GOVERNMENT LOANS

Comment by

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Mr Wood's paper is clearly a wide-ranging, yet penetrating discussion of a subject which is close to the heart of difficulties facing many international commercial banks and indeed, the world banking system: the problems of capital adequacy, liquidity, threats to profitability, brought on by questions relating to the quality of assets - many of which are represented in sovereign risk lending covered by eurocurrency loan agreements.

Of course, in some cases, the major commercial banks' problems go beyond the risks and difficulties associated with sovereign risk exposures. Many also have problems linked to domestic asset portfolios. Further, the inter-linking of banks through the money markets and interbank lending, poses the threat of a domino effect.

My comments on the paper are made from the standpoint of the lending banker - with a certain level of practical experience in the field.

However, it should be noted that the Australian banks, whilst involved to a certain degree, have not the substantial sovereign and country risk exposures to the rescheduling nations, that many international banks have. And, in quite a few cases, this exposure was initially of a trade-financing nature. Given the scope of the problem, this is an enviable position to be in, and it has been reflected in the high credit ratings accorded a number of Australian banks when they have borrowed both short and long-term off-shore on their own account.

Another point is that where they have been lenders in sovereign credits, Australian banks have mainly contributed at participant or perhaps co-manager level - they have generally not been in the lead management ranks with responsibility for documentation etc.

The degree of involvement that the average participating bank has had in loan documentation is interesting in itself. Often, these eurocurrency loan syndications have been made up of scores of participating banks, each taking their 1 or 2 million United

States dollars working with a small group of lead managers, who contribute larger amounts and take care of the loan agreement and administration aspects. Whilst the smaller participants have had the opportunity of reviewing draft documentation in many cases, the practicalities of the situation, meant that they accepted what was submitted to them - relying on the lead managers and their lawyers. The competition, for positions in many of these sovereign syndications was strong, and many banks, even if they had reached a doubt on some point, chose not to "rock the boat".

You may note that I speak in the past tense in referring to syndications as the means of commercial bank lending to governments. A substantial portion of such lending was to the Lesser Developed Countries, and this has very largely been overtaken by rescheduling agreements. Also, in the past few years the syndicated loan as a means of raising funds has been in decline, replaced more and more by the securities' issue.

The point is made that states are sensitive to contracts which reflect on their sovereignty, freedom to govern, require information, or put certain conditions on economic management, and which contemplate political or economic collapse. This has been most pertinent to the LDCs. Nationalistic pride and the competition between lead managers for loan mandates are two factors which have influenced the relevant content of agreements in favour of borrowers. It has gone further, to comparisons of interest rate margins between countries - with considerations of national "face" sometimes resulting in margins being held down, with unpublicized front-end fee adjustments achieving a more palatable all up - return for lenders.

Covenants requiring the provision of information such as economic data have proved in some cases academic, due to the unreliability of the data provided, eg some Comecon countries. As to economic management, banks, especially in the period of looming difficulties, prior to the rescheduling era, tended to rely on IMF assessments and the conditions relating to drawdown of that institution's support facilities.

The bulk of sovereign syndicated loans appear to have been governed by British or New York law - a point borrowers were usually willing to concede - and in the final analysis, the way events have gone, this does not appear to have been a particularly vital point.

On aspects such as the borrowing vehicle, choice of law, deimmunisation - apart from the legal considerations - the comfort factors have clearly been, in a commercial sense, important to lead managers with an eye to the orderly selling down of their underwriting commitments, to form a syndication.

The question whether certain borrowing vehicles, qualified as sovereign risk in terms of banks' "in-house" guidelines for lending discretions, and country lines of credit, has arisen on occasion. For example, Venezuela, in the 1980-81 period, with its multiplicity of government agencies, many with seemingly autonomous and uncoordinated borrowing programmes, posed a doubt on this point in a eurocurrency bank in which I was working - because of a fairly strict definition of sovereign risk.

The features of the law of sovereign immunity which Mr Wood outlines are instructive. The view, that if a sovereign descends to the marketplace, whatever the purpose of the loan, he must accept the sanctions of the marketplace, is not an unreasonable one, from the lenders' stand point. But there are obvious practical difficulties, eg deimmunisation from execution against assets is sensitive because of the prospect of retaliation by the sovereign debtor against foreign assets.

It is of interest to note the events of default, including cross default, which have appeared in eurocurrency sovereign agreements because we have, in the past two years, seen country after country not paying principal and interest, and not complying with loan agreements. The result, in general, has been that we have not seen acceleration under cross default clauses or otherwise. As Mr Wood notes, the provocative aspect - especially in cross defaults, has tended to promote inertia amongst the banks.

The fact of the matter is that world banks in the modern boom-time of sovereign syndicated lending - in the mid 1970s to early 80s - took a favourable view forward over a period of time - say 10 years of a sovereign borrower's debt-service capacity - based on some kind of analysis of the country risk, taking into account political and economic aspects. The expectation was that the sovereigns would manage their affairs to maintain their credit worthiness and future borrowing capacity. The need to re-cycle eurodollars after the first oil shock, linked with the asset-based expansion plans of the banks, combined with the great willingness of the sovereign LDCs to borrow, kept the show rolling forward. Political, economic, and commercial realities constrained the provisions in the agreements and the subsequent actions thereunder.

The practice of transferring portions of sovereign credits, by means of a bank taking a sub-participation in another bank's portion, is common. Many of these transactions are undisclosed to the borrower. The sub-documentation takes various forms and is often very simple and brief. It would be interesting to see how sub-participation agreements would stand up. There have been some cases but it appears most have been settled out of court. The sub-participant has the disadvantage of not having a direct claim in law or equity on the borrower.

It is interesting also to note the recent trading in sovereign LDC loans that is developing in the secondary market - most on a discounted basis.

Under the heading State Insolvency, the hierarchy of creditors is outlined. A situation, which my bank has encountered, relates to a floating rate note issue by Costa Rica. Whilst experience in other cases has supported the non-rescheduling of public bond issues, in this instance the FRN was in effect lumped with the commercial bank debt. One of the arguments at the time, if my memory is accurate, was that the FRN holders were not the traditional widows or orphans - but mainly international banks which had invested in the notes as an alternative to a syndicated credit.

The rescheduling of country debt is well underway and is a main preoccupation of the commercial and official banking communities. My own bank is involved in (11) cases, the most recent being the Philippines. Thankfully, the aggregate amount is very small in relation to our asset footings.

As the paper points out, the commercial banks have in the vast majority of cases cooperated with the relative steering committees in putting in place rescheduling agreements. The reasons for these reschedulings have been painfully obvious: the borrowers' inability to meet short-term commitments with the result that many banks have had to transfer principal outstandings to non-performing portfolios. To avoid loss of income from interest, potential principal write-offs, and consequent impact on capital adequacy, banks have had little alternative other than to cooperate.

Yesterday's single syndicated credits are being transformed and consolidated into today's restructured debt - with the obligor typically a public sector borrower guaranteed by the LDC government or central bank. A servicing bank takes the place of the standard agent - the responsibilities are the same except that a commitment to future drawdowns is replaced by a rescheduling of past debt.

Along the way, there have been various alarms - such as the threat of a Latin American Debtors' Cartel. In many cases, the reschedulings have only included maturities for two years forward. However, recently the Mexico rescheduling covered US$48.5 billion over 14 years with half the debt having to be repaid in the period 1994-98. The interest margin was 1.11% over LIBOR - extremely generous to the borrower. Additionally, Mexico expects to raise $17 billion of new money in the next 6 years, $12 billion from commercial banks.

The objective in this and the other cases is to buy time for the debtor nations to restructure their economies and develop their exports. It is a tremendous task and there may well be some difficult passages ahead.

As Mr Wood points out, the whole process has been relatively orderly, compared to the state insolvencies prior to the 1920s.

In most cases, rescheduling has been contingent upon the states meeting IMF requirements involving tough domestic austerity measures. This has been a prickly aspect and the questionmarks of possible social unrest, and political consequences, remain in some cases - especially with Latin American LDCs.

Over the years, the syndicated eurocurrency loan agreement has evolved until it has reached considerable complexity - not to mention weightiness. On the other hand - the commercial, political and economic realities of lending to sovereigns have been such, that the commercial banks have had to largely work outside the provisions of the loan agreements, in an endeavour to solve the problems of default.

A theme through these remarks has been the rescheduling of sovereign debt. First rounds of rescheduling have been completed for most of the defaulting countries - mainly covering debt maturing in 1982-84: Second round reschedulings, covering later maturities, have been agreed in a few cases, and are underway with other debtors. The commercial banks, and the international agencies, are showing a high degree of cooperation in these processes.

What does the future hold? Will there be defaults of countries, additional to those already seen? Will the existing rescheduling agreements hold up?

Well, even recourse to the proverbial crystal ball, and vigorous polishing thereof, is of marginal assistance in addressing these questions.

In general, and as a personal view, I believe the outlook is more hopeful than it was. Obviously, the situation remains complicated and serious, but a certain stability has been achieved with frameworks put in place, wherein the parties have experience of working and living with the situation. Time has been gained to endeavour to work out the severe problems.

The possibility of new defaults, of breakdowns of existing reschedulings, will be influenced by a host of factors: interest rate movements, currency movements, oil price changes, the internal political situations of the debtor countries, not to mention the state of world trade, and the debtor nations' ability to lift exports and economic growth.... These are only a few of the inputs which will influence the debt service factor.

The debtor nations will need fresh borrowings from both the commercial banks and the world agencies. The availability of these funds, their wise deployment by the borrowers, and the share of this lending undertaken by the world agencies also will be dynamic influences on the overall situation.

Clearly, some countries have better prospects of trading their way out of their problems than others.

The commercial banks' steering committees, in cooperation with the world financing agencies, can only confront and patiently address each new problem as it presents itself. In military parlance, the line is being held, but there is still a long way to go through the minefield.