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University of Arkansas
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by

Christine A. Bogdanowicz-Bindert

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The Role of Financial Advisors in Bank Debt Reschedulings

CHRISTINE A. BOGDANOWICZ-BINDERT*

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

* Senior Vice President, Shearson Lehman/American Express Inc., New York, N.Y., and former economist at the International Monetary Fund, Washington, D.C. The views expressed are those of the author.

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.

* * * * *

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.