating a comprehensive debt renegotiation agreement and the steps necessary to implement it. Finally, some general observations will be noted concerning the renegotiation process and certain aspects of its current practice.

I. Selecting Outside Counsel and Deciding to Renegotiate

During the 1970's, the combination of increased energy costs, aggressive use of funds from private commercial banks, and the demand for credit for development projects and for financing existing debt resulted in dramatic increases in external borrowing by developing countries. In the 1980's, the recession in the developed countries and an increase in the worldwide supply of petroleum contributed to decreased demand for exports from developing countries, reduction in the amount of funds to be "recycled" to the developing countries and higher interest rates.[2] Because of the limited foreign exchange that can be raised through sales of developing countries' exports, particularly commodity exports, many of these countries are suffering balance of payments deficits which make them unable to pay the principal of and interest on medium- and long-term loans that were incurred four or five years earlier, and which require further loans to finance current debt service and development projects.[3] Upon finding itself faced with such a severe balance of payments deficit, a developing country is forced to consider the necessity of some form of debt renegotiation and to con-

2. *See* Mendez, *Recent Trends in Commercial Bank Lending to LDC's: Part of the Problem or Part of the Solution*, 8 Yale J. World Pub. Order 173, 179 (1982). "Recycling" refers to the practice which emerged after 1973 by which sums paid to oil-exporting states were deposited with banks which lent the sums back to the developing countries. *See* A. Sampson, *supra* note 1, at 176; Solomon, *Developing Nations and Commercial Banks: The New Dependency*, 12 J. Int'l L. & Econ. 325, 332 (1978). The recent decrease in oil prices has reduced the amount of funds to be recycled by the oil-exporting states and in fact some oil-exporting states have become net borrowers. *See Recycling OPEC's Deficit*, Economist, Feb. 20, 1982, at 84. These trends have made it more difficult for non-oil producing states to obtain funds and have contributed to the rise in interest rates.

3. *See* Madison, *In Praise of Borrowing*, Nat'l J., Nov. 26, 1983, at 2489. Countries can remedy a balance of payments problem by limiting demand for imports, increasing sales of exports or financing through reserves or borrowed money. *See* H. Gray, International Trade, Investment and Payments 464 (1979). Because worldwide economic trends have reduced commodity prices and decreased demand for exports, developing countries have been forced to rely on economic austerity programs and external borrowing to meet their balance of payments needs. Much of the borrowing is required simply to meet interest payments on existing debt. *See* Wines, *Banks Taking the Heat for Near-Panic of '82*, Nat'l J., Mar. 19, 1983, at 604.

sider retaining legal counsel to assist in the preparation of a renegotiation plan.

There is no particular pattern to the process by which countries decide to retain legal counsel to assist them in the renegotiation of their external indebtedness and by which they ultimately choose a particular adviser. The decision to employ outside legal counsel may be based on the suggestion of the country's financial advisers or commercial lenders, the country's lack of experience in the area of renegotiation, the use of foreign law to govern the renegotiation agreements, or the country's lack of sufficient personnel to deal with several hundred lenders spread throughout the world.[4] For whatever reason and by whatever process, a growing number of developing countries have retained counsel to assist in the renegotiation process.[5] The growth in the number[6] and complexity of precedents set by earlier negotiations, as well as the likelihood that the commercial lenders who are creditors to a sovereign borrower will be represented by special counsel, make it advisable that a sovereign planning to renegotiate its indebtedness seek the assistance of legal counsel in order to obtain a balanced and workable agreement.[7]

Debt renegotiation can consist of either rescheduling or refinancing, or a combination of the two. Generally, rescheduling extends current maturities on modified terms for some specified period while refinancing provides new credit to pay existing loans. The decision whether to seek to reschedule or to refinance, and the scope of the debtors, creditors and debt to be included in such a plan, is reached only after the sovereign and its advisers undertake a comprehensive analysis of the sovereign's legal system and its external debt portfolio.

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4. *See* Brown, *The Leading Law Firms in Sovereign Restructuring*, INT'L FIN. L. REV., September 1983, at 4; Stoakes, *The Risks and Benefits of Advising Sovereign Clients*, INT'L FIN. L. REV., March 1984, at 10.

5. For a list of more than 15 countries that have used outside legal advisers to assist in the renegotiation of their external debt, see Brown, *supra* note 4, at 5-6. Among the countries that have chosen to renegotiate without the assistance of outside legal advisers are Cuba, the Dominican Republic, Ecuador, Jamaica, Madagascar and Poland. Stoakes, *supra* note 4, at 13.

6. The "Paris Club," *see infra* notes 21-23 and accompanying text, hosted 56 negotiations involving some 20 debtor countries between 1956 and 1982. *International Banking Survey*, *supra* note 1, at 27.

7. The role performed by outside legal advisers will vary, of course, from case to case and will depend on when counsel first is consulted and the urgency of the sovereign's debt problems. This article assumes that counsel is retained simultaneously with the sovereign's initial decision to seek renegotiation of its debt and on the further assumption that circumstances permit ample time to complete the analysis and review described herein.

A. *Analysis of Legal and Exchange Control Systems*

At the outset, it is necessary for the sovereign and its counsel to review the data available concerning the sovereign's external debt portfolio and legal system, as well as the expressed intention of its creditors, to decide which types of debt are capable of being renegotiated and how much additional credit, if any, will be needed. The difficulty in obtaining accurate information concerning a developing country's external indebtedness is a recurring problem that sometimes is not fully appreciated by all parties involved and is an area that should be addressed by the sovereign and its counsel at the beginning of the renegotiation process. The availability of accurate information largely may determine the nature of the renegotiation plan that ultimately is presented to the international financial community.

Among the topics that the sovereign and its counsel should investigate at this time are the sovereign's borrowing structure and debt registration system. It is important to determine who the borrowers of external indebtedness are—for example, the sovereign itself, governmental entities, private sector companies— and to ascertain the levels of indebtedness of each type of debtor to both public and private creditors.[8] The accuracy of the records of each borrower also should be reviewed to determine if debt figures will need to be verified by their respective lenders. If the sovereign does not have a comprehensive debt registration system already in place, it may be necessary to begin collecting data from the various governmental and non-governmental borrowers in order to reach an informed decision as to which debt to include in the renegotiation plan, and to establish feasible target figures and schedules for completion of the plan.

The sovereign and its counsel also must review the sovereign's exchange control regulations and constitutional and political framework to determine what legislative or executive action may be necessary to implement the renegotiation plan and to assess the likelihood of political opposition to the renegotiation. Depending on

8. In addition to the overall increase in external indebtedness, during the past decade there has been a shift in the percentage of loans to foreign governments and government-controlled entities as opposed to private foreign borrowers. The increase in the percentage of sovereign loans is due largely to the fact that developing countries, who account for most of the increase in overall indebtedness, tend to channel the loans through governmental entities to private sector borrowers. *See* Reisner, *Default by Foreign Sovereign Debtors: An Introductory Perspective*, 1982 U. ILL. L. REV. 1, 3. Even though governmental entities account for most of the external borrowing in developing countries, several recent renegotiations have included external debt held by private sector borrowers as well as public sector entities. *See infra* notes 10, 12 and accompanying text.

constitutional requirements and political climate, it may be wise to structure the renegotiation plan so as to avoid acrimonious and time-consuming debate in the legislature. The forms of domestic approval utilized also may reduce the exposure of local officials to lawsuits and political pressure.

Review should also be made of the sovereign's payment and exchange control systems[9] to determine the most practicable way to structure future repayments under, and promote internal compliance with, the renegotiation plan. For example, it may be necessary to require non-governmental banks or commercial entities to deposit proceeds of external loans with the central bank in exchange for local currency if such banks are not already required to do so. If a governmental agency is to serve as an intermediary on behalf of private entities, or if some other form of governmental guarantee is to be extended on behalf of private entities, the sovereign should investigate the creditworthiness and registration systems of the entities involved.

B. Formulating a Renegotiation Plan

Once a review of the available data and the legal system is completed, the specific terms of the renegotiation plan can be formulated. The sovereign and its advisers should work to prepare as comprehensive a proposal as possible before approaching the different groups of creditors. Even though all the terms formulated by the sovereign and its advisers are subject to revision in negotiations with the IMF, government lenders and the commercial banks, the preparation of a comprehensive and well-documented proposal frames the issues for negotiation and lays the groundwork for the basic features of a plan. If the sovereign's initial proposals are supported by reliable information made available to the various groups of creditors, many of the most troublesome issues may be resolved merely by explaining the nature of the country's debt portfolio and workable solutions to its problems.

In addition to the basic financial terms of a proposal, such as whether to request any additional credit, or better interest rates and repayment terms, three basic groupings for the renegotiation must be defined: (1) the classes of debtors to be included in the plan; (2) the classes of creditors to be included in the plan; and (3) the type of debt to be included in the plan.

9. For example, many Latin American countries have extensive regulations governing foreign exchange transactions. *See* Allison, *Capital Controls in Latin America*, in INTERNATIONAL FINANCIAL LAW 163 (R. Rendell ed. 1980).

1. Classes of Affected Debtors

Which classes of debtors will be affected by the renegotiation plan should depend largely upon the results of reviewing the available data described above. Based upon the respective amounts of external indebtedness incurred by the sovereign itself, by governmental entities and by private sector companies, and based upon the severity of the country's balance of payments problems, the sovereign may choose to have all or just some portion of domestic debtors included in the renegotiation plan. Further, the sovereign must decide whether each of the affected debtors should be party to the renegotiation agreement or whether a single government agency or bank should act on behalf of all of the affected parties. Because renegotiation agreements typically include broad waivers of immunity from legal proceedings and prejudgment remedies in foreign courts, the choice of a government agency or bank to serve as agent may be influenced by the extent to which the various entities maintain assets overseas and the desire to protect those assets from attachment or execution if a lawsuit subsequently were brought concerning the renegotiation agreement.

The treatment of private sector borrowers deserves special attention. Given the substantial participation of private sector companies as both borrowers and lenders in many developing countries, often private sector debts have to be included in the basic renegotiation agreement or principles have to be established to govern the renegotiation of private sector debt. Among the options available are: including private sector entities as parties to the renegotiation agreement, and making them either directly responsible for the repayment of their debts or backed by the guarantee of the sovereign; assigning private sector debts to the sovereign's agent, usually a government-controlled bank, for purposes of controlling the flow of foreign exchange; or leaving the treatment of private sector debts to individual negotiation with the foreign lenders under a framework established by the sovereign. Recent debt renegotiations illustrate a number of approaches. Argentina has instituted a scheme whereby public debt instruments may be delivered to creditors either to pay or to guarantee foreign currency loans to private sector borrowers.[10] Mexico has converted approximately $2 billion of private sector debt to government-to-government debt[11] and has established a

10. *See* Cardenas, *How Argentina is Refinancing Its Private Sector Debt*, INT'L FIN. L. REV., June 1983, at 28.

11. Zamora, *Peso-Dollar Economics and the Imposition of Foreign Exchange Controls in Mexico*, 32 AM. J. COMP. L. 99, 134 & n. 162 (1984).

comprehensive foreign exchange program, Fideicomiso Para la Cobetura de Riesgos Cambiarios (FICORCA), under which Mexican private sector companies can obtain dollars at a fixed rate for the repayment of foreign creditors.[12] Peru recently concluded a renegotiation plan that allows foreign creditors to maintain direct relationships with Peruvian private sector borrowers and gives the creditors the option of electing to have the sovereign guarantee the repayment of the debt.

2. Classes of Affected Creditors

The sovereign needs to establish which classes of creditors are to be affected by the renegotiation plan. The basic groups of creditors that the sovereign must consider are international lending institutions (e.g. the IMF and the International Bank for Reconstruction and Development (World Bank)), governments (both as direct lenders and as guarantors of commercial bank debt), public debt holders, and commercial bank lenders and suppliers. International lending institutions and public debt holders usually are excluded from renegotiation plans on policy grounds. International lending institutions are excluded because they provide the basic funding for financial stability[13] and development projects. Public debt holders are excluded because of the reluctance to disturb the structure of the international bond market, the difficulty of identifying the holders of the bonds, and the desire to protect unsophisticated individual investors from the complexities of renegotiation.[14] Likewise, suppliers' credits typically are excluded from debt renegotiations due to the difficulty in identifying and negotiating with the large number of suppliers and the difficulty in allocating the amount of interest to be repaid and the amount of principal to be renegotiated.[15] There are recent examples, however, of commercial banks or sovereigns themselves seeking to include both public bond holders (particularly if it is believed that commercial banks own a large portion of the bonds)

12. *See* El Koury, *Mexico's Foreign Exchange Programme for Private Sector Companies*, INT'L FIN. L. REV., July 1983, at 18; Zamora, *supra* note 11, at 134-40. By taking advantage of the FICORCA program and converting bank debts into floating rate notes, several Mexican private sector companies recently have concluded debt renegotiations that will be exempt from local withholding tax. *See A Tax Break to Help Companies Repay Foreign Debts*, BUS. WK., Mar. 5, 1984, at 45.

13. *See* Wood, *Debt Priorities in Sovereign Insolvency*, INT'L FIN. L. REV., November 1982, at 4, 8.

14. *Id.* Problems concerning the protection of bondholders are discussed in Note, *International Debt Obligations of Enterprises in Civil Law Countries: The Problem of Bondholder Representation*, 21 VA. J. INT'L L. 269 (1981).

15. *See* Wickersham, *Rescheduling of Sovereign Bank Debt*, INT'L FIN. L. REV., September 1982, at 8, 9.

and suppliers in renegotiation plans.[16] Hence, there is latitude for including or excluding either class of creditors in the formulation of a renegotiation proposal.

The remaining classes of creditors, holding the vast majority of the debt, are governments and commercial banks. Government-to-government debt, whether incurred as direct loans or through export agency loans or guarantees, generally is addressed in the Paris Club negotiations,[17] or in bilateral negotiations with countries which do not participate in the Paris Club. Depending on the amount of debt outstanding pursuant to export agency programs and the sovereign's ability to pay, the sovereign may consider repaying all or the unguaranteed portion of government-guaranteed debt.

The sovereign, and the commercial banks themselves, generally want to include in the renegotiation plan as much of the debt held by commercial lenders as possible. Special attention should be paid, however, to the extent and status of loans denominated in foreign currencies extended by local branches of foreign banks and by both local and foreign branches of domestic banks. The sovereign may conclude that financial or political considerations favor excluding from renegotiation the external indebtedness owed by one or more of the special categories of commercial lenders described above.

3. Types of Affected Debt

The third major analysis that the sovereign and its advisers should undertake in formulating a comprehensive renegotiation plan is the type of debt to be included. Typically, banks will insist that only principal payments, and not interest payments, be deferred, but there is precedent for including interest payments in a renegotiation proposal when financial conditions so dictate.

One of the first steps in establishing the categories of affected debt is to fix a cut-off date based on the date that the debt is incurred or on the date that the debt falls due, or on some combination of both. For example, the sovereign could propose to renegotiate the principal maturities which (1) relate to debt incurred up to and including the date the proposal is announced to the international banking system and (2) fall due in the three-month, six-month, one-year or other such period immediately following the date of the plan. The length of the period established will depend

16. The issue of rescheduling publicly issued floating rate notes arose in the Polish and Costa Rican renegotiations. *See International Banking Survey, supra* note 1, at 28.

17. *See infra* notes 21-23 and accompanying text.

upon the sovereign's expectations concerning ability to pay forthcoming maturities.

As to debt falling due within the established period, the sovereign may choose to differentiate between medium-term debt (debt with an original maturity of one year or longer) and short-term debt. Although there is some reluctance to include short-term debt in renegotiations, especially trade-related debt and letters of credit, because it supports the daily economic life of the sovereign,[18] there is ample precedent for including short-term debt in the overall package. In some cases sovereigns have chosen to include short-term as well as medium-term debt in the renegotiation package, but have established different terms for the short-term portion or for the trade-related portion.

In addition to the basic medium/short-term distinction, there are several special categories of debt that might be analyzed. Some types of debt probably are best excluded from any renegotiation proposal because of their importance to the sovereign or their vulnerability to seizure by creditors. These special categories of debt include secured debt, leases, interbank placements and deposits, private placements, foreign exchange contracts and precious metals contracts.

II. NEGOTIATING THE AGREEMENTS

After the sovereign and its advisers have completed a thorough review of the sovereign's legal system and external debt portfolio and have decided on the basic contours of a renegotiation proposal, they must approach the various groups of creditors to negotiate the agreements.

Recently, the cornerstone of the renegotiation package has been the sovereign's arrangement with the IMF.[19] As recent experience in Argentina, Brazil, Mexico and Peru illustrates, government and commercial creditors generally insist that some form of IMF facility be in place or scheduled to be in place before agreeing to renegotiate or agreeing to disburse new money under existing credit agreements. The IMF program usually includes access to one of the IMF's credit facilities and establishes performance criteria for the sovereign to

18. *See* Wood, *supra* note 13, at 10-11.

19. In virtually all recent cases of debt renegotiation, the debtor country has adopted an adjustment program supported by a loan of funds from the IMF. *See International Banking Survey, supra* note 1, at 27; Nowzad, *Debt in Developing Countries: Some Issues for the 1980's*, 19 FIN. & DEV. 13, 14 (March 1982) *See also* ECONOMIST, Apr. 24, 1982, at 107 (rescheduling of Rumanian debt dependent on renewal of IMF stand-by credit).

meet in seeking to solve its balance of payments problems.[20]

Once consultations with the IMF are underway, the sovereign commences negotiations with official and commercial creditors. Official creditors are approached by representatives of the sovereign acting on their own at meetings of groups of creditors at the Paris Club[21] or a similar creditors' club and through bilateral consultations with governments not members of the creditors' club.[22] The product of Paris Club negotiations is a non-binding agreement between the official creditors and the debtor country that governs the basic terms and procedures for renegotiation of government debt. The Paris Club agreement then is implemented by bilateral agreements between each creditor state and the debtor state. Certain terms of the Paris Club and bilateral agreements have an impact upon negotiations with commercial lenders: terms that deal with commercial debt that is partially guaranteed by a government agency and terms which require that no other creditors receive more favorable treatment than the government creditors.[23]

The final group of creditors to be approached is the commercial lenders. The negotiations with these creditors generally prove to be the most time-consuming. Even in a well-organized renegotiation, free from major controversy, the time required to gain agreement to

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20. Member states that seek access to IMF funds are subject to increasingly strict conditions as the amount requested exceeds certain increments of the member state's quota. Drawings that cause a member to exceed its quota are in the credit tranche, which is divided into units of 25%, and are subject to "conditionality." *See* F. Southpard, *The Evolution of the International Monetary Fund*, in ESSAYS IN INT'L FIN., No. 135, at 18 (1979); IMF SURVEY, Supplement on the Fund, 6-10 (May 1981). If the member state fails to comply with the performance criteria, the IMF may withhold further loans under the original credit arrangement. *See generally* Dell, *On Being Grandmotherly: The Evolution of IMF Conditionality* in ESSAYS IN INT'L FIN., No. 144 (1981); J. Gold, *Conditionality* in IMF Pamphlet No. 31 (1979). The doctrine of conditionality has been criticized by developing countries and some commentators for being overly intrusive and contributing to political and social unrest. *See, e.g.*, NORTH-SOUTH: A PROGRAM FOR SURVIVAL, (REPORT OF THE INDEPENDENT COMMISSION ON INTERNATIONAL DEVELOPMENT ISSUES) 234-39 (1980); Adede, *Loan Agreements Between Developing Countries and Foreign Commercial Banks—Reflections on Some Legal and Economic Issues*, 5 SYR. J. INT'L L. & COM. 235, 243-46 (1978); Solomon, *supra* note 2, at 344-46. Because typical IMF conditions include limitations on expansion of internal credit, restrictions on subsidy programs and other government spending, currency devaluation and modifications of wage and price controls, the country and its citizens often are required to make substantial financial and social sacrifices. *See* Kincaid, *Conditionality and the Use of Fund Resources*, 18 FIN. & DEV. at 18-21 (June 1981); Note, *Procedural Guidelines for Renegotiating LDC Debt: An Analogy to Chapter 11 of the U.S. Bankruptcy Reform Act*, 21 VA. J. INT'L L. 305, 326-28 (1981); *One By One, They Come to Terms*, EUROMONEY, March 1984, at 38.

21. The Paris Club and its procedures are described in *International Banking Survey*, *supra* note 1, at 27.

22. *Id.*; Note, *supra* note 20, at 328.

23. Note, *supra* note 20, at 328, n.93.

a 75-150 page renegotiation agreement and accompanying documents from as many as 500-600 banks should not be underestimated. If the sovereign is in immediate need of credit to meet a balance of payments shortfall, it may be necessary to approach a small group of government lenders or the steering committee of commercial lenders to obtain interim financing until the renegotiation agreement is completed.

Because of the large number of banks involved in a typical renegotiation, the commercial lenders usually appoint a group of 10-15 of the banks with the largest exposure in the debtor country as a steering committee to deal with the major issues and to act as liaison with the banks at large.[24] The sovereign also approaches a large bank to act as agent or manager of the renegotiation plan. The agent bank usually is responsible for day-to-day negotiations with the sovereign and administers the operation of the renegotiation plan once its terms have been finalized.[25] Other participants in negotiations concerning the commercial bank debt, besides the steering committee banks and the agent bank, include representatives of the finance ministry or central bank of the sovereign, counsel to the sovereign, and counsel to the lenders.

The initial negotiations focus on the basic terms of the renegotiation plan. Once a summary of the principal terms of the renegotiation plan have been agreed to—including the definitions of affected debtors, affected creditors and affected debt, the repayment schedule and interest rates applicable to the rescheduled debt and to new money, if any, and extension fees—the terms are provided to the banks at large for review and comment, and detailed negotiations between the sovereign and the agent bank begin. At this stage, outside counsel to the sovereign and to the lenders often play their most active role. Most renegotiation agreements specify that they are to be governed by U.S. state law or English law.

The following section describes some of the more important and controversial provisions that are negotiated.

A. *Negative Pledge Clause*

The negative pledge clause limits the sovereign's ability to incur future debt that will rank ahead of the obligations governed by

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24. *International Banking Survey*, *supra* note 1, at 27.

25. For a description of some of the responsibilities of the lead bank in a debt renegotiation see Wickersham, *supra* note 15, at 9. For a more comprehensive treatment of the functions performed by agent banks in the sovereign lending process, see Clarke & Farrar, *Rights and Duties of Managing and Agent Banks in Syndicated Loans to Government Borrowers*, 1982 U. ILL. L. REV. 229.

the renegotiation agreement. The clause is important because it may have an impact upon the sovereign's daily banking and commercial activities.[26] The sovereign's counsel should negotiate a clause that is not too stringent or so vague as to cast doubt on the status of future loan agreements or development projects. A well-drafted negative pledge clause should include exceptions which enable the sovereign to conduct its normal business activities by granting, for example, security in respect to project financings, liens arising by operation of law and statutory liens, liens arising in the ordinary course of banking transactions, and liens securing debt not exceeding a stated aggregate limit.[27] Such exceptions should be acceptable to the lenders since it is in their interest to allow the debtor country to conduct daily banking and trade activities without running the risk of defaulting under the renegotiation agreement. In addition, the sovereign's IMF arrangement imposes on the sovereign a comprehensive program of spending and borrowing limits which accomplishes many of the goals sought by the negative pledge clause.[28]

B. Cross-Default Clause

The cross-default clause links together the various groups of lenders by making it a default under the renegotiation agreement if a default occurs under any other agreement to which the sovereign or any governmental entity is a party. The lenders justify the inclusion of such a clause on the grounds that all creditors of the same class should be treated as equally as possible, and that a cross-default prevents one group of creditors from declaring a default and receiving payment before other creditors.[29] The danger of a narrowly drafted cross-default provision, however, is that an unintentional or technical default under a minor agreement could result in the entire renegotiation agreement being in default and all of the country's debt subject to acceleration.[30] For this reason, the sovereign and its counsel should seek to add grace periods and material-

26. A lawyer with experience as counsel to lenders has noted that "[a]fter the 1978 restructurings of Peru's debt, bankers became aware that the negative pledge provisions could be drafted so restrictively that they precluded transactions which both the country and the banks themselves wished to undertake or had no real intention of prohibiting at the outset." Brown, *supra* note 4, at 7.

27. For a discussion of the negotiation of negative pledge clauses, see Pergam, *The Borrower's Perspective on Euroloan Documentation*, INT'L FIN. L. REV., August 1983, at 14-15.

28. *See* Wickersham, *supra* note 15, at 9.

29. *See* Ryan, *Defaults and Remedies Under International Bank Loan Agreements with Foreign Sovereign Borrowers—A New York Lawyer's Perspective*, 1982 U. ILL. L. REV. 89, 95-96.

30. One observer has noted that the banks themselves have an interest in limiting the

ity standards to the cross-default clause. The agreement, for example, should provide that a cross-default is not triggered unless payment defaults under other agreements account for more than a specified dollar amount.[31]

One form of cross-default clause that is particularly troublesome to borrowers is a provision that gives the lenders the right to accelerate their debt if other lenders are capable of declaring a default, even if they have not done so. The inclusion of such a "capable of" clause makes the renegotiation agreement subject to the most restrictive provisions of any of the sovereign's many loan agreements.[32] If a "capable of" clause were included in the renegotiation agreement, technical violation of a minor and perhaps outdated agreement would trigger the default and notice provisions of the renegotiation agreement, and would require the sovereign to contact each of several hundred lenders even while attempts were underway to remedy the original default. Sovereign's counsel should make sure that the cross-default clause allows the sovereign an opportunity to cure any underlying defaults before the renegotiation agreement is affected.

In addition, the sovereign and the lenders should agree that certain forms of debt or events be excluded from the cross-default provision. The exclusions would include any failure to pay debt payments owed to commercial lenders who are not party to the renegotiation agreement, payments owed to suppliers or other classes of creditors not covered by the renegotiation agreement, and possibly payments owed to government creditors if Paris Club negotiations or bilateral negotiations are not expected to be completed soon after the signing of the agreement with the commercial lenders.

C. *Borrower or Governmental Agency*

The determination of which entities are included in the definition of "borrower" or of "governmental agency" is important for the operation of the negative pledge clause, the cross-default clause and other events of default. A broad definition of governmental agency increases the risk that a relatively minor default will trigger an event of default, or the cross-default clause, and may inhibit the ability of

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scope of the cross-default clause because technical or minor defaults may force them to list defaulted loans on their books and thus lower earnings. Wickersham, *supra* note 15, at 10.

31. For some policy arguments concerning negotiation of cross-default clauses, see Pergam, *supra* note 27, at 15-18.

32. Because of its restrictiveness, the "capable of" clause has been nominated as the worst clause in the Euromarkets. *See* Carroll, *The Worst Clause in the Euromarkets*, EUROMONEY, June 1981, at 90.

trade and project-oriented companies to grant security to their creditors in the ordinary course of business. In addition, the sovereign may lack the authority to control effectively the borrowing and repayment activities of certain public companies. For these reasons, the sovereign's counsel should review carefully the impact of these provisions on each governmental agency and should seek to limit the operation of these clauses to specific entities where appropriate.

D. Material Adverse Change

The lenders typically want a catch-all event of default clause which permits each individual lender to declare a default if it determines that a "material adverse change" in circumstances threatens the sovereign's ability to repay its obligations.[33] Such a subjective standard leaves each lender with the right to call a default even if none of the other objective events of default has occurred. The sovereign and its counsel should delete such a clause or at least limit the power to declare a default due to a "material adverse change" to the occurrence of objectively stated circumstances, and then only if exercised by lenders holding a specified portion of the debt.

E. Required Banks

The concept of "required banks," or the percentage of banks required to take certain action pursuant to the renegotiation agreement, is important for determining the existence of defaults (such as a "material adverse change"), for accelerating the loans or pursuing other remedies following an event of a default, and for obtaining consents and amendments to the renegotiation plan. Different percentages may be established for taking different courses of action. For example, whereas a majority of the banks may be required to make technical amendments to the agreement, two-thirds or three-fourths could be required to accelerate the loans or declare that a material adverse change has occurred. Again, it is important to consider the large number of banks involved in a typical renegotiation, and the time it may take to contact and receive affirmative responses from a high percentage of the lenders, particularly if certain lenders have political or financial considerations to weigh. Recent practice indicates that many renegotiations become almost continual processes, with constant need for amendments and waivers in light of current conditions. The sovereign must be careful that it is not prevented by an unrealistically high percentage of required bank

33. *See* Ryan, *supra* note 29, at 98-100.

approval from responding to and taking remedial action in case of changing circumstances.

III. Implementing the Renegotiation Plan

Once negotiations have been completed with the various groups of creditors, a process which can take several months, the sovereign and its advisers review the agreements to determine what steps must be taken to implement the terms of the renegotiation plan. Some of the issues which typically arise at this stage of the renegotiation process involve domestic legal requirements, conditions subsequent to the effectiveness of the agreement, conditions precedent to further borrowings, and dissident banks and lawsuits.

Formal registration, notarization or recording requirements are often imposed by the domestic law of the sovereign. For example, the sovereign's exchange control or debt registration system may require that all external indebtedness be recorded with the central bank or other governmental agency. In addition, some form of executive order or exchange regulations may be needed to validate guarantees issued on behalf of private sector companies or to enforce internal compliance with the terms of the renegotiation plan. Failure to comply with all formalities may undermine domestic compliance with the renegotiation plan and subject the agreements to legal or political attacks from opposition parties or from dissatisfied domestic banks.

The renegotiation agreements themselves may contain conditions that must be fulfilled in order to make the agreements effective or to allow the sovereign to make further drawdowns of credit under the agreement. For example, the agreement may require the sovereign to sign all bilateral agreements concerning government-to-government debt by a certain date, or require that specified percentages of private sector debt, short-term debt or suppliers' credits be renegotiated by a certain date. Such conditions often impose considerable demands on the sovereign and its advisers by making it necessary to negotiate specific terms with each creditor.[34]

Complying with conditions or covenants related to status under IMF programs has proven troublesome for a number of sovereigns. Fulfilling the terms of an IMF austerity program often causes political and financial problems for the sovereign and adjustments to the

34. The Peruvian renegotiation agreement, for example, required that separate agreements be prepared and signed for approximately $1.7 billion of short-term debt as a condition precedent to further borrowings. The requirement resulted in the preparation of more than 800 agreements and the process took almost a full year to complete.

original IMF arrangement may be required.[35] Depending on the terms of the renegotiation agreement, failure to meet IMF performance criteria or to purchase IMF funds as they become available may result in an event of default under the agreement with the commercial lenders.[36] If a default does occur, the lenders have the right to accelerate all existing loans and to withhold disbursements of any remaining loans under the agreement.

If a default does arise or is anticipated, the sovereign and its advisers should be prepared to consult with the agent bank and, if appropriate, meet with the steering committee and distribute information to the banks at large so as to minimize the risk that any of the lenders will accelerate the underlying loans. Depending on the nature of the default and its impact upon future borrowings, it also may be necessary to seek a waiver of the default or modification of the condition by obtaining the consent of the required banks.

The cross-default clause often includes an exclusion for defaults in payments to commercial lenders who choose not to sign the renegotiation agreement,[37] but prohibits prepayment on other than a *pro rata* basis. This prohibition should be restricted to optional prepayments, since otherwise such a provision could be construed against the commercial lenders as an inducement to breach agreements with dissident banks.[38] Instead, renegotiation agreements typically provide as a covenant that an event of default will result if payments to non-participants in the plan are made on more favorable terms than payments pursuant to the renegotiation agreement.

Banks who choose not to sign the renegotiation agreement may make threats or commence legal action against the sovereign for repayment of their debt according to the schedule set forth in the original loan documents. In such cases, the sovereign and its legal advisers need to consult with the agent bank and review the terms of the renegotiation agreement so as to avoid making a payment that would result in a breach of a covenant and an event of default. The sovereign's legal counsel also may be asked to defend any lawsuits that are actually filed against the sovereign.

IV. General Observations

The current debt crisis is largely the result of what one observer

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35. *See supra* note 20 and accompanying text.
36. *See* Ryan, *supra* note 29, at 98.
37. See *supra* notes 32-33 and accompanying text.
38. *See* Wood, *supra* note 13, at 4.

has described as a "tremendous violation of expectations."[39] Yet, sovereign borrowers and their creditors now have begun to realize that to a considerable degree their interests converge.[40] Borrowers and lenders must take a cooperative approach to the debt crisis in order to assure the continued vitality of the international financial system. Continued cooperation requires that both borrowers and lenders take a long-term perspective of the debt crisis and avoid taking drastic actions that inhibit the ability of the developing countries to meet their balance of payments needs and thereby weaken the entire system. For the sovereign borrowers, a long-term approach means avoiding the temptation of announcing a repudiation of all foreign debt or of abandoning austerity programs in favor of simply borrowing more money.[41] For official and commercial lenders, a cooperative approach means continuing to make credit available[42]

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39. *See* Madison, *supra* note 3, at 2489 (quoting Richard N. Cooper, Professor of International Economics, Harvard University, and Under Secretary of State for Economic Affairs during the Carter administration).

40. *See* Clausen, *Let's Not Panic About Third World Debts*, HARV. BUS. REV., Nov.-Dec. 1983, at 106, 112-14; Mendez, *supra* note 2, at 196. The lenders' mutual interest with their sovereign borrowers arises mainly from the extent of the banks' exposure in the developing world. As of June 1982, for example, the nine largest U.S. banks had made loans of $60.3 billion to the 40 non-OPEC developing countries, a figure equal to 222% of those banks' combined capital. Wines, *supra* note 3, at 603. The exposure in developing countries is not limited to the large banks: the U.S. Treasury has identified nearly 400 banks in 35 states and Puerto Rico with foreign loans on their books. *Id.*

41. Among the reasons that developing countries increased their borrowing from commercial lenders during the past decade was a desire to avoid IMF austerity conditions. *International Banking Survey*, *supra* note 1, at 55. For a discussion of other factors contributing to increased reliance on private sources, see Barnett, Galvis & Gouraige, *On Third World Debt*, 25 HARV. J. INT'L L. 83, 90-92 (1984). The IMF austerity programs adopted by developing states as part of recent renegotiation plans may reduce the demand for new credit over the course of the next few years.

42. As A.W. Clausen, current President of the World Bank, has observed:

> If commercial banks and other financial institutions do not provide capital and if the industrialized world does not protect the concept of free trade, the developing nations cannot manage the current short-term difficulties or finance productive domestic investment. The prophecy will be self-fulfilling; they will, in short, become insolvent. Commercial bank loans will turn into losses, and the fastest growing export market for America's industrial goods will vanish.

Clausen, *supra* note 40, at 107. *See also* Bolin & Del Canto, *LDC Debt: Beyond Crisis Management*, 51 FOREIGN AFF. 1099, 1106-12 (Summer 1983) (discussing the importance of finding sources of future credit for developing countries). Concern over the global debt crisis and the well-publicized problems of Mexico and Brazil in particular has resulted in a sharp reduction in the amount of new credit available to developing countries. Smaller lenders, such as regional U.S. banks, have been particularly reluctant to extend new loans. *See* Barnett, Galvis & Gouraige, *supra* note 41, at 95; Madison, *The Third World's Debt Crisis—Maybe Less than Meets the Eye*, NAT'L J., Dec. 4, 1982, at 2068, 2070-71; Wines, *supra* note 3, at 601, 604-606. The hesitation of the regional banks to extend additional credit has created further problems and delays in trying to conclude renegotiation agreements and has contributed to the creation of an active secondary market for participations in syndicated

rather than refusing to make any additional loans to developing countries, or insisting on even higher rates of interest,[43] or on repayments of principal which surpass the country's ability to pay.

At the same time, it is evident that strict adherence to current lending practices is no longer practical or appropriate, and that some far-reaching reforms may be required to diversify the risks currently borne by the developing states and their commercial lenders and to assure continued sources of credit for the sovereign borrowers.[44] The Intergovernmental Group of Twenty-Four, a group of developing countries within the IMF, has proposed a number of reforms to respond to the balance of payments problems of the developing countries.[45] Within the United States, both the Congress and bank regulators have devoted much attention recently to the exposure of U.S. banks in the developing countries, and have con-

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loans. *See A Boom in Broking Out Loans*, EUROMONEY, November 1982, at 37; Brown, *Selling Restructured Debt*, INT'L FIN. L. REV., March 1984, at 9. Although the use of participations may help banks diversify their risks and thus increase overall levels of lending, *see* Mendez, *supra* note 2, at 183-85, the consequences for the renegotiation process of widespread swapping and selling of loans to developing countries are unclear. An active secondary market in such loans may make it more difficult for the sovereign to identify the nature of its outstanding debt and the number of its creditors.

43. Although fixed interest rates were commonly used in loan agreements with developing countries through the early 1970's, floating interest rates are now used in the majority of agreements. The use of floating rates and the increase of interest rates generally have contributed to large increases for developing countries in the cost of servicing their debts. *See* Mendez, *supra* note 2, at 185. The average nominal interest rate of loans to developing countries nearly doubled from 1978 to 1981, rising from 8.7% to 16.5%, but rates decreased somewhat after 1981 before rising again in 1984. *See* Clausen, *supra* note 40, at 109 (chart). For a discussion of how interest rates are calculated for Eurodollar loans, see Mitchell & Wall, *The Eurodollar Market: Loans and Bonds*, in INTERNATIONAL FINANCIAL LAW 53, 62 (R. Rendell ed. 1980).

44. Proposals for fundamental reform of current practices include: (1) the exchange of existing short-term loans for long-term, low-interest notes to be issued by a national or multinational agency (*see Third-World Debt Problem*, N.Y. Times, Mar. 10, 1983, at D5, col. 1); (2) creation of a new institution, allied with the World Bank and backed by the export credit agencies of the major developed countries, that would make long-term funds available to sovereign borrowers (*see* Bolin & Del Canto, *supra* note 42, at 1110-11); and (3) creation of an adjunct to the IMF with broad powers to deal with debt problems (*see* Barnett, Galvis & Gouraige, *supra* note 41, at 131).

45. *Outline for a Program of Action on International Monetary Reform*, in IMF SURVEY, Oct. 15, 1979, at 319. *See also* J. GOLD, LEGAL AND INSTITUTIONAL ASPECTS OF THE INTERNATIONAL MONETARY SYSTEM 17, n.30 (1979). The Commission on International Development Issues ("Brandt Commission"), formed in 1977 at the suggestion of then World Bank President Robert S. McNamara to study global economic and development issues, has issued a report which contains far-reaching proposals concerning both official and commercial lending practices. *See* NORTH-SOUTH—A PROGRAM FOR SURVIVAL, *supra* note 20. For a description of the origins and work of the Commission, see *Monetary Reforms Included in Wide-Ranging Proposals Published in Brandt Report*, IMF SURVEY, Feb. 18, 1980, at 49; Hooke, *The Brandt Commission and International Monetary Issues*, 18 FIN. & DEV. 22-24 (1981).

sidered some far-reaching proposals for reform of regulation of loans to such countries.[46]

Even if such reforms are undertaken, however, it is likely that debt renegotiation will continue to perform an important role in assisting individual states during short-term crises and in assuring the viability of the overall financial system.[47] In order for the renegotiation process to fulfill a meaningful role in the future, both borrowers and lenders must be willing to reevaluate traditional policies that may increase short-term gains but work against long-term stability.[48] The practice of limiting renegotiation agreements to narrow periods of maturities and thereby increasing the need for new negotiations, for example, may result in more fees and higher earnings for lenders,[49] but may divert the sovereign's funds and its limited technical resources from development projects and other domestic programs. Similarly, restrictive cross-default or negative pledge clauses which theoretically give lenders greater control over the sovereign's borrowing activities may in fact inhibit the sovereign's and the banks' ability to engage in trade transactions or to attract short-term capital for daily operations,[50] and contribute to a cycle of frequent defaults and continual negotiations.

Constructive renegotiations also require a willingness to approach each sovereign borrower on its own merits and to evaluate the necessity of "standard" terms or provisions that were included in the most recently concluded agreement. Provisions and terms that may be needed for large debtors such as Mexico or Brazil may be

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46. *See* Madison, *IMF Boost No Bailout, Administration Insists*, NAT'L J., Mar. 19, 1983, at 596; Wines *supra* note 3, at 606-607.

47. Although the current case-by-case approach to debt renegotiation has been criticized for being wasteful and disruptive, Barnett, Galvis & Gouriage, *supra* note 41, at 95-96; Mendez, *supra* note 2, at 190, the renegotiations concluded to date have helped debtor states and their lenders avoid a complete breakdown of an individual country or the international financial system. Even if more formalized procedures are developed, it still will be necessary to convene negotiations between the sovereign and its lenders in each instance since those parties have the most interest in and the best knowledge of the issues at stake. *See* Bolin & Del Canto, *supra* note 42, at 1102-03. *See also Third-World Debt Problem, supra* note 44, at D5, col. 3 (observation of Irving Friedman that uniqueness of each country's problems makes general solution unrealistic). Thus, at least until a major reform that transforms the nature of the sovereign debt to be renegotiated, and probably thereafter as well, some form of case-by-case renegotiation along the lines currently practiced will be necessary.

48. For a discussion of the impact of certain loan terms and lending practices on the balance-of-payments situation of the developing countries, see P. DHONTE, CLOCKWORK DEBT 29, 35 (1979); Mendez, *supra* note 2, at 185-87, 196-99.

49. Renegotiation agreements typically provide for the payment of "up-front" charges such as commitment, extension, management and agent fees. *See* P. DHONTE, *supra* note 48, at 35-37; Note, *supra* note 20, at 307 n. 10.

50. *See supra* notes 25-32 and accompanying text.

entirely inappropriate and unnecessary for a smaller country with a different debt portfolio.[51] Likewise, provisions found in standard Eurodollar loan agreements may be unworkable in a renegotiation agreement that must accommodate the conflicting requirements of the sovereign and all of its lenders.[52] Current developments indicate that creative documents and negotiations will be needed to deal with the long-term ramifications of the international debt crisis. Lawyers serving as counsel to sovereign borrowers can contribute to the continued success of the debt renegotiation process by assisting their clients in the preparation of well-informed and realistic approaches to their debt problems, and by working for solutions that promote respect for the rule of law.

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51. Of the 15 developing countries that renegotiated debt in 1981 and 1982, eight were low-income African countries. Clausen, *supra* note 40, at 108.

52. *See* Wickersham, *supra* note 15, at 8.

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The Role of Financial Advisors in Bank Debt Reschedulings

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The Role of Financial Advisors in Bank Debt Reschedulings

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The Minister of Finance of the Republic of Isla Grande dreamed. In his dream, as in life, he had been struggling for the last six months with triple-digit inflation, a widening budget deficit, a dramatic loss of reserves which were by now equivalent to only three weeks of imports, and a flourishing black market. As exports were stagnating, imports kept pouring in, and foreign bankers eagerly lined up to extend more credit to Isla Grande. Thanks to the bankers' credits, so far Isla Grande had been able to pay on time both the principal and interest on its foreign debt and to meet its oil bills — able, in a word, to go on consuming more than it was producing.

The Minister had long tried to warn his colleagues in the Cabinet. They argued that since the difficulties facing Isla Grande *were only temporary* and due to factors beyond the government's control, short-term bridge financing from the commercial banks was exactly what was needed. Indeed, they said, the high interest rates in the United States were bound to drop soon, while the recession in the industrial countries could not go on forever.

In the Minister's dream, the banks suddenly decided that Isla Grande's short-term credits would not be renewed and that payments had to be made. How much was owed, he was not sure, but with reserves so low and with already stagnant exports undergoing their seasonal slump, he knew with certainty that it would have been virtually impossible to come up with the amount needed.

The Minister awoke from his dream and realized that today was March 31, and 90 percent of the short-term loans that the bankers had extended to Isla Grande were due and had to be rolled over. When he got to the office, he needed no more than five minutes to realize that his nightmare had come true. Telexes from London, Tokyo, Miami, New York and Paris banks conveyed identical messages: the short-term credits could not be rolled over, but would

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have to be repaid. The Minister decided to call the local representative of the largest foreign bank. The representative was very apologetic, but also very firm: his instructions had come from New York, and could not be changed. After making a couple of phone calls each to New York, Miami and Paris, the Minister realized that nothing he could do would change the attitude of the banks.

Now the Minister tried to determine how much cash was on hand for the debt service payments, only to find that to compile such information the Central Bank would require three days. He then tried to determine the exact amounts due only to find out that the Ministry always had relied on the figures given in the banks' telexes in making the payments. With great regret, the Minister remembered that his project to centralize the debt data and organize a debt management department had never gotten off the ground; all the government agencies, ministries and state-owned enterprises had been free to make their own borrowing decisions.

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This story may sound farfetched, but since 1980, more than 40 sovereign governments have found themselves unable to make payments on their foreign debt obligations. These debtors have found it necessary to postpone the payment of maturities falling due, and to negotiate reschedulings of portions of their debt with their foreign creditors. For most, this was the first time the government, or a particular administration, had faced a financial crisis of this magnitude.

Typically, the government discovers it is ill-equipped to deal with its creditors. Debt records are poorly kept, coordination and communication among government agencies are lacking, personnel are inexperienced or unskilled in dealing with such a crisis, and domestic pressure against repaying foreign creditors mounts as the situation deteriorates.

The government is also confronted with various categories of creditors, each with its own ideas. For example, commercial banks usually feel that creditor governments should be willing to accept repayment for official credits over longer periods than for those credits granted by the banks; on the other hand, official creditors argue that banks should be willing to grant to debtors comparable terms to those terms extended by governments. Even multilateral organizations sometimes can disagree among themselves.

In this chaotic and high-pressure environment, there is a niche for financial advisors specializing in the problems of sovereign borrowers. These advisors provide independent, professional and confidential assistance, free from the conflicts of interest which affect

advice from parties to the restructuring. Financial advisors offer the debtor country the experience they have gained in other restructurings, and supply additional skilled manpower to augment the capacity of the ministries and government agencies involved.

Because advisors are located in key financial centers, they keep fully abreast of the ongoing shifts and trends in the financial and capital markets. In addition, through an excellent network of relationships, they provide access to the top levels of both the banking industry and the Organization for Economic Cooperation and Development (OECD) governments.

Financial advisors work entirely on behalf of their client countries. They do not act as lenders, and engage in no financial transactions in countries whose governments they are advising. Advisors sit on one side of the table only.

Financial advisors, as intermediaries between the debtor country and its creditors, relieve some of the pressure on both debtor and creditor government officials. Further, advisors can facilitate the negotiation process between a sovereign debtor and its creditors by providing a convenient centralized communication channel to facilitate negotiations, disseminate information to creditors, and help all concerned parties to understand better each other's political, regulatory and social environment.

At all stages of the negotiations, financial advisors can provide a full range of technical skills to assist the debtor in evaluating options and strategies for restructuring its external debt. In the short run, financial advisors help a sovereign government to restore a contractual relationship with its creditors. The longer term goal is that of restoring external confidence in, and thereby allowing the resumption of normal capital flows to, the debtor country.

I. The Advising Process

Financial advisors typically assist a debtor government at all stages of the debt restructuring process. The steps in the process generally include:

- defining and analyzing the problem;
- preparing information analyses to keep creditors abreast of economic and financial developments;
- formulating restructuring proposals for presentation to the creditors;
- elaborating strategies for dealing with foreign creditors, including formulation of new restructuring proposals in response to those made by the creditors;

- reviewing cash-flow implications of all proposals;
- coordinating the various creditors, including the multilateral institutions, with the debtor;
- reviewing, with legal advisors, the documentation of any agreements reached;
- monitoring all developments in capital and financial markets, while assessing the implications for the country being advised; and
- implementing the agreement reached, especially by monitoring the cash flow to ensure that the agreed upon repayment schedule remains a realistic one.

In sovereign debt reschedulings, assembly of the facts required to define the problems may present major difficulties. Quite often, both information on the total debt owed to foreign creditors and data on the current economic and financial situation of the debtor are neither readily available nor very accurate once obtained.

The first step in assessing the magnitude of the problem, therefore, is usually for financial advisors to assist the debtor in conducting a full debt audit on a loan-by-loan basis. Information is organized by class of debt, by debtor agency, by creditor, and by the debt's maturity, interest rate, currency and fee structure. In addition, the economic aspects of special legal provisions such as negative pledge clauses are analyzed. All the data collected are thoroughly reviewed and the information from the debtor is carefully reconciled with that from the creditors. Ideally, all the data are computerized in a sophisticated but easily managed and flexible system, which permits the debt inventory to be updated, and which further makes examination of various restructuring scenarios quick and easy.

The next task is to compare the various projected debt service payments with the expected foreign exchange resources, in order to determine the debtor country's true capacity to service its debt. This requires detailed forecasts of the balance of payments in the context of an International Monetary Fund (IMF) program, taking into account the amount exports can be boosted in a short time, the compressibility of imports, expected capital inflows, and the amount, if any, by which the debtor can still draw down on its foreign exchange reserves.

Simply projecting the balance of payments, however, is not enough. An essential step is the construction of an accurate monthly cash flow for the debtor country. Failure to predict leads and lags in the trade account, in the case of a country like Brazil, for example, can make a difference of several billion dollars in the cash actually available for debt service payments. This is a difficult step because it incor-

porates subjective judgments which, in a crisis environment, can be particularly difficult to make. What disbursement patterns can be expected in connection with capital flows from public sources? With government projects? With private capital flows? What types of government financing will be available for imports? For exports? This step is complicated further in some cases because the IMF does not forecast a country's foreign exchange position on an accrual basis, nor on a cash flow basis. By acting as an intermediary, the financial advisor helps ensure more realistic assumptions about the availability of cash flow, with the result that a more realistic rescheduling arrangement is achieved.

At the same time, the debtor country, together with its financial advisors, must analyze various domestic policy options for stabilizing the economy. The negotiations with the IMF typically include devaluating the currency, slashing budget expenditures, increasing taxes, and liberalizing prices and interest rates.

Finally, armed with a coherent and consistent stabilization program endorsed by the IMF, a carefully prepared analysis of its debt service projections, and figures on its actual debt service payment capacity, the debtor country is ready to engage in meaningful negotiations with its creditors.

II. Negotiating with Creditors

The first step in any meaningful and constructive negotiation is for the debtor to ensure a constant flow of information to its creditors. The debtor must provide information on a regular basis to its creditors to keep them abreast of domestic economic and financial developments, debtor efforts to confront the crisis, and the debtor's commitment to restore, as soon as possible, a contractual relationship by honoring its obligations.

Communication usually is accomplished via telex, telephone conversations, and detailed, informative memoranda containing all relevant economic data. Good communication between debtor and creditor is a necessary condition to the establishment of a climate of confidence and cooperation and avoidance of disruptive and costly litigation.

Once a dialogue is established with the various groups of creditor multilateral institutions, financial advisors assist the debtor country in preparing for formal meetings with its creditors. This may include additional documentation and analysis, formulation of answers to anticipated questions, and discrete inquiries to determine

the attitudes of creditors, regulators and officials of the international institutions.

Advisors review with the debtor country authorities the various rescheduling scenarios and options for treating the different categories of creditors, before a formal restructuring proposal is made to the creditors. This proposal must be fair in its treatment of the different classes of creditors, and moreover must be realistic to ensure that the debtor country will be able to honor its commitments in the light of its projected cash flow. The realism and feasibility of the restructuring must further be measured against the domestic social and political situation, and against the possible impact of future import compression and deflationary measures. Finally, a successful restructuring proposal must be acceptable to the creditors.

This last requirement does not mean that the debtor country should present initially a proposal intended for complete, immediate acceptance by its creditors. Rather, the proposal must be a reasonable point of departure for further discussions. As part of this exercise, the advisors closely track debt rescheduling negotiations elsewhere, so that favorable precedents can be used to defend the debtor country's position. Advisors also keep debtor country authorities abreast of developments in the capital and financial markets and in the regulatory environment which could affect the country's bargaining position.

Although the fair and equitable treatment of all categories of creditors is essential to a restructuring plan, the difficulties a debtor country faces in enforcing strict comparability of treatment between creditors cannot be overemphasized. For example, governments which are members of the Paris Club typically agree to reschedule large portions of both interest and principal, but the constraints imposed by U.S. regulatory agencies on U.S. commercial banks give those banks a great dislike for the rescheduling of interest payments. Of course, banks can extend new money as part of a refinancing package to provide more favorable treatment to the debtor without adhering to strict comparability.

Financial advisors can be particularly helpful in dealing with individual creditors who apply pressure, threaten or attempt to seize assets in settlement of specific claims, or otherwise try to cut a better deal for themselves. Unfortunately, such tactics are much more common than might be expected and are practiced by a surprising range of institutions. This threatens not only the debtor but also the guiding principle that all members of a similar class of creditors should be treated equally. The advisors must protect this funda-

mental principle of equity, without which the confidence required for successful completion of a negotiation is likely to be absent.

Because financial advisors keep in close touch with creditors, when problems arise, the advisor can be instrumental in explaining the issues involved and what is at stake for both debtor and creditors. If necessary, the advisor may apply pressure to resolve the problem and to make sure that all the banks participate in the rescheduling package. Among other things, financial advisors also may try to influence the banks worldwide to opt for the London Interbank Offered Rate (LIBOR) — instead of prime — as a reference rate, to soften or eliminate conditions precedent or negative pledge clauses from the rescheduling agreement, and to persuade banks to withdraw from lawsuits they may have initiated.

In addition, financial advisors work closely with the agent bank, to ensure efficient implementation of the rescheduling package. Financial advisors help the debtor authorities save money by establishing a procedure for, and assisting in, the verification of the claims of past due and current obligations submitted by the commercial banks. Generally, such a procedure includes verification of the original governing instruments, calculation of the amounts due according to such instruments and according to the rescheduling agreement, verification of payments made, if any, since the beginning of the rescheduling negotiations, and comparison of the results of calculations performed by the debtor's team with the claims submitted by the banks. This procedure provides a solid basis for approaching banks which have submitted claims that do not agree with the results obtained by the debtor's team.

If temporary difficulties arise in the foreign currency cash flow of the debtor, financial advisors assist the government and the central bank as they try to obtain bridge financing from commercial banks, foreign governments or government-controlled financial institutions.

Finally, once an agreement has been reached, financial advisors assist the debtor in reviewing the loan documentation. The desire to avoid lawsuits, the potential interference of cross-default and negative pledge clauses with the completion of a restructuring package, and the importance of making sure that the legal documentation fully protects the sovereign debtor interests and future freedom of choice are examples of important legal considerations that make it essential for the debtor government and its financial advisors to work in close coordination with competent lawyers.

Once the restructuring agreement is signed, the debtor country

faces the challenge of restoring the country's credit standing and regaining access to the international financial markets. Experience shows that countries which have recovered from economic and financial crises must struggle to regain access to a normal flow of credit. Financial advisors can assist the authorities in this long and time-consuming process in various ways.

The advisor can help the debtor government maintain its credibility through full and effective compliance with the terms and conditions of the refinancing agreement. This requires a complete understanding of the relevant contractual agreements and the implementation of appropriate procedures at the central bank, in the Ministry of Finance and in the office of all public sector obligors. Consultation with the Central Bank or the obligors is necessary to identify and rectify situations which might lead to default, as well as preparation or review of all documents necessary to satisfy the reporting requirements of the rescheduling agreement. Finally, consultation with the autonomous state-owned enterprises is important to ensure that their borrowing programs and business plans stay within the limits set out in the agreement. If compliance with the rescheduling agreement is impossible, financial advisors can assist the country in requesting waivers in a manner that will minimize the banks' concern and avoid possible fees. This requires an ability to interpret the agreement from the bankers' point of view. Moreover, it requires an understanding of the way in which banks react to alternative ways of seeking a waiver.

The advisor also may help the debtor country regain access to international markets by examining the external flow of funds and consequent borrowing requirements in order to prepare, well in advance, any request for additional credits or financing. The advisor should continue the normalization of the country's relations with creditors through the provision of a regular and detailed flow of information, which may include responses to inquiries concerning the refinancing agreements themselves or any other aspect of the country's economic and financial system. Finally, the advisor should identify and assess for the debtor possibilities for obtaining new credits in the international markets.

To assist debtors in the above tasks, financial advisors can provide extensive knowledge of the terms and conditions of bank and government lending and refinancing agreements, documentation, and monitoring systems, as well as knowledge of precedents and of changing market conditions.

III. Conclusion

The international financial transactions which will be characteristic of the 1980's will require an exhaustive familiarity with international markets and with lending and syndication techniques, which are currently in a state of flux. These transactions will require the ability to compile and communicate complex financial information, and to draft and negotiate highly customized loan documentation. In view of the slowing of international lending activity, most financings will demand carefully designed marketing programs and documentation to stimulate lender interest. Financial advisors can play a key role in helping sovereign countries recover from the "nightmare" of debt crises, and instead deal successfully with the international financial community.

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The Paris Club, 1978-1983

by

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The Paris Club, 1978-1983

ALEXIS RIEFFEL*

At the International Conference Center in Paris, in a meeting room used by the Paris Club, there hangs a magnificent eighteenth-century tapestry depicting an elegant damsel, leaning against the statue of a goddess. As she is being courted by a dashing young man, a small terrier plays with leaves and a pair of angels observes from above. One popular interpretation given this scene is that the virtuous maiden represents the creditor countries, and the young man on bended knee is a developing country seeking debt relief. The goddess represents the principles of the Paris Club, and the angels are the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank). The little dog is the United Nations Conference on Trade and Development (UNCTAD).

* * * *

The Paris Club was "born" in 1956 when a group of creditor governments met in Paris to negotiate a debt-relief arrangement with Argentina.[1] In the late 1950's and early 1960's, the countries that sought debt relief were primarily Latin American countries that had been the all-too-eager recipients of suppliers' credits, vigorously promoted by the governments of the industrial countries. Commercial banks were not asked to provide relief because they were not major creditors and the debt problems did not appear to be associated with bank lending.[2]

* U.S. Department of Treasury. During the period described, the author was the U.S. Treasury Department's technical expert on debt relief relating to credits extended or guaranteed by the U.S. government. The views expressed, however, are not necessarily those of the U.S. Treasury Department. Acknowledgement is given to Russel L. Munk, Ricki Rhodarmer Tigert and Ciro DeFalco for their encouragement and thoughtful suggestions.

1. The debt-rescheduling process is organized from the perspective of the creditors, not the debtors. Credits extended by governments or by private lenders with a creditor-government guarantee are rescheduled in the Paris Club. Credits extended by commercial banks without any creditor-government guarantee are rescheduled in the London Club. Credits extended by non-bank lenders without any creditor-government guarantee are not rescheduled through direct negotiations with the lenders but generally are rescheduled by the debtor country on terms similar to those offered by the other creditor groups. In other words, a debtor-government guarantee does not influence where the credit is rescheduled.

2. The following definitions may be useful in connection with foreign debt negotiations. "Debt reorganization" and "debt renegotiation" are virtually synonymous and are the broadest terms describing any changes in the payment arrangements associated with an ex-

In the late 1960's, creditor governments experimented with the use of debt relief as a form of development assistance, with India and Pakistan being the principal beneficiaries.

In the early 1970's, creditor governments faced the first cases of what might now be called debtor-country insolvency: Indonesia and Ghana. In each case, the creditor governments granted a long-term rescheduling at concessional interest rates. There was still no pressure for debt relief from banks and other private creditors.

The mid-1970's was a transitional period. Official creditors abandoned debt relief as a form of aid and commercial banks were faced with handling reschedulings on their own. Zaire in 1976-78 was the test case for the banks. The banks argued that friendly governments should provide whatever debt relief and new financing was necessary to ensure that Zaire would remain current on its bank debt. The governments insisted that the private banks provide "comparable" debt relief, and in this instance the banks eventually found an acceptable form of relief.

I. The Basic Principles of Debt Relief

In some larger context, the interests of creditors and debtors may be similar, but in the context of debt-relief negotiations, the debtor tries to pay as little as possible, while the creditors try to get paid as much as possible.[3]

The first principle of debt relief is known as *imminent default*, which guards creditors against constant requests for relief from debtor countries.[4] In brief, creditor governments will not entertain a

isting stock of debt mutually agreed upon by the debtor and the creditor. "Debt relief" is any deferment or cancellation of arrears or of scheduled payments, or any interest rate concession, granted by a creditor. "Debt restructuring" is a form of debt reorganization in which the entire schedule of amortization payments relating to an existing stock of debt is modified, normally to extend the period of repayment. "Debt rescheduling" is a form of debt reorganization in which payments of principal and/or interest falling due in a specified interval are deferred for repayment on a new schedule. "Refinancing" is new borrowing primarily for the purpose of meeting specific payment obligations on existing debts. "Refunding" is new borrowing undertaken primarily to retire (prepay) existing debt, usually to take advantage of better terms or to obtain a more favorable maturity structure. In this paper, "guarantees" by official creditors are understood to include insurance (and other forms of protection or cover) against inconvertibility for a private lender.

3. Agreement is possible only because the creditors would rather have a promise to pay later than accept an outright loss, and the debtor would rather pay a little now than risk an abrupt and perhaps lengthy suspension of trade and financial relationships with the creditors. The common meeting ground is some period of time in the future when the debtor thinks he will have the wherewithal to pay and the creditor thinks he cannot get a better deal.

4. Since 1978, the only clear case where debt relief was granted by official creditors in the absence of imminent default was the Pakistan rescheduling of 1981. Arguably, the sec-

request for debt relief unless there is strong evidence that the debtor country will default on its external payments in the absence of such relief. There is a straightforward, analytical test of "imminent default": the existence of an ex ante financing gap.[5] When a debtor country's uses of foreign exchange, which are usually projected for one year in advance, exceed its sources,[6] there is prima facie evidence that a situation of imminent default exists.[7]

The case of Senegal illustrates the principle of imminent default. Senegal began experiencing debt-servicing difficulties in 1980 and expressed interest in Paris Club negotiations. Some creditors were prepared to negotiate but others argued persuasively that the balance of payments projections offered by Senegal (and endorsed by the IMF) failed to support a finding of imminent default. Within two years, however, the balance of payments numbers worsened, to the point that substantial arrears had accumulated and most loans were in default. Senegal's first Paris Club agreement was signed in October 1981. Senegal's creditors, however, might have been better off by agreeing to reschedule at an earlier stage since Senegal might have passed through its debt crisis faster and less traumatically. Yet it seems just as likely that Senegal would have taken advantage of earlier relief to postpone necessary economic reforms.

A second principle of debt rescheduling is *conditionality*. Debt relief does not solve debt problems. Rather, their solution comes from the adoption and effective implementation of sound economic policies. This may be the most important lesson of the last six years. In the absence of sound policies, debt relief is wasted.

Consequently, in the early history of the Paris Club, the practice evolved of making debt relief conditional upon the existence of an economic program supported by a borrowing arrangement with the IMF,[8] involving drawings in the upper credit tranches.[9] The

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ond year of relief granted to Peru in 1978 also was not based on imminent default. Peru informed its creditors that because of its improved balance of payments situation it would not need the second year of relief that had been granted.

5. In some cases, default already has occurred at the point the request for debt relief is made. These are cases where substantial arrears have built up and foreign-exchange reserves have been exhausted.

6. The sources include exports of goods and services, workers' remittances, private and official transfers, loan disbursements, direct investment, borrowing from the IMF, and foreign exchange reserves. The uses include imports of goods and services and debt-service payments.

7. *Ex post*, of course, sources must equal uses. If nothing more can be done to increase sources, and cutting imports would be economically damaging or politically unacceptable, then balance can be achieved only by reducing debt-service payments.

8. The IMF was established to assist countries experiencing balance of payments difficulties, and a debt-servicing problem is the most extreme form of balance of payments diffi-

current practice is quite strict. Official creditors will not enter into negotiations with a debtor country until a new standby or extended arrangement has been approved by the IMF Executive Board.[10] The economic program accepted by the IMF is what the creditors are "buying" with their debt relief, and it is the frame of reference for determining the appropriate terms of debt relief.

There is a fundamental contradiction in the principle of conditionality: the better the adjustment efforts of the debtor, the less debt relief is needed. The Paris Club's slowness in recognizing this contradiction may have contributed to the low Paris Club "success" rate since 1978. One reaction to the contradiction might be to grant every debtor requesting debt relief (where imminent default clearly existed) the same initial terms. Debtors with weaker policies would have to come back for more relief and creditors could demand more policy reform. Debtors with stronger policies would get an extra boost from the relief and would reestablish their creditworthiness that much sooner. The problem with this approach is that there has been a distinct tendency for the debtors to delay reforms past the early stages of debt-servicing difficulties.

The most uncomfortable period for the creditors comes when arrears begin piling up and the debtor shows no signs of negotiating seriously with the IMF. Debt relief would make it possible to eliminate the arrears, but relief cannot be given because the conditionality principle has not been met.[11] The pressure on commercial banks to reschedule generally is greater than pressure on governments.[12]

culties. The staff of the IMF has the greatest expertise of any international organization in the relationship between specific economic policies and the balance of payments, and it regularly reviews economic developments in each member country.

9. The arrangement must involve borrowing in the upper credit tranches (above 25% of a country's quota) because drawings in the first credit tranche do not require meaningful policy reforms by the member country.

10. If the debtor country is not a member of the IMF, the official creditors negotiate policy reforms directly with the debtor country. Poland in 1981 was the first country to seek debt relief in the Paris Club that was not a member of the IMF. Cuba in 1982 was the second and Mozambique in 1984 was the only other to date. The efforts to achieve conditionality were frustrating and probably doomed to fail.

11. In the first half of 1982, the Paris Club sent a formal communication to the government of Venezuela calling attention to the arrears that were accumulating. The Paris Club did not receive an answer until the spring of 1984. In the meantime, arrears to the official lending agencies accumulated rapidly.

12. The official creditors, however, did not defend the principle of conditionality in the case of Nicaragua. To give the new Sandinista government the benefit of the doubt about its commitment to pursue sound economic policies, the Paris Club agreed to open negotiations in 1980 with the understanding that the debt-relief agreement that emerged would not go into effect until an IMF arrangement was in place. In fact, by the time the negotiations began in October, there was considerable evidence that meaningful reforms would not be adopted. Consequently, several major creditors (notably the United States) blocked any

As a consequence, the banks negotiated debt-relief arrangements without waiting for an IMF standby on several occasions during the 1978-83 period.

Burdensharing represents a third principle: all creditors must provide relief that is commensurate with their exposure in the debtor country. The application of the principle is one of the most complicated aspects of Paris Club negotiations.

There are four broad, competing groups of creditors: multilateral lending institutions; official creditors participating in the Paris Club negotiations; official creditors *not* participating in these negotiations; and private creditors, such as commercial banks.[13]

As of mid-1984, the multilateral lending institutions[14] have established a superior position vis-à-vis the other three groups, and are exempt from providing relief commensurate with their exposure. There are two arguments for exempting multilateral institutions. First, the creditor countries are members and therefore benefit indirectly from the exemption. Second, multilateral institutions bear their share of the burden by continuing to lend to the debtor country. The major issue in this area is how long a list of multilateral institutions should be recognized as preferred creditors. As a temporary expedient, the Paris Club recently developed a rule of thumb. The Paris Club will accept the exemption of a self-proclaimed multilateral institution only when the institution provides net credit to the debtor country during the period of debt relief from the Paris Club.[15]

The essential "raison d'etre" of the Paris Club is to ensure burdensharing among participating creditors. Despite 28 years of Paris Club negotiations, debtor countries still have a strong ten-

discussion of specific rescheduling terms and no Paris Club agreement was signed. Nevertheless, the political and financial pressures were so great that major creditors, other than the United States, extended relief on a bilateral basis. This exceptional approach has not been repeated for Nicaragua or any other country.

13. Foreign investors do not figure in debt-relief negotiations because earnings are not repatriated according to a fixed schedule. Convertibility problems are a calculated risk for these investors, but they have the option of reinvesting earnings. This is an area that warrants further study.

14. These include without question the IMF, the World Bank and the three major regional development banks: the Inter-American Development Bank, the Asian Development Bank and the African Development Bank. The category also has included other multilateral institutions such as the European Investment Bank and the OPEC Special Fund.

15. There is an unresolved debate over the status of private and official lenders that "co-finance" with multilateral institutions. The multilateral institutions would like to extend their exemption from rescheduling to their co-financing partners in order to attract more partners. Creditors that reschedule are opposed since such treatment simply would increase the debt-relief burden they must bear.

dency to seek bilateral relief before they accept a multilateral approach. They are rarely successful with creditor countries that belong to the Organization for Economic Cooperation and Development (OECD), but often succeed with countries that are not OECD members.[16] Given the intense political pressures that can build up in such cases, the record of adherence to the multilateral approach is remarkable. There is, nevertheless, a serious burdensharing issue among the OECD creditors relating to new credits. In several of the recent cases (Sudan, Mexico, Brazil), official creditors have had to provide new credits in addition to providing debt relief. So far the pledging process has been ad hoc, and this has produced some tensions as some donors (notably the United States) came to feel they were pledging more than their fair share. Unless a stronger sense of equitable burdensharing emerges, official creditors may have to devise a burdensharing formula for new lending that corresponds to the formula used by the commercial banks.[17]

Burdensharing with non-participating official creditors is a fascinating aspect of the Paris Club process. The two main categories of non-participating creditors are centrally-planned countries and developing countries. The creditors participating in the Paris Club ensure burdensharing by non-participating creditors through a "non-discrimination" clause in the standard Paris Club agreement. This clause commits the debtor country to obtain relief on the same terms from non-participating creditors. If the debtor country makes larger payments to non-participating creditors than is consistent with the Paris Club terms, the non-discrimination clause gives the Paris Club creditors the right to demand larger payments from the debtor. To date, there has never been a serious ex post analysis of any specific case to determine if non-discrimination was achieved, and there has been no case where Paris Club creditors have sought to invoke the non-discrimination clause to get better treatment. Generally, compared with Paris Club creditors, debtor countries tend to get more relief from centrally-planned creditor countries and

16. The United States provided debt relief on a bilateral basis to Yugoslavia (1971), Egypt (1971), Turkey (1972) and Poland (1973 and 1981). Currently, the OECD country that seems most prone to grant relief on a bilateral basis is France which, by some reports, provided relief to Senegal before the 1981 Paris Club rescheduling, and to Iraq more recently.

17. Commercial banks use a very simple formula. New lending is expressed as a percentage of each bank's exposure in the debtor country on a specified date. This works better for institutions that are all lending for the same purpose (profit) and on the same terms (market-determined), than for governments that have lent for a variety of different purposes on very different terms.

less relief from less-developed country creditors.[18]

Burdensharing with private creditors is probably the "hot" issue of the mid-1980's and is epitomized in the phrase "bailing out the banks." Whereas before 1970 official creditors could reschedule without worrying much about what the banks were getting, by 1978 commercial banks were important lenders to almost all of the countries seeking debt relief in the Paris Club. Without some debt relief from banks, creditor governments would have had to provide 100% relief *plus* large amounts of new money to keep the debtor countries from suffering prolonged setbacks in their economic development. The banks accepted the need to provide debt relief without much of a struggle, and the questions of how to negotiate and how much relief to provide were also settled quite simply. The official creditors were not at all interested in bringing the commercial banks into Paris Club negotiations, and the banks did not push to come in. The two-track (London Club, Paris Club) approach evolved naturally.

Official creditors have struggled over the appropriate terms for relief from commercial banks. Extending the non-discrimination clause to banks would be too rigid an approach for two reasons. First, the motivations for lending by the two categories of creditors are quite distinct. Commercial banks lend as a business, to get the greatest return possible, and all of their loans are at market rates of interest. Governments, by contrast, lend for a variety of reasons: national security, commercial, humanitarian.[19] Some official credits

18. Centrally-planned creditor countries seem to be soft on debt relief in order to preserve their anti-capitalist image. Arab creditor countries seem to be soft because of Islamic sensitivities about usurous lending. A good example of better treatment from lesser developed country creditors is the case of Uganda, where Tanzania and Zambia were larger creditors than most Paris Club participants. According to press reports, the terms of debt relief offered by these two countries appeared to be more favorable to Uganda than the Paris Club terms. The Paris Club creditors did not make an issue of it because that simply would have exacerbated the debt-servicing problems of Tanzania and Zambia.

19. For example, in the United States, the Agency for International Development makes project loans and the Department of Agriculture sells surplus agricultural commodities to poor countries on highly concessional terms: repayment over 40 years, including 10 years of grace, with interest at two percent during the grace period and three percent thereafter. Military equipment has been financed under a variety of terms at different times. Currently, all military loans are at non-concessional rates of interest (linked to U.S. Treasury borrowing rates), but the repayment terms vary from six to thirty years. The Export-Import Bank generally makes loans on commercial terms, but can offer various concessions to meet competition from other export credit agencies. The Commodity Credit Corporation (CCC) supports agricultural exports strictly by providing guarantees on commercial bank credits up to a maximum of three years. While there should be a "reasonable assurance of repayment" for all these loans, there have been a number of occasions when this criterion was overridden by foreign policy considerations. The most prominent example may be the CCC credits

are at commercial rates, some have small subsidies, and some are at rates so concessional as to approximate grants. These differences suggest that terms of rescheduling by official creditors should be more generous than those offered by banks. Second, rescheduling interest obligations has tax, income and regulatory implications for banks that do not exist for government agencies. To reflect these differences, the concept of "comparable treatment" evolved. In essence, the debtor government agrees to seek a measure of relief from the banks that is as generous in the context of normal commercial lending as the relief offered by creditor governments in the context of their lending.

II. The Paris Club Process

Rarely does a country go to the Paris Club before trying other options first. One natural instinct when a country is beginning to strain to meet its debt-service obligations is to seek out a "friendly" creditor and try to negotiate a special deal. A country heavily dependent on official aid will ask its major donors to provide additional fast-disbursing grants or loans, or to shift the composition of their aid from project aid to balance-of-payments support. Debt-servicing difficulties are so widespread at the present time that almost all developing countries are getting some help of this kind from both multilateral and bilateral donors.[20]

A debtor country under pressure may also "preemptively" reschedule with its commercial bank creditors. Jamaica tried to do this in 1978-81. Debt-service obligations to official creditors were relatively small, and Jamaica's request for "rolling over" principal obligations to the banks was moderate. The banks accepted without questioning the need for a Paris Club rescheduling.

The important point is that a request for debt relief from official creditors generally comes at a point when the extra money required from creditors to stay current on existing debt becomes excessive *in the eyes of the creditors.* In effect, the creditors "blow the whistle." Implicitly, they are saying that the debt-servicing problem must be addressed by more adjustment and less financing. It is a point of principle, however, that creditors never tell a debtor

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provided to Poland in 1980. Recent military credits to Sudan and Zaire are another example.

20. An extreme example of this pattern is the decision by the U.S. Congress to increase grants to Israel from the Economic Support Fund for fiscal year 1984, with a rather explicit link to Israel's debt-service payments on military credits from the United States.

country to seek debt relief. The request for relief must be initiated by the debtor.

There are major frustrations for the creditor at this point in the process. The debtor seldom is reluctant to point out to the creditors that arrears could be avoided if a little more financing were provided. When export credit agencies begin paying off claims from private lenders whose loans they have guaranteed, there is a strong temptation for them to suggest to the debtor country that it seek debt relief. It is also natural for official creditors, when pressed for emergency balance of payments financing, to note the possibility of getting debt relief from commercial banks. Meanwhile, commercial bankers may be pointing out the possibility of getting debt relief from official creditors. Officials from the IMF and the multilateral development banks also may suggest that the time has come to request debt relief.

Once a debtor country has decided to seek debt relief, the normal procedure is for the country to contact the government of France regarding negotiations in the Paris Club. A debtor-country official stopping in Paris will generally find it easy to arrange a meeting (discreetly and on short notice) with an official in the French Finance Ministry to be briefed on the procedures of the Paris Club. If the country should prefer to begin with another OECD member, the country usually can find an official familiar with Paris Club procedures, but it is unlikely to find a member willing to provide debt relief outside the multilateral Paris Club framework. Alternatively, there are officials in the IMF and the World Bank who are familiar with the Paris Club and can respond to inquiries from debtor countries. Once the debtor country decides to go the Paris Club route, a formal request is sent to the Chairman for a meeting with official creditors.

In some respects "the Paris Club" is a misnomer, for it has no "members." Rather, it has "participating creditor countries." The Paris Club is less an institution and more an ad hoc procedure for renegotiation of debts owed to official creditors, normally under the chairmanship of a French Treasury official. There is no international secretariat funded by the creditor countries. Indeed, some creditors would argue that there is no secretariat at all; that the French officials who support Paris Club negotiations are violating the spirit of the procedure by calling themselves a secretariat. There have even been objections raised to the use of stationery with "Paris Club Chairman" in the letterhead.

The ad hoc character of the Paris Club reflects the creditor

point of view that debt rescheduling is an extraordinary event justified in only the most extreme circumstances. If the Paris Club were viewed as a permanent institution, it would be an admission that debt rescheduling is a normal financial transaction. This would undermine the concept of the sanctity of contracts, and would tend to encourage debtor countries to seek debt relief.

In principle, the Paris Club is open to any creditor country, and the Chairman invites all creditor countries that have significant exposure in the debtor country concerned to each negotiation. In practice, the creditor countries that have participated in Paris Club negotiations have been almost exclusively members of the OECD.[21]

A. *Preparation by the Debtor*

In theory, the debt-relief terms extended to a debtor country are not influenced by the form or content of the country's request for relief. They are determined strictly by an objective financial analysis of the country's ability to pay and by terms granted previously to other countries facing debt-servicing difficulties of a similar magnitude. In practice, however, the debtor country can place itself in a stronger negotiating position through thoughtful preparation.

Since the foundation of every negotiation is a financial analysis, the debtor country helps itself by providing the components of the analysis to the creditor countries at an early stage. The two principal components are a balance of payments forecast reflecting the results of the debtor country's new economic program and a detailed breakdown of outstanding debt and debt-service obligations.

The balance of payments forecast normally emerges from the

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21. Exceptions include Abu Dhabi which attended negotiations with Zaire in 1979, Israel (Ecuador, 1983), Argentina (Peru, 1983), Mexico (Costa Rica, 1983) and South Africa (Malawi, 1982). The Mexican case demonstrates that a country can appear in Paris Club negotiations both as a debtor and a creditor.

Another point of confusion is that some French-chaired multilateral debt-rescheduling negotiations are not called "Paris Club" negotiations: Turkey in 1979-80 rescheduled in a Working Party of the OECD's Consortium for Turkey; Poland rescheduled in a special creditors' meeting (1981); Mexico rescheduled at the OECD (1983). To the creditors participating in the negotiations, these have all been Paris Club negotiations in the large sense. There are only two reasons for calling them something else. First, the debtor country is afraid that going to the "Paris Club" will damage its creditworthiness or will create domestic political problems. Second, the creditors may anticipate some departures from conventional procedures or terms. They want to avoid creating a negative precedent for future cases, so they call it a non-Paris Club rescheduling. The best examples of the second approach are the rescheduling negotiations with non-IMF members: Poland (1981) and Cuba (1983). Since the traditional link to an IMF arrangement was not possible in these cases, some creditors felt more comfortable "changing hats" for these negotiations. It should be emphasized, however, that the basic "rules of the game" do not change when the creditors change hats.

negotiations with the IMF for a standby arrangement. But this creates a dilemma which has been a surprisingly important element in some of the negotiations in the 1978-83 period. The IMF staff would like to present to its Executive Board a balance of payments forecast that has no financing gap. At the same time, the creditors refuse to negotiate debt relief terms until there is an IMF arrangement in place. Thus, the IMF staff is faced with the choice of assuming the terms of debt relief to be offered (thereby closing the gap) or sending the arrangement to the Executive Board with a gap (to be closed by some combination of debt relief, new financing or additional adjustment measures). The creditors have a strong preference for the second approach, and are less willing to give the debtor the benefit of the doubt when they feel boxed in by the IMF.

The creditors also advance a conceptual point in favor of the second approach: the creditors as a group always have the option of giving more new money in lieu of debt relief. The form of financial support should not matter to the IMF as long as the total is sufficient to close the financing gap. Recognizing this inherent tension between the IMF and the creditors, the debtor can help defuse it by providing the IMF and the creditors with an accurate and complete accounting of the main components of the financial analysis at an early stage so the creditors have plenty of time to study it and prepare their positions.[22]

A principal issue regarding the preparation of a debtor country's request for relief is the use of outside advisors or consultants. The leading purveyors of this service are the investment banking "troika" consisting of Lazard Freres (Paris), Warburg and Co. (London), and Shearson Lehman/American Express (New York). For retainers that can exceed a million dollars, a financial consultant can: (1) prepare an economic memorandum on the debtor country tailored for the Paris Club similar to the economic memorandum routinely prepared for commercial banks; (2) undertake a major reconciliation effort to conform the debt records of the debtor country with the credit records of the creditor countries; and (3) provide tactical advice on negotiating in the Paris Club. The results of these

22. In the case of Zaire in 1983, the creditors asked for a "pre-meeting" with the debtor country to review (in the presence of IMF representatives) the country's new economic program, and to explain their reluctance to go beyond normal rescheduling terms. Because of uncertainties about how generous the creditors would be, the IMF Executive Board only granted conditional approval of Zaire's new standby arrangement for 1983-84. The standby arrangement became effective after the Paris Club negotiations with Zaire had been concluded and the IMF staff was satisfied that there would be no financing gap.

efforts have been mixed.[23]

B. Preparation by the Creditors

There are two major aspects of preparations by the creditors: exchange of data on debts subject to rescheduling, and the formulation of negotiating positions. The debt data aspect is one of the weak points of the Paris Club process. An example is the case of the negotiations with Brazil in November 1983. During the negotiations with the IMF in the summer of 1983, a carefully balanced package of debt relief and new financing from both official and private creditors was worked out. Based on information available to the Brazilian government, the payments subject to rescheduling in the Paris Club for the August 1983-December 1984 period were on the order of $2.3 billion, and this estimate was used to compose the package. When the creditors started exchanging information in September, there were early indications that the Brazilian estimate was low. By the time of the Paris Club negotiations, the creditors' own estimate was up to $3.8 billion. The large discrepancy in this case (as in most) was associated primarily with credits extended by commercial banks or other private lenders that were guaranteed by export credit agencies in the creditor countries.[24] While shifting these debts into the Paris Club category increased the total amount of debt relief *ceteris paribus* (because the Paris Club rescheduled interest as well as principal obligations), the negotiations with Brazil almost unravelled because some creditors pointed out that harder terms on a larger stock of debt would generate the same amount of relief, and others argued that the additional amount of debt relief provided under the proposed terms should count against the commitments of the new financing they had made.

Until 1981, there was a fairly relaxed attitude toward debt statistics and the routine was for each creditor-country delegation to provide data on its credits to the Paris Club "secretariat" on the first day of the negotiations. The secretariat would compile the submis-

23. The low point was reached in 1979 when a New York lawyer, after the terms had been accepted, took the microphone for a debtor delegation and began to haggle over specific dates and words. This was considered in bad taste by the creditors. Since then, the debtors' advisors have tended to stay out of the negotiating room. Another problem with "hired guns" is that creditors sometimes get the feeling that the money paid to the consultants is money that could better be used to service their debts.

24. The debtor countries in most cases are not aware of which credits from private lenders are guaranteed by an official export credit agency. The lenders and the guarantors prefer to keep the debtor in the dark out of concern that the debtor might assign a lower priority to repayment obligations associated with guaranteed credits if the debtor encounters debt-servicing difficulties.

sions and return the results on the second day, often after agreement on terms had been substantially completed. Currently, the French are requesting creditor data at the time invitations for the negotiations go out, and a table showing both creditor and debtor figures is circulated on the first day of the negotiations. It is often the case, however, that several of the creditors do not submit their data in advance and the table is incomplete, or there are very large discrepancies between the creditor and the debtor data. In the wake of the Brazil experience, a more intensive effort has been undertaken in special cases (e.g., the Phillipines and Argentina). In particular, the IMF has requested that creditors provide data in advance of concluding its standby negotiations with the debtor country in order to ensure that discrepancies are dealt with at an early stage.

It is too soon to say how successful these efforts will be. The difficulty on the creditor side is collecting information on guaranteed credits, which are relatively more important than direct credits in the major debtor countries like Brazil and the Philippines, compared to the smaller countries like Senegal or Cuba. The difficulty with guaranteed credits is that the guaranteeing agency may not know from day to day what has been loaned out and what has been paid. This is particularly true for short-term trade credits where there are many commercial lenders that operate under blanket guarantees; there are a large number of borrowers, and the export credit agencies will not pay out on claims until the relevant documents have been checked.[25]

The procedures for formulating a negotiating position vary considerably from country to country. The procedures of the U.S. government — which are probably more elaborate than most — are described here.

Beyond the collection and reconciliation of debt data, there is little a creditor can do until the IMF staff paper describing the debtor country's standby request is circulated to the IMF Executive Board. Copies are circulated immediately to the U.S. government agencies concerned, and intensive preparations begin. The first step is a financial analysis, done primarily by the Treasury Department, following a well-tested format. In brief, the balance of payments table in the IMF standby paper is adjusted and rearranged to highlight the foreign exchange available to meet debt-service obliga-

25. In the case of Mexico (1983), the U.S. Export-Import Bank estimated that there were 800 guaranteed exporters and 1,300 Mexican borrowers affected by its rescheduling. The bank's estimates of arrears and future payments subject to debt relief are in the $250-650 million range.

tions. The initial adjustment is to take debt-service payments out of the current account and the capital account. The current account, less interest, will have a positive or negative balance. To this are added capital inflows: direct investment, loan disbursements from official and private sources, short-term flows (including capital flight), net IMF financing, bridge loans, and reserve changes (a reserve buildup would be a negative entry). This sum represents the amount of foreign exchange available to meet debt-service obligations in the period under consideration (usually a year).

In a separate table, all debt-service obligations in the period are totalled, including arrears at the beginning. If the sum of the obligations exceeds the foreign exchange available, there is prima facie evidence of a situation of imminent default; the difference represents the ex ante financing gap. In a third table, the available foreign exchange from the first table is allocated by making different assumptions for the different categories of creditor. First, it is assumed that all obligations to multilateral development banks will be met. Next an assumption for debt relief by commercial banks is selected after reviewing reports on negotiations between the debtor country and the banks. The payments that must be made to the banks after the assumed relief are deducted from the remaining foreign exchange, leaving a residual amount for official creditors.

Next, the payments that would have to be made to the Paris Club creditors if relief were granted on the terms requested by the debtor are compared with the residual amount. If the two amounts are roughly the same, the analysis might stop here. If not, alternative terms are tested. An important lesson here is that it helps to focus more on what the debtor must pay after relief than on the amount of relief.

The objective at this stage of preparation is to identify the largest stream of payments to official creditors consistent with the projections underlying the IMF standby arrangement, without exceeding the parameters of a standard rescheduling.

Once the analysis has been completed, a position paper is prepared that provides some background information on the specific debt problem, states the objectives of the U.S. government in the upcoming negotiations, describes in detail the U.S. government credits subject to negotiation, summarizes the financial analysis, and sets forth negotiating limits for each of the major variables of a debt-relief package. This paper is formally circulated to the agencies concerned through the secretariat of the National Advisory

Council (NAC).[26] As it becomes necessary, the paper is revised in response to comments received from the agencies. There is a discussion of the negotiating position at a weekly meeting of the NAC Staff Committee, further revisions may be made, and then there is a formal vote on the negotiating position.

C. *The Negotiation*

The contrast with the London Club negotiations is striking. In the Paris Club there are no expenses billed to the debtor, no lawyers with briefcases full of legal documents, and generally it is all over within 36 hours.

A typical negotiation begins at ten o'clock. The Chairman welcomes the delegations and invites the debtor to make the opening presentation.[27] Following the debtor's presentation, there are statements by the IMF representative, the World Bank representative and the UNCTAD representative.[28] Most of these statements are typed up and circulated. After a coffee break, the creditor delegations have an opportunity to direct questions to the debtor country or to the IMF and the World Bank. The process is completed by one o'clock and the negotiations are suspended for lunch.

After lunch, the creditors caucus without the debtor to discuss the request. (Usually the IMF observer is invited to join the caucus and occasionally the World Bank observer.) The Chairman opens the caucus by inviting general comments, but as quickly as possible he begins a "tour de table" on the main variables of a rescheduling package. When the range of views has been expressed, the Chairman suggests an initial offer, generally consisting of the hardest po-

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26. The National Advisory Council on International Monetary and Financial Policies originated in the Bretton Woods Agreement of 1945. The Secretary of the Treasury chairs the NAC and other agencies that are members are the Departments of State and Commerce, the U.S. Trade Representative, the Federal Reserve Board, the Export-Import Bank, and the International Development Cooperation Agency (which includes as a subdivision the Agency for International Development (AID)). Other agencies that participate actively in the work of the NAC include the Departments of Agriculture and Defense, the National Security Council, and the Office of Management and Budget. The U.S. government's policy on reorganizing government credits to foreign countries was formally adopted in NAC Action 78-5 on Jan. 6, 1978.

27. The Chairman of the Paris Club from 1978 to 1984 was Michel Camdessus, who held the position of Director of the French Treasury at the end of his tenure as Paris Club Chairman. The Chairman himself presided only over the most important negotiations, such as the Brazil negotiations in 1983. In the 1978-83 period, less important negotiations were conducted by less senior officials, such as Philippe Jurgensen, who chaired the negotiations with Zaire, and Jean-Claude Trichet, who chaired the negotiations with Senegal.

28. For Latin American debtors, the observer from the Inter-American Development Bank generally makes a statement. Observers from other international agencies such as the European Investment Bank and the OECD are usually silent observers.

sition proposed for each variable. A coffee break is taken, and during the break the Chairman meets privately with the debtor to describe the initial offer. In most cases, the initial creditor offer is much harder than the terms requested by the debtor, and consequently the package is rejected. When the caucus resumes, however, the Chairman should be able to give the creditors a sense of which variables the debtor is most concerned about. The Chairman may suggest an alternative proposal, and another "tour de table" will firm it up, sometimes with an understanding that one or two delegations are not prepared to accept one variable or another. If it is after six o'clock and no contentious issues have surfaced, the caucus will adjourn for the day and again the Chairman will meet privately with the debtor to communicate the second offer, making it clear to the debtor that the creditors have very little room to maneuver at this point.

The next morning the Chairman reports the debtor's reaction to the creditor caucus. There may be some more "fine tuning," but generally agreement in principle is reached before noon. In the meantime, the "secretariat" has produced a first draft of the "Agreed Minute" for creditors to review. Eighty percent of the typical minute is boilerplate, so it is possible (with the help of word-processing equipment) to have agreed texts by one o'clock. To encourage the participants, a formal lunch is offered in a dining room at the conference center for all delegations as soon as the Agreed Minute is signed. (A French touch that is quite effective.) As the final act before lunch, the plenary meeting is resumed, the Chairman summarizes the agreement, the debtor acknowledges it, pleasantries are exchanged, and the texts are signed.

Two side-notes merit attention. First, the Chairman always speaks in French; most of the creditor delegations use English. The debtor may use a native language or French or English. Simultaneous translation into these three languages can be provided. The text of the Agreed Minute is done in both French and English. Second, the debtor country delegation is generally led by the Finance Minister or another senior official. The creditor delegations generally are led by an official at the senior staff level in the finance or economics ministry. (The U.S. practice since 1978 of having a head of delegation who is a sub-ministerial official from the foreign ministry is quite unusual.) Many creditor delegations have only one or two members. The largest might have six or seven members including representatives from the export credit agency, other lending agencies, the foreign ministry and their Paris embassy. The debtor delegation is often larger than any creditor delegation.

III. The Rescheduling Variables

Nine rescheduling variables are discussed in this article, but it is possible to have a longer or shorter list by subdividing some and adding others of less importance. Not all variables are equal, and naturally the creditors feel more strongly about some while the debtors feel more strongly about others.[29]

A. Eligible Credits

All credits extended by official creditors or guaranteed by them are subject to rescheduling in the Paris Club, but generally several categories are excluded. This is an important technique the creditors use to reduce the amount of debt relief provided. The first category to be excluded is short-term credits (original maturity of one year or less). The creditors want to exclude these because the processing of short-term credits is extremely time-consuming, since most are guaranteed. The debtors usually are willing to exclude these because they recognize that renewal of short-term credit lines will be interrupted if they are rescheduled and that this will adversely impact on their recovery efforts.

In a number of cases, credits to private sector borrowers which are extended *without* a guarantee by the debtor-country government are excluded. This is always done in cases where there is a convertible local currency, such as in Franc-zone countries in Africa, and in Liberia which uses the U.S. dollar. In these countries, private sector borrowers do not face an inconvertibility problem; their commercial operations generate a currency that is acceptable to foreign countries in payment of their obligations, or convertibility is guaranteed. In one or two cases, rescheduling of private sector debt has not been "necessary" and excluding it from the rescheduling was seen as a means of preserving the creditworthiness of these borrowers.

Where creditors have extended debt relief under a previous Paris Club agreement, payments due under the earlier agreement (known as previously-rescheduled debt or PRD) are excluded. Though this is a point the creditors feel very strongly about, in several important cases PRD has been rescheduled.[30]

Occasionally credits to a specific borrower are excluded, such

29. The procedures of the Paris Club for dealing with these variables have evolved by and large in an ad hoc fashion. In recent years, however, the French have tried to be more systematic and have held a series of "methodology" meetings to discuss ways of dealing with specific negotiation or implementation problems, such as the participation of non-traditional creditors, the formula for calculating grace and repayment periods, and comparable treatment of commercial banks.

30. Most notably in the cases of Turkey (1980), Sudan (1983) and Zaire (1983).

as credits for a regional aviation facility that happens to be located in the debtor country. There have also been heated debates among creditors about the treatment of credits repayable in kind or credits being serviced out of an off-shore payments facility or escrow account.[31] Generally, the view has prevailed that equivalent debt relief must be provided by creditors that have specific reasons for wanting to exclude such credits. This is one of the dark corners of Paris Club rescheduling. It is an area where creditors can take actions that undermine the purpose of the exercise.

B. Contract Cut-off Date

After a country begins experiencing critical debt-servicing difficulties, any creditor that makes a loan to the country is doing other creditors a favor. This is the reason for having a contract cut-off date. Eligible credits signed after the specified contract cut-off date are expected to be serviced in full on schedule. Thus, the creditors tend to push for an earlier contract cut-off date and the debtor for a later one. By convention, the cut-off date is January 1 of the year in which the rescheduling agreement is negotiated, but this can be moved without too much resistance from creditors up to the first day of the consolidation period.

The major issue involving this variable arises in serial reschedulings. The "rule" of the creditors is to keep the original contract cut-off date in all subsequent reschedulings. This is especially important in cases where official creditors have contributed to a multilateral package of new credits in support of the debtor's economic program. In several recent cases, however, where the financing gap has been especially large the creditors have preferred to move up the contract cut-off date in lieu of rescheduling PRD, capitalizing interest, or promising new credits.

C. Treatment of Arrears

To discourage the accumulation of arrears and encourage debtors to address their problems at an earlier stage, the creditors generally have rescheduled arrears on less favorable terms to the debtor than consolidated debt.[32] The "as of date" selected is generally the

31. For example, some export credit agencies made loans to Zaire's parastatal mining company which were to be serviced out of dollar accounts in New York into which proceeds of certain copper exports were deposited.

32. Another concern is that arrears often exist on short-term credits. If these are rescheduled over the same period as medium- and long-term credits, then a three-month credit might be transformed into a twelve-year credit. For some creditors, this is worse than extending a ten-year credit into a twenty-two-year credit.

day before the consolidation period. The creditors try to get the arrears repaid within a year or two, or at least before the end of the grace period. If necessary, however, arrears will be rescheduled on the same basis as consolidated debt.

D. Consolidation Period

Official creditors will not restructure the entire outstanding indebtedness of a debtor country seeking debt relief, as commercial banks sometimes do. In the first place, some official credits have very long maturities, as long as 50 years. It does not make financial sense to defer a payment due 50 years from now. In the second place, official creditors prefer a "short-leash" approach because they are more exposed to criticism (from parliaments and taxpayers) over their debt-relief decisions. Consequently, official debt relief normally extends to debt-service payments on eligible credits that fall due during a limited period of time, commonly referred to as the "consolidation period." The practice of the Paris Club is to limit the consolidation period to one year, roughly coinciding with the period of the debtor's IMF standby arrangement. The consolidation period can be stretched back in time to simplify the rescheduling by picking up arrears, or to begin on the day after the end of the consolidation period in a previous rescheduling.[33] The consolidation period can also be stretched forward by several months, but the Paris Club has never rescheduled a full two years of payments at one time.[34]

In the 1978-83 period, eight reschedulings were done on a "one-plus-one" basis where a second year of relief on exactly the same terms as the first was granted to the debtor, conditional upon the debtor having an IMF standby arrangement covering the second year of relief and being able to draw under it. And there was one case where three consecutive years of relief were granted with an IMF link: Turkey in 1980. The practice stopped because several of the countries obtaining such arrangements failed to meet the IMF condition. In these cases, the creditors found it difficult to withhold the second year of relief. The lesson is that creditors cannot effectively take back debt relief once it has been granted.[35]

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33. At the London Summit in 1984, a commitment was made to provide "multi-year" rescheduling to countries successfully adjusting in cases where commercial banks also were prepared to provide multi-year relief.

34. Paris Club agreements are always careful to specify that the terms only apply to payments due "and not yet paid." This means that payments made in full on schedule after the beginning of the consolidation period do not have to be reimbursed by the creditors.

35. A debtor, however, can give back relief it has received. This has happened only once, in connection with the 1978 rescheduling with Peru.

The length of the consolidation period may be the most controversial variable in Paris Club reschedulings. Debtors invariably seek a "multi-year" rescheduling covering payments falling due over two or three years. Creditors have remained firm at seeking roughly one year. They do not want to give up the leverage of a new round of negotiations (and a new IMF standby) for debtors that are adjusting too slowly. And they believe the vicissitudes of the international economic scene are too great to make it possible to determine how much debt relief will be needed beyond the next year.

E. *Including Interest Payments*

Official creditors are more willing to reschedule interest payments than banks for several reasons. First, they are not constrained by regulators and do not have to make special provisions for loans made to borrowers unable to meet interest payments. Second, while it is relatively easy for banks to make new loans, governments often must go to legislatures for authority to make new loans and may obtain the authority at the expense of lending to some other (more creditworthy) country.[36] Third, rescheduling interest is one way the official creditors can compensate for the fact that their lending is influenced by non-commercial motives and may be more costly than commercial lending because it is procurement-tied or currency-tied or inconsistent with the economic value received. From the creditors' perspective, then, rescheduling interest payments is a low-cost concession, and that is why it has been done in the majority of cases in the 1978-83 period. Nevertheless, the financial principle still applies: if there is not an analytical basis for rescheduling interest, only principal is rescheduled.

36. The natural assumption is that debt relief is additional to normal flows of financing. In the case of the U.S. Agency for International Development, this is so because loan repayments go to the Treasury and not to the Agency. Consequently, shortfalls in receipts due to debt relief or arrears do not affect the Agency's lending level. In the case of the CCC, however, a lower level of reflows means that the CCC will be able to do less lending unless its overall lending ceiling is raised by the Congress. Where reflows affect new lending levels, individual agencies are tempted to reduce new lending to a country receiving debt relief in order to avoid offsetting reductions in lending to other countries. A related issue in the United States is that debt relief is provided outside the appropriations process. Since financial assistance to a particular country can be increased through debt relief far beyond the levels envisioned by the Congress, the Executive Branch must be very careful to ensure that debt relief is only granted in situations of imminent default where conditionality and burden-sharing have been obtained.

F. Percent Consolidated

One of the mysteries of the Paris Club is the distinction between consolidated and non-consolidated debt. The distinction may have arisen in some early reschedulings where it was not necessary to reschedule the full amount of the payments falling due in the consolidation period. The portion that was rescheduled became known as the consolidated debt (because payments under many different loans were "consolidated" within a single rescheduling agreement). The portion that was not rescheduled was to be paid according to the terms of the original contracts and therefore was called non-consolidated debt. Confusion was introduced in some relatively recent reschedulings when these non-consolidated portions were also consolidated, with a shorter deferral of repayment than for consolidated debt.[37]

Creditors have worked hard to draw the line at a consolidation percentage of 90%, but they had to yield in the 1983 negotiations with Sudan, Cuba and Zaire. By contrast, creditors became quite generous in the 1978-81 period by stretching out non-consolidated debt over the grace period. Since then, they have insisted that relatively larger amounts be paid by the end of the consolidation period.

G. Repayment Terms

After the consolidation period, the most controversial variables in Paris Club reschedulings are the grace and repayment periods. Debtors naturally want longer grace and repayment periods, and the problems being experienced with serial reschedulings at the present time raise doubts even in the creditors' minds about the conventional repayment terms. A three-year grace period followed by a

37. The confusion may be alleviated by using an example. The sum of principal and interest payments on eligible credits falling due during the consolidation period might be $20 million. If the creditors agree to a 90% rescheduling, the consolidated debt amounts to $18 million and the non-consolidated debt to $2 million. Repayment of the $18 million might be deferred for nine years, including a three-year grace period, and the $2 million non-consolidated portion might be deferred for three years with no grace period. But the non-consolidated portion might be split three ways. One quarter of the non-consolidated debt, or two and one-half percent of the total debt ($500,000) would be due on schedule according to the original contracts. Another quarter would be due on the last day of the consolidation period. The remaining one-half would be due in two tranches, 12 months and 24 months respectively after the end of the consolidation period. There is also confusion surrounding the term "downpayment." Very loosely, it is synonymous with non-consolidated debt. More narrowly defined, it refers to any repayment of rescheduled debt due before the end of the consolidation period, or the portion that must be paid according to the original contracts. Most narrowly, it is a portion of the arrears that must be paid off at the beginning of the consolidation period, or as soon as bilateral implementing agreements are signed.

four-year repayment period ("three plus four" in the trade) is generally available to any debtor that goes to the Paris Club. The sticking point for the creditors is five years of grace and seven years of repayment. Only in the special case of Sudan have creditors been more generous, and it is possible that giving Sudan sixteen years (six plus ten) was a mistake.[38]

H. Interest Rates

Another surprise to the uninitiated is that Paris Club reschedulings do not involve negotiations over interest rates.[39] The one immutable variable in Paris Club negotiations to date is that interest rates are negotiated bilaterally. This means that each creditor can charge different interest rates. The rationale is simple: interest rate structures and practices vary substantially among creditors. If a single rate is negotiated, this will lead to a windfall for some and a penalty for others.

The practice does not seem to lead to inequitable treatment among creditors. In part this may be due to the convention that concessional rates of interest are charged on credits that had concessional rates when they were originally extended, and market-related rates are charged on rescheduled non-concessional credits.[40] In

38. There is another point of confusion worth mentioning here: the starting point for counting grace and repayment periods. The logic is dubious and the bias is wrong, but the present practice of the Paris Club is the following. The grace and repayment periods are measured from the middle of the consolidation period. Take a "three-plus-four" arrangement with a consolidation period covering calendar year 1983. According to the present Paris Club "methodology," the grace period ends on Dec. 31, 1986, when the first of eight semiannual installments of principal must be paid, and the final payment is due on June 30, 1990. The extra six months in the grace period are necessary, when repayments are semiannual, to make the three-plus-four add to seven. Other methods of calculation are equally valid, and these account for the fact that the same arrangement will be described as a three-plus-four rescheduling by one source and a three and one-half plus three and one-half rescheduling by another source. These various distinctions appear to have evolved as a means of camouflaging a more generous repayment schedule. It is possible to drop the distinction between consolidated and non-consolidated debt and simply work out a schedule of repayment as follows: two and one-half percent on schedule, two and one-half percent at the end of the consolidation period (end of Year One), two and one-half percent at the end of Years Two and Three, eighteen percent at the end of Years Four through Nine. But this would eliminate one of the central mysteries of the process.

39. The interest charged on rescheduled payments, which often include interest payments, commonly is referred to as "moratorium interest."

40. Some creditors actually "negotiate" the interest rate with the debtor country. The long-standing practice of the United States is to charge the same rate to all debtor countries for each credit program. For AID and P.L. 480 loans, the moratorium interest is the average of the outstanding loans, generally between two and three percent, fixed for the period of repayment. For military credits, the rate is calculated in the same fashion but it is currently in the ten to twelve percent range because the original credits were at non-concessional rates. For Export-Import Bank loans, the rate is adjusted every six months to reflect the current

part, treatment is similar because the debtor can refuse to begin repayment until an acceptable interest rate is offered. This is another dark corner of the Paris Club. It would be useful to have a clearer picture of the current practices of the major creditors.

I. The De Minimus *Level*

Minor creditors do not have to provide debt relief since the major creditors accept that the smaller ones will receive full payment on schedule. The question is where to draw the line between major and minor creditors. The starting point is SDR[41] one million of rescheduled debt. All creditors over this limit are considered major creditors. In smaller debtor countries, however, the *de minimus* level is reduced to SDR 500,000 or even SDR 250,000 (in the case of Sierra Leone in 1984, for example). Creditors that are *de minimus* may attend the Paris Club negotiations as observers (and can be quite vocal in the creditor caucus), but they do not sign the Agreed Minute.

J. Boiler Plate

In addition to setting forth the rescheduling variables, Paris Club Agreed Minutes contain numerous "boiler plate" paragraphs. The most interesting are described below.

Non-discrimination Clause. The debtor agrees to extend to all participating creditors "treatment not less favorable" than that provided to any non-participating creditor on similar credits. This is in effect a most-favored-nation provision directed at developing country and eastern-bloc creditors.

Comparable Treatment Clause. The debtor agrees to seek "comparable treatment" from private creditors on similar credits. This is to avoid a situation where official creditors are "bailing out" commercial banks. This clause was invoked in the case of Zaire after the 1976 and 1977 reschedulings. It is enforced by a refusal by the official creditors to extend further relief until comparable treatment has been obtained. It is extremely difficult, however, to measure comparable treatment in a specific situation. This may be another weak point in the Paris Club process.

Goodwill Clause. In cases where the debtor is anxious to have

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borrowing costs of the agency. For CCC loans, the rate is adjusted at the beginning of each calendar year to reflect the rate at which the agency "rolls over" its outstanding indebtedness to the Treasury Department.

41. The SDR (special drawing right) is both the unit of account and principal financial asset of the IMF.

assurances that creditors will grant further debt relief after the agreed consolidation period, and the creditors suspect more relief will be needed, a "goodwill clause" may be included in the Agreed Minute. Varying degrees of goodwill can be expressed. In the most limited form, the creditors will agree to meet "to consider" the debtor's request for further relief if it meets various conditions (especially having an IMF arrangement in place for the new consolidation period). The most generous form of a goodwill clause is the one included in the Agreed Minute with Peru in 1983. There the creditors agreed to grant a second year of relief on the same terms as the first year, except for the percent of payments to be consolidated, subject to the obvious conditions.

Settlement Date. A date is usually fixed three months after the Agreed Minute is signed, by which time the debtor should have eliminated any arrears on payments *not* rescheduled in the Agreed Minute.

Bilateral Signature Date. Similarly, a date is set about six months after the Agreed Minute is signed by which all bilateral implementing agreements should be signed.

Exchange of Information. The debtor agrees that the IMF will keep the Paris Club Chairman informed of the status of its standby arrangement. The creditors agree to inform the Paris Club Chairman of the date of signature of their bilaterals, the amounts rescheduled thereunder, and the interest rates set. They also agree to provide to other participating creditors upon request copies of their bilateral agreement with the debtor.

K. Implementation

Unlike a London Club agreement, a Paris Club agreement is not the conclusion of the rescheduling process. It is only an umbrella or framework agreement signed *ad referendum* by the heads of delegation who have agreed to recommend to their respective governments the terms negotiated.

To give the rescheduling agreement the force of law, bilateral agreements between the debtor country and each of the participating creditor countries must be executed.[42] For some countries, including the United States, a third step is required: implementing agreements with each individual creditor agency.

42. In the case of the United States, each bilateral agreement must be provided to the foreign relations and appropriations committees of the Congress 30 days before it goes into effect, and the effective date is the day the State Department notifies the debtor country that the agreement complies with all U.S. laws.

There is considerable diversity in the practices of creditors following the conclusion of a Paris Club agreement. Some creditors quickly draft a bilateral agreement and submit it to the debtor for signature. Others are notoriously slow. Some skip the bilateral stage and simply present agency implementing agreements. Others combine the two into a single agreement. Some creditors actually send officials out to the debtor country to negotiate the bilateral agreement, and occasionally the debtor country is able to obtain further concessions from individual creditors.[43] Other creditors prefer to sign in their own capitals. Sometimes the bilateral agreements for an initial Paris Club agreement are signed in Paris on the eve of a follow-up negotiation.

Even more variations are encountered at the final levels of implementation. For example, some agencies, such as the U.S. Agency for International Development, provide debt relief through a rescheduling agreement modifying the terms of the original loan agreement. Others provide relief through a "refinancing credit" that leaves intact the schedule of payments under the original credits. Some creditors may wish to exempt a particular credit from rescheduling and provide equivalent relief by "over-rescheduling" other credits.[44]

A chronic problem in the implementation phase is the accumulation of arrears on newly rescheduled debt. The problem is aggravated by delays in concluding bilateral and agency-implementing agreements, since debtors have an excuse for not paying anything on the rescheduled debt until these are signed. In the 1983 Paris rescheduling with Zaire, a new procedure was introduced. After reaching agreement on the rescheduling terms, a careful calculation was made of the payments that would have to be made to the participating creditors during 1984. The total was divided by 12 to arrive at an amount of foreign exchange to be deposited by Zaire at the end of each month of 1984 into an account at the Federal Reserve

43. "Non-discrimination" between official creditors is a one-way street. If the debtor gives preferential treatment to one creditor, all the others are entitled to the same treatment. If a creditor gives more favorable terms to a debtor, however, the other creditors are not required to follow suit.

44. Some implementing agreements of export credit agencies extend the repayment procedures to the unguaranteed portion of private loans, as a convenience to the private lenders. In other cases, export credit agencies buy out loan amounts outstanding at the end of the consolidation to save themselves the trouble and expense of processing claims a year later if further debt relief is anticipated. In the 1978 rescheduling with Peru, loans guaranteed under the Housing Investment Program were excluded from the U.S. bilateral implementing agreement. In return, an equivalent amount of extra debt relief was provided on AID loans.

Bank of New York. As bilateral agreements are concluded, amounts due under these agreements may be drawn out of the special account. This arrangement is not intended to give official creditors preferential access to the debtors' foreign exchange resources. It is simply an administration procedure that helps assure that full payment will be made on newly-rescheduled debt. It also provides monthly evidence that Zaire is adhering to the economic program negotiated with the IMF that was the quid pro quo for debt relief. The new procedure is especially attractive in the case of countries that have demonstrated a chronic inability to service debts on schedule. (It has been duplicated in several cases in 1984.)

IV. CONCLUSION

The Paris Club system works. There have been more than 65 Paris Club agreements completed since 1956, and given the amounts involved, the conflicting interests of debtors and creditors, and the differing views among creditors, it is remarkable how smoothly the negotiations proceeded in all but a few cases.[45] It also is remarkable how little time, effort and expense has been involved in these negotiations.

The system, of course, could work better, perhaps through institutional reform. With negotiations at the rate of one a month, the pressures for giving the Paris Club process a more permanent form have increased. The high incidence of rescheduling, however, is not a permanent feature of the international economic landscape. It is hard to imagine any kind of institution that would be efficient handling only two to three negotiations per year. One small anomaly is the role of the French government. The Chairman of the Paris Club, during the 1978-83 period, Michel Camdessus, performed his role with distinction, but one of his predecessors was controversial. Perhaps it would be useful to consider other nationalities for this position. An American chairman can be ruled out because the United States is too often the largest creditor, and would not be considered sufficiently impartial by either the creditors or the debtors. A chairman from one of the smaller European creditor countries might be most appropriate.

Another suggested improvement is to get broader creditor participation, especially among developing and eastern-bloc countries. Yet, while appealing on the surface, experience suggests that both

45. In the 1978-83 period, 40 Paris Club agreements were concluded with 23 different countries. The amount of debt rescheduled was approximately $22 billion, of which more than $4 billion was rescheduled by the U.S. government.

sides are better off with an OECD-oriented group of creditors. The debtors seem to get better terms on their own from non-participating creditors, and having a larger number of creditors with more diverse interests would prolong and complicate the negotiations.

Combining the Paris Club with the London Club is a popular idea with developing country spokesmen. It does not appeal to anyone who has been involved in the process, for debt rescheduling procedures, to be effective, must be flexible and fast. Both of these features of the present approach would be sacrificed if the London and Paris Clubs were combined.

The Paris Club is also feeling a great deal of pressure on the terms of rescheduling arrangements. The negotiations could be completed more expeditiously and serial negotiations presumably would be less frequent if creditors were prepared to grant more generous terms. There are costs, however, to being more generous to all debt-relief candidates. First, it weakens the incentive for debtors to avoid debt-servicing difficulties, makes it easier for them to delay necessary adjustments, and makes the pain of adjustment more severe when it eventually is undertaken. Second, it discourages creditors from new lending. If lending is discouraged, this means that global output will be less than it could be. External borrowing is an important source of financing economic growth in the developing countries. It is hard to imagine any less-developed country becoming a newly-industrialized country without an increase in external borrowing. Even if a country does not borrow for investment, rising levels of trade will be reflected in rising levels of trade credit, which would be recorded as an increase in external debt.

The Paris Club process for rescheduling debt owed to official creditors will continue to evolve. Far-reaching institutional changes are unlikely, but there should be steady improvements in some areas: exchanging debt data in advance of negotiations; better coordination with the IMF; a clearer understanding of which multilateral lending institutions should be exempted from rescheduling; a better grasp of what constitutes "comparable treatment" between official creditors and commercial banks; and some rules of thumb for equitable burden-sharing among official creditors.

Within the next five years, only two major breakthroughs seem likely. The first relates to the treatment of countries like Sudan that seem to have no chance of becoming current on their existing stock of external debt. At some point, the creditors will decide that a long-term "workout" arrangement is better than coming back year after year to reschedule what already has been rescheduled. It will

be interesting to see whether the creditors are able to hold off doing this until the debtor country has a sound set of economic policies, and then whether they defer the outstanding debt without charging moratorium interest (as was done in the Indonesian workout of 1970) or capitalizing moratorium interest.

The second breakthrough depends on the evolution of the global economy. If the present economic recovery stalls before most of today's debt-relief candidates have reestablished their creditworthiness (by having sustainable current account deficits and satisfactory rates of gross national product growth at the same time), then the pressures for some form of generalized debt relief may become irresistible. In its mildest form, this could come through a decision by the OECD countries to reschedule automatically all outstanding aid loans to low-income, developing countries. A stronger form would expand the coverage to official export credits (direct and guaranteed), or include all developing countries as beneficiaries. The most sweeping form would be a decision by official creditors to buy out commercial bank debt to developing countries and reschedule it on favorable terms. Yet allowing this extreme situation to materialize would be a major misfortune, since it would represent the failure of the various parties involved to deal with debt problems constructively. Moreover, it probably would condemn both debtors and industrial-country creditors to an extended period of economic stagnation.

The experience of the last five years demonstrates a high degree of flexibility by creditors and an appreciation by debtors that the easy solutions in the short run are not the best in the long run. This author's personal assessment is that the odds are strong that the world will muddle through the current "debt crisis" successfully.

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The Problems Posed by Negative Pledge Covenants in International Loan Agreements

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The Problems Posed by Negative Pledge Covenants in International Loan Agreements

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In the summer and fall of 1982, many events seriously and adversely threatened to affect the recovery of the United States and the world economy. The heavy indebtedness of a significant number of developing countries and the related exposure of the commercial banking system of the industrialized world had placed strains on the international financial system. These strains could be traced in part to the two massive oil price increases of 1973-74 and 1979-80 which increased substantially the current account deficits of many oil-importing countries. Moreover, current account deficits of many developing countries, including oil-exporters, increased sizeably during this period as a result of the pursuit of policies of rapid domestic economic growth. As commercial banks increasingly served as intermediaries in the balance of payments financing process, these deficits were financed largely by expanding international bank lending. During the 1970's, however, rising world inflation and low, or even negative, "real" interest rates made these increasing debt burdens appear to many to be manageable.[1]

Unfortunately, the second large increase in oil prices, the slowdown in the world economy, and the rise in interest rates in the late 1970's and early 1980's all contributed to high levels of borrowing by a number of countries and made expansionary economic policies unsustainable. While there have been occasions in the recent past when the financial strains of particular countries have been so se-

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1. *International Financial Markets and Related Problems: Hearings Before the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 1st Sess. 41 (1983) (statement of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System) [hereinafter cited as *Hearings*] and *International Debt: Hearings Before the Subcomm. on International Finance and Monetary Policy of the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong., 1st Sess. 240 (1983) (statement of Paul A. Volcker).

vere as to necessitate restructuring of their debt and adoption of comprehensive economic adjustment programs, the situation that emerged in 1982 was unique in its scope and potential effects. The individual economic and financial difficulties of several major debtor countries occurred at the same time, and threatened to spread to others.[2]

The potential for cascading liquidity pressures, undermining the stability of the international financial systems, was of particular concern to the U.S. Federal Reserve and to other governmental monetary and financial authorities. As stated by Chairman Paul A. Volcker in February 1983:

> The international financial system is not separate from our domestic banking and credit system. The same institutions are involved in both markets. A shock to one would be a shock to the other. In that very real sense, . . . [w]e are talking about dealing with a threat to the recovery, the jobs, and the prosperity of our own country, a threat essentially without parallel in the postwar period.[3]

In the summer and fall of 1982, the U.S. government developed a comprehensive program to manage and diffuse these serious strains to the international financial system. The plan involved actions by governments, private lenders and international institutions. Each phase of the program was integral to the whole, involving the following cooperative measures.

First, central banks and monetary authorities should provide short-term bridge financing until other sources of financing could be arranged for the countries experiencing serious difficulties with their balance of payments. In each case, this bridge financing would be provided to encourage development by the country of an economic adjustment program with the International Monetary Fund (IMF) to deal with the country's fundamental balance of payments problems.

Second, once short-term bridge financing has been provided, the debtor country should adopt an IMF or other adjustment program.

Third, private banks should then restructure the debts of sovereign and private borrowers in the country while providing the needed financing.

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2. *Hearings, supra* note 1, at 41. The diversity of the particular economic problems of the individual countries, and the corresponding need to manage the "debt problem" on a pragmatic case-by-case approach, is discussed in *Problems of the International Debt: Hearings Before the House Comm. on Foreign Affairs*, 98th Cong., 2d Sess. (Aug. 8, 1984) (statement of Paul A. Volcker).

3. *Hearings, supra* note 1, at 66 (testimony of Paul A. Volcker).

Fourth, the United States and other foreign governments should initiate a major replenishment of IMF resources by increasing IMF quotas and levels of the IMF's General Arrangements to Borrow.

Finally, creditor countries such as the United States should initiate a program for strengthening domestic supervision of international lending and for more effectively coordinating that supervision internationally.[4]

The first, critical stage in this program called for government monetary authorities to provide emergency short-term financing to borrowing countries with major debt burdens while other sources of financing and economic adjustment policies could be put into place. In 1982 and 1983, short-term bridge financing was arranged by central banks and monetary authorities for four major borrowing countries — Mexico, Argentina, Brazil and Yugoslavia — in amounts upwards of $5 billion.[5] The provision of this essential bridge financing almost was precluded, however, because of the widespread use of negative pledge covenants in both official and private international loan agreements with sovereign borrowers. The needed central bank funding was forthcoming only with some innovation and considerable international cooperation.

The lesson drawn from this experience is that unrestricted negative pledge covenants, as commonly used in international loan agreements, can seriously damage the interests of both the sovereign borrower and the lender, to the ultimate detriment of the international financial system.

I. The Nature and Scope of Negative Pledge Covenants

Customarily, international loan documents provide that the borrower shall not create liens or charges on its assets or revenues in favor of other creditors. If such a security interest is provided to one creditor, the second creditor shall share equally in the security.[6] Violation by the borrower, like a breach of any other major covenant, typically is considered an event of default under the loan agreement. These "negative pledge" or "pari passu" clauses are a common fea-

4. *See supra* note 1.

5. For a discussion of several of these financing arrangements, see *Hearings*, *supra* note 1, at 80-83 (testimony of Paul A. Volcker).

6. For a discussion of negative pledge clauses in international loan agreements, as well as sample clauses, see generally G. DELAUME, LEGAL ASPECTS OF INTERNATIONAL LENDING AND ECONOMIC DEVELOPMENT FINANCING 251 (1967). For a discussion of negative pledge covenants in the domestic context, see generally McDaniel, *Are Negative Pledge Clauses in Public Debt Issues Obsolete?*, 38 BUS. LAW. 867 (1983).

ture in certain domestic financings,[7] and are a long-standing feature of international loan agreements.[8]

Developments in the use of these covenants in the last decade largely contributed to the problems now faced by central banks in arranging short-term financing packages for developing country borrowers. Virtually *all* developing country borrowers are now affected because these clauses are standard in all World Bank loans[9] and are contained in private jumbo syndicated loans, which are an increasingly prevalent form of financing sovereign debt.[10] Further, the breadth of these restrictive covenants has increased so that essentially all the assets and revenues of the sovereign borrower and its agencies and instrumentalities are affected, virtually any arrangement giving another creditor a preferred status is restricted, and few, if any, exemptions from application of the negative pledge clause are provided by contract.[11]

A typical negative pledge clause of the broadest scope found in these syndicated loan agreements reads as follows:

> The Borrower will not enter into any arrangements with respect to any External Indebtedness or other obligations currently outstanding or hereafter incurred which arrangements would have the effect of placing any creditor in a position of preference (by means of any Encumbrance or any preferred arrangement of any kind) over the Lender with respect to the availability of any of the assets of the Borrower for the satisfaction of its indebtedness to the

7. *See* McDaniel, *supra* note 6, at 867; AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURES 349 (1971); AMERICAN BAR ASSOCIATION, TERM LOAN HANDBOOK 155 (J. McCann ed. 1983).

8. For example, negative pledge covenants are contained in: the General Bond of the German Government International 5½% Loan of 1930 (the Young Loan); the World Bank Twenty Year Bonds of 1962, issued in the United States; and the Compagnie Francaise des Petroles, Paris 4½% Loan of 1963, issued in Switzerland. G. DELAUME, *supra* note 6, at 251.

9. For information on the large number of developing countries in which World Bank loans are currently outstanding, see WORLD BANK ANNUAL REPORT 1983 (1984) (and prior years).

10. For a discussion of the increased use of syndicated loans, see, for example, Bee, *Syndication*, in OFFSHORE LENDING BY U.S. COMMERCIAL BANKS 151 (F. Mathis ed. 1975). For data on the increase in 1973-82 of developing country debt to foreign banks, see *Hearings*, *supra* note 1, at 69. For a discussion of increased loan syndications, see generally BANK FOR INTERNATIONAL SETTLEMENTS, ANNUAL REPORT, for years 1974-82, particularly chapters relating to the international credit and capital markets.

11. The World Bank typically has two types of exemptions from the application of its negative pledge covenants: purchase money mortgages and liens arising in the ordinary course of business and securing short-term debts. Delaume, *supra* note 6, at 255. While the former exemption is used on occasion by private creditors in international loan agreements, the latter exemption is not common.

> Lender hereunder except that the Borrower may create, without being required to extend the benefits of the same to the Lender, any Encumbrance over any assets acquired by the Borrower after the date of this Agreement to secure the payment of the whole or any part of the purchase price of such asset or financing obtained for the payment of the purchase price of such asset. For purposes hereof "External Indebtedness" shall mean indebtedness which is payable in a currency other than [local currency] or is payable to any person, firm, corporation or other entity resident or having its head office or chief place of business outside the [country of the borrower].

Moreover, a typical broad definition of the assets of a sovereign borrower includes:

> assets of the Borrower or any of its political subdivisions or of any agency of the Borrower or of any such political subdivision, including the [name of central bank] or any institution performing the functions of a central bank.

Application of these clauses precludes the central bank of a debtor country from entering into any arrangements by which foreign monetary authorities are given a legal preference over other creditors, even when the debtor country is seeking short-term emergency financing.

II. Effect on Central Bank Financing

As indicated earlier, central bank financing was arranged for a number of developing countries in late 1982 and in 1983. This type of financing has been provided for well over fifty years by U.S. monetary authorities, through the Federal Reserve and the U.S. Treasury Exchange Stabilization Fund, for foreign central banks and foreign monetary authorities. Usually the financing takes the form of currency swaps, but it also may take the form of other central banking transactions of a monetary character. Typically, the purpose is to provide short-term balance of payments support for the foreign central bank. The basic features of the enabling statutes of most central banks and monetary authorities, including the United States' authorities, are that the purpose for financing must be directly related to a stable system of currency and credit, and that the assets acquired by the "creditor" institution must be essentially monetary in character. Other central banks as well as the Bank for International Settlements (BIS) follow the same lending arrange-

ments either as a matter of law or of policy.[12]

The context in which the central bank balance of payments financing was provided in late 1982 and early 1983 made particularly important the provision of collateral or some tangible form of assurance by the borrowing country that it indeed would have resources with which to repay the central bank financing in the short-term. Consequently, the negative pledge covenants in loan agreements contracted by the parent foreign governments of the central bank borrowers posed a major obstacle to provision of these central bank credits.

In view of these negative pledge covenants, the prospective central bank creditors had a choice of three options to assure the successful collection of their bridge loans:

1. Ignore the negative pledge covenants and insist on the provision of collateral in support of the credits;
2. Require the borrower to obtain waivers of the negative pledge covenants and provide collateral in support of the credits; or
3. Enter into some alternative arrangements with the borrower, consistent with the applicable negative pledge covenants, that enhance sufficiently the liquidity of the central banks' claims.

The first alternative clearly was not acceptable. From a purely legal standpoint, whatever security interest the central banks obtain by contract either might be set aside or might be diluted by the other creditors of the foreign government taking legal action to enforce the negative pledge or *pari passu* clauses in their own loan agreements with the foreign government. While no court in the United

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12. The statutory authority for use of the U.S. Treasury Exchange Stabilization Fund (ESF) appears at 31 U.S.C. § 5302 (1982). The statute specifies that the ESF cannot be used to make loans to foreign governments that remain outstanding for more than six months in any twelve-month period, absent unique or exigent circumstances.

The Federal Reserve can enter into currency swaps and similar arrangements based on Section 14(e) of the Federal Reserve Act, 12 U.S.C. § 358, which gives the Federal Reserve banks the authority to open and maintain deposits in foreign countries. The scope of the Federal Reserve's authority is discussed in *Hearings on H.R. 10162 Before the House Comm. on Banking and Currency*, 87th Cong., 2d Sess. 142 (1962). Consistent with this authority, the Federal Open Market Committee (FOMC) authorization for foreign currency swaps with designated foreign central banks provides that drawings by either party must be liquidated within twelve months unless, because of exceptional circumstances, the FOMC specifically authorizes a delay. 69TH ANNUAL REPORT OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM at 82-83 (1982). *See also* 69 FED. RESERVE BULLETIN 426 (1983).

For the enabling legislation of foreign central banks, for example, see the central banking laws of the Federal Republic of Germany, France and the United Kingdom in IMF, CENTRAL BANKING LEGISLATION (Vol. I, 1961; Vol. II, 1967) as well as the CONSTITUENT CHARTER OF THE BANK FOR INTERNATIONAL SETTLEMENTS AND STATUTES OF THE BANK FOR INTERNATIONAL SETTLEMENTS (Jan. 20, 1930, amended 1975).

States has enjoined a borrower's pledge of assets to a subsequent creditor as a violation of a negative pledge clause, or ordered a proportionate sharing in the security, the U.S. law in this area is far from clear.[13] In addition, a suit might be brought by other creditors of the sovereign borrower against the central bank creditors themselves for damages based on tortious interference with the loan agreements containing the negative pledge clauses.[14] Again, the likely outcome in U.S. courts is difficult to predict.[15] This uncertainty as to whether other creditors would have a legal remedy against the central banks is compounded because syndicated loan agreements containing negative pledge clauses involve banks from numerous nations and are governed by the laws of a variety of different countries.

A further significant factor making the first alternative undesirable from a legal standpoint was that breach of a negative pledge covenant typically is considered an event of default under the inter-

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13. In Kelley v. Central Hanover Bank & Trust Co., 11 F. Supp. 497 (S.D.N.Y. 1935), *rev'd*, 85 F.2d 61 (2d Cir. 1936), a company had pledged the stock of its operating companies as collateral against short-term notes. When less than one year later the company went into receivership, a debentureholder brought suit to have the pledged stock returned to the company or to have the debentureholders share equally and ratably in the security. The suit was based on a negative pledge covenant. The covenant contained an exception for property to secure loans "contracted in the usual course of business for periods not exceeding one year." The court held there had been no violation of the negative pledge clause, and even if there had been and the new creditors knew about it, the negative pledge covenant did not create an equitable lien on the company's assets.

On appeal, the Second Circuit reversed and remanded, instructing the trial court to determine whether the new secured loans had been "in the ordinary course of business" and whether the lenders knew about the restrictive covenants. Kelley v. Central Hanover Bank & Trust Co., 85 F.2d 61 (2d Cir. 1936). The suit ultimately was settled out of court.

The ruling in *Kelley* follows the traditional line of cases holding that an equitable lien arises only when the intent of the parties to create a lien is clear but where, for instance, that intent was frustrated for a technical reason. *See* Fisher v. Safe Harbor Realty Co., 150 A.2d 617, 620 (Del. 1959) (citing 4 POMEROY, EQUITY JURISPRUDENCE §§ 1235, 1237). For a further discussion of *Kelley*, see Ryan, *Defaults and Remedies under International Bank Loan Agreements with Foreign Sovereign Borrowers — A New York Lawyer's Perspective*, 1982 U. ILL. L. REV. 89, 105-06.

The mere existence of a negative pledge clause may not itself create an inference that the parties intended to create a lien. *See, e.g.*, Kuppendheimer & Co. v. Mornin, 78 F.2d 261 (8th Cir. 1935). *Contra* Coast Bank v. Minderhout, 61 Cal. 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

14. Such a claim was filed in a suit by Citibank, N.A. against the Export-Import Bank of the United States and Manufacturers Hanover Trust Company based upon a negative pledge covenant in a Citibank loan agreement with Zaire. Citibank, N.A. v. Export-Import Bank, 76 Civ. 3514 (S.D.N.Y., filed August 13, 1976).

15. The action in note 10, *supra*, also was settled out of court. Courts are likely to look closely at all the facts and circumstances in such a case. Relevant factors include: the actor's conduct and motive, the interest interfered with, the interest advanced by the actor, society's interests, the proximity of the actor's conduct to the interference, and the parties' relations. RESTATEMENT (SECOND) TORTS § 767 (1963).

national loan agreements in question.[16] If a default is called on one loan because of the breach, then the application of cross-default clauses in other agreements[17] could result in widespread default. This would jeopardize the entire program of controlling the debt problem of the borrower both in the short-term and on a more sustainable long-term basis.

Finally, the first alternative was undesirable because central banks, whose aim is to protect the integrity of the international credit system, did not want to contravene the provisions of valid loan agreements.

The second option — requiring the government of the central bank borrower first to obtain waivers of all relevant negative pledge covenants before the new central bank bridge financing is provided and for which collateral or similar security is given — was practicable only in a limited instance and even then long delays were encountered. The option was *not* available where the government of the central bank borrower had a large number of outstanding syndicated loan agreements, containing negative pledge clauses for which waivers from hundreds of banks throughout the world would be needed, thus providing leverage for individual banks or groups of banks to use the required waivers to obtain unrelated concessions in loan negotiations. Emergency funding did not allow for the process of obtaining waivers in such circumstances.

Accordingly, the third alternative was pursued in a number of cases. A solution relied upon in these cases by the central banks is one familiar to U.S. banking institutions: the central banks utilized the statutory preference afforded by New York law (or similar laws of other jurisdictions) to creditors of a right of set off. Historically,

16. Negative pledge covenants typically were contained in the syndicated loan agreements to which each public secotor borrower was signatory (such as government-owned utilities, oil companies and airlines) as well as those in which the foreign government itself was guarantor. Thus, negative pledge covenants in numerous loan agreements were at issue. The "event of default" provisions in the loan agreements typically would state that if the borrower or guarantor "shall fail to perform or observe any term, covenant or agreement" contained in the loan agreement, "and any such failure shall remain unremedied for 10 days after written notice thereof" has been given by any bank in the syndicate, then the majority banks in the syndicate may declare that obligations to make advances under the agreement are terminated, and that the entire unpaid principal and accrued interest is immediately due and payable. "Majority banks" are customarily defined as banks having made at least two-thirds percent of the aggregate principal amount of the loan outstanding, or if no amounts are outstanding, banks having at least two-thirds percent of the loan commitments.

17. A typical cross-default clause defines a default to be one of three events: (1) a default in payment of other debt, (2) a default in performing or observing a covenant or other term, or the occurrence of another event, permitting the maturity of other debt to be accelerated, or (3) the actual acceleration of the maturity. Ryan, *supra* note 13, at 95-96.

banks have had broad rights to set off claims from assets held at the bank. Set off is permissible so long as there are "mutual demands and debts" between the parties and the debt owed the bank is matured and liquidated.[18] In addition, New York state law provides:

> Every debtor shall have the right upon . . . the issuance of any execution against any of the property of; . . . or the issuance of a warrant of attachment against any of the property of; a creditor, to set off and apply against any indebtedness, whether *matured or unmatured*, of such creditor to such debtor, any amount owing from such debtor to such creditor, at or at any time after, the happening of any of the above mentioned events, and the aforesaid right of set off may be exercised by such debtor against such creditor . . . notwithstanding the fact that such right of set off shall not have been exercised by such debtor prior to the making, filing or issuance or service upon such debtor of, or of notice of . . . issuance of execution . . . or order or warrant.[19]

Thus, where assets of the borrowing central bank are on deposit with the creditor central bank at the time the debt matures, the creditor may, without need for recourse to the courts, and despite a court order of attachment on behalf of another creditor, set off against those assets the amount of its claim on the borrower. Because the common law and statutory right of set off creates a preference for a specific creditor by operation of law and not by virtue of an agreement of the borrower and the lender, the position reasonably can be taken that the existence of and reliance upon such a right is not inconsistent with obligations contained in negative pledge covenants. This conclusion indeed is reinforced by the terms of numerous loan agreements that contain at the same time the broadest of negative pledge clauses and also an unqualified right of the creditor to set off against any and all assets of the borrower to the full extent permissible by operation of law.

For example, one such clause states:

> The Borrower (a government agency) and the Guarantor (a government) hereby grant to each Bank the right, to the extent permitted by applicable law, at any time and from time to time, without notice to the Borrower or the Guar-

18. For a discussion of the right of set off under New York law, see Ryan, *supra* note 13, at 106; Mayer & Odorizzi, *Foreign Government Deposits: Attachment and Set-Off*, 1982 U. ILL. L. REV. 289.

19. N.Y. Debt. & Cred. Law § 151 (McKinney 1981)(emphasis added).

antor (any such notice being expressly waived by the Borrower and the Guarantor), to set off and apply any and all deposits (general or special, time or demand, provisional or final) at any time held and other indebtedness at any time owing by such Bank to or for the credit or the account of the Borrower or the Guarantor, at any branch or office or in any currency, against any and all of the obligations of the Borrower or the Guarantor now or hereafter existing under this Agreement and the Notes held by such Bank and the Guaranty, when the same shall become due and payable, whether at maturity, upon the acceleration of the maturity thereof or otherwise and irrespective of whether or not such Bank shall have made any demand under this Agreement or such Notes or the Guaranty and although such obligations may be unmatured.

While the needed emergency central bank bridge financing of 1982-83 did proceed, unnecessary and undesirable delays occurred in finalizing the agreements due to the uncertainty about what option to take in dealing with the negative pledge covenants. In the end, some central banking authorities would have preferred different financing arrangements than those ultimately adopted.

III. Conclusion

Questions can be raised as to the practical purpose served by negative pledge clauses in international loan agreements with sovereign borrowers. Certainly they do not assure that sufficient assets exist to satisfy all general creditors. Negative pledge covenants do not prevent a borrower from selling its assets, only from pledging them. Moreover, these clauses do not prevent another general creditor from obtaining a legal preference through operation of a common law or statutory right of set off. Finally, as has been amply demonstrated in the last several years, they do not serve as any meaningful inhibition on a sovereign's aggregate borrowing.[20]

Recent experience demonstrates that widespread use of negative pledge covenants in loan agreements with sovereign borrowers can be inimical to the interests of both the lender and the sovereign borrower since emergency short-term central bank funding effectively can be precluded. Such short-term funding often plays a pivotal role in resolving the financial problems of the borrower by

20. For data on the growth of developing country debt 1973-82, see *Hearings, supra* note 1, at 69.

providing temporary funds while maximizing the likelihood that the borrower will take the difficult economic steps needed to correct its underlying economic difficulties. Such funding also provides confidence to private lenders to play their essential role in the adjustment process. As such, in the end the central bank financing serves to make the borrower more creditworthy. As one writer has stated so vividly regarding a domestic corporate rescue effort: "If the negative pledge clause blocks a rescue effort . . . it will be small satisfaction to the . . . [creditors] that they will share 'equally and ratably' in the ashes."[21]

Thus, there is no question that if negative pledge covenants are retained in loan agreements with sovereign borrowers, they should contain a routine exemption for credit provided by central banks or governmental monetary authorities.[22] Failure to provide such ex-

21. McDaniel, *supra* note 6, at 881. The author explains the problems with obtaining government-guaranteed loans for Chrysler because of negative pledge clauses in two outstanding Chrysler debenture issues.

22. A court has held that a negative pledge clause, containing an exception for pledges that secure notes with maturities of not more than a year, nonetheless is applicable to notes that have a stated maturity of less than a year but were rolled over and so did not in fact mature within a year. Kaplan v. Chase Nat'l Bank, 156 Misc. 471, 281 N.Y.S. 825 (N.Y. Sup. Ct., 1934). Thus, an exception for central bank financing maturing in one year or less may not be sufficiently broad in the event that the maturity of a short-term credit is extended.

23. Like the negative pledge covenants in international loan agreements of sovereign borrowers, a restrictive covenant in debt instruments of a bank holding company recently has posed similar obstacles to governmental efforts to contribute to the orderly and equitable resolution of financial difficulties. In July 1984, an assistance program for Continental Illinois Bank was arranged. A major element of this program was a capital infusion to the bank by the Federal Deposit Insurance Corporation (FDIC). In analogous situations in the past, the FDIC would make such an infusion by a direct capital investment in the affected bank. By providing assistance in this form, in the event the rescue were not successful, the FDIC's resources would be protected to the maximum extent possible in liquidation. In the case of the Continental Illinois assistance package, a restrictive covenant in the indenture agreements governing Continental Illinois Corporation's (CIC) long-term debt necessitated a different approach.

The covenant at issue requires that the holding company, CIC, hold at least 80% of the capital stock of Continental Illinois Bank. A breach of the covenant constitutes an event of default. This or a similar covenant is contained in a number of CIC's debt instruments. The presence of standard cross-default clauses in CIC's debt instruments more generally hampered the FDIC in following the approach of directly acquiring capital stock of the bank. Instead, the approach adopted to provide a capital infusion consistent with the restrictive covenant involved investment by the FDIC in preferred stock of the holding company, providing rights to 80% of the common stock. This solution had the disadvantage that, under the hypothetical circumstance where the bank closed, CIC noteholders would be more senior claimants than the FDIC, which would be a preferred stockholder. On balance, however, it was considered that, in view of the restrictive covenants, this form of capital infusion was the best way of meeting a number of objectives: maximizing the possibilities for a successful rehabilitation of the bank, minimizing the cost to the FDIC and maintaining general market confidence.

emptions, particularly in large syndicated loan agreements where timely waivers of restrictive covenants are impracticable, merely will frustrate governmental efforts to contribute to the orderly resolution of international financial difficulties in the future, to the detriment of creditors and borrowers alike and, ultimately, to the detriment of the financial systems more broadly.[23]

The Federal Reserve has stated its concern about bank holding company debt covenants, such as those of CIC, which circumscribe the FDIC's ability to make a direct capital investment in a bank which the FDIC deems appropriate in the exercise of its statutory responsibilities. If such covenants are now or were to become widespread, regulatory action to limit their scope may be appropriate. *See* Letter from Paul A. Volcker to Jake Garn, Chairman, Senate Comm. on Banking, Housing and Urban Affairs (Aug. 8, 1984). As with negative pledge covenants in international loan agreements, interests of all parties, and the financial system as a whole, would be served best by drafting the covenant so as not to limit assistance by official lenders.