# EUGENE H. ROTBERG: Toward a Solution to the Debt Crisis

*The former top World Bank financial strategist offers his long-awaited debt proposal. The plan: a way to share risks and pain*

THE PURPOSE OF THIS ARTICLE is to identify the players and the pressures, and to suggest a "solution" to the debt crisis that addresses the concerns of a diverse constituency of interested parties. This article assumes as a sine qua non to any proposal a country-specific, wise economic development strategy and a healthy world economy. It also assumes that no piece of financial engineering or sharing of risk can be cloned onto an unworkable political economy. These thoughts also are based on the premise that financial engineering or innovation that addresses primarily the means to write off LDC debt in a fashion acceptable to banks, without providing for or facilitating new lending, is of doubtful significance. Indeed, while rhetoric may label such developments "at least a beginning," I believe they are basically counter-productive to increasing the new flows necessary for development and productivity—and fundamental to encouraging the discipline needed for domestic macro economic changes.

It may be useful first to summarize what happened in the 1970's and early 1980's. That background is relevant to defining the problem and providing a frame of reference for its "solution."

## WHY DID COMMERCIAL BANKS LEND TO LDCs?

Commercial banks lent to the LDCs for a number of reasons: First, governments were pressuring, or at least encouraging, banks to recycle OPEC financial surpluses. They did so—to the LDCs.

Second, there was little other investment for OPEC financial surpluses. Clearly banks could not buy U.S. Treasury bills at 2% less than their marginal cost of attracting deposits.

Third, there had been little previous pain. All "foreign" debt in recent memory had been serviced.

Fourth, herd instinct—a desire for market share—played a role. Japanese banks were moving to London and creating competition at narrow spreads. It was a borrowers' market, with little distinction drawn on the basis of perceived credit standing.

Fifth, the loans were syndicated to non-money center banks—often "regional" ones eager to participate in international business and affiliate with a rapidly expanding distribution network outside the United States.

Sixth, the dread factor—the loss potential was so severe, given the magnitude of the lending, that little attention was paid to the uses of the funds or the development program of the borrowers.

Finally, central banks, it was assumed, would always be there as a lender of last resort. In short, the financial

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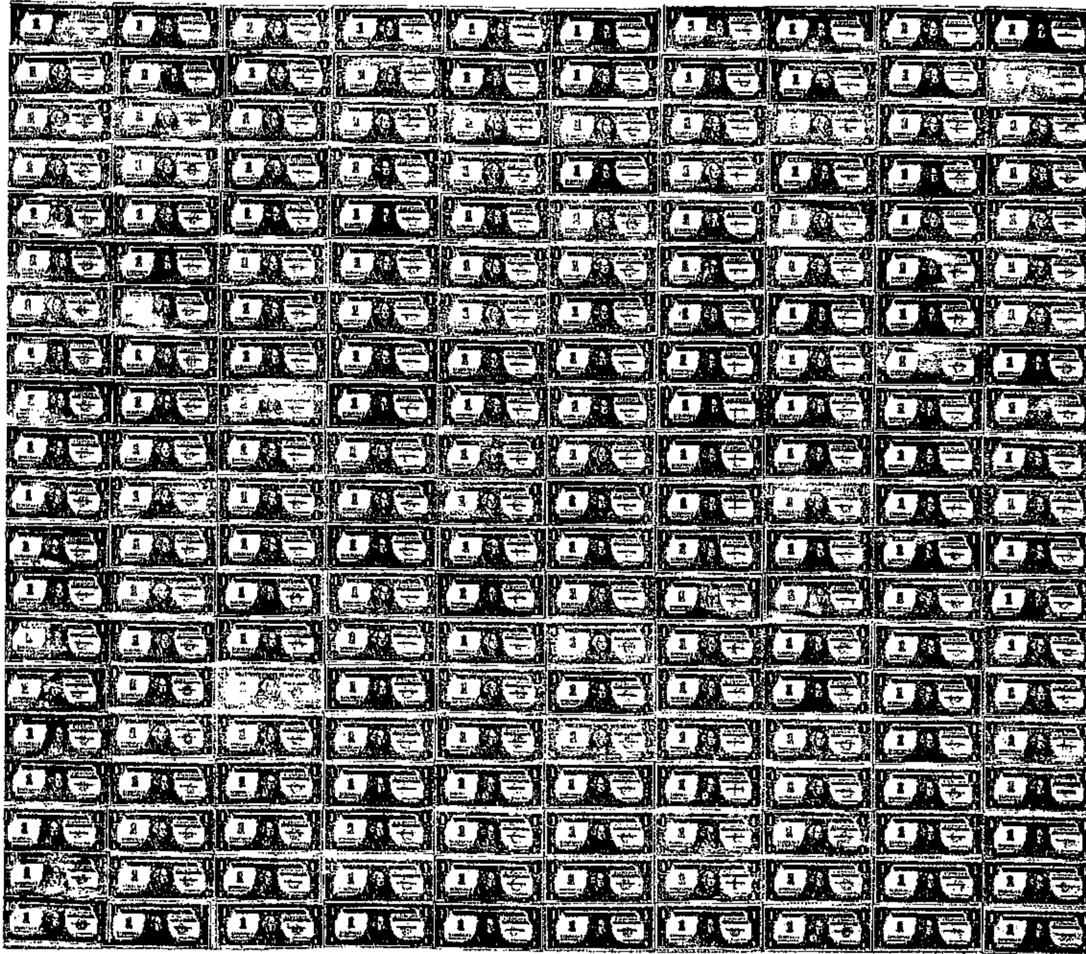

Andy Warhol, *200 One Dollar Bills*, 1962
Private collection, photo courtesy of Sothebys, N.Y.

system would be safe so long as the obligations remained on the books of commercial banks.

It was a scenario that lasted a decade. It was one in which risk exposure increased and credit standing deteriorated, with no market mechanism in place to price risks or value the portfolios. Now, after years of ad hoc negotiations, reschedulings, provisioning, confrontations, interruption in debt service, a reassessment is taking place, part of a continuing process as each constituency seeks to protect its interest. And the relevant question has become, "What are LDC prospects for servicing debt?"

It is a truism bordering on cliché that each country must be examined individually, that solutions must be tailored to the demands and requirements of each country, and that fatigue is likely to make us hostage to extremism. Nonetheless, despite these concerns there is need for some straight talk. The fact is most heavily indebted LDCs are not likely to repay principal in the foreseeable future. Most likely, almost all principal falling due in the next five years, and probably longer, will be rescheduled or refinanced. The difference, however, between repaying and not repaying principal over a long period, assuming interest is paid, is but a few basis points. The real issue is whether LDCs can service their debt with a reasonable certainty and maintain modest growth, without money packages equal to a substantial fraction of

their interest rate obligations. I think not.

Unfortunately, recent experience would lead to the conclusion that over the next several years, the amount of net new lending by commercial banks will not come close to the interest payments due to those institutions. To the extent that loans are sold in the market at a discount from par, that market price will measure and reflect the impact of the banks' decision not to continue to lend new funds to facilitate payment of interest.

### COMMERCIAL BANKS: A CONSTITUENCY

During the periods of stress (protectionism, recessions in the West, escalating interest rates) we will see interest rates for LDC debt set below market rates, prepayments by industrialized countries for major LDC exports, and conversion of loans to bonds at discounts from par with selective credit enhancement. As banks begin to sense leverage and power, I expect that some interest will be paid, even without new lending, if pressures develop to withdraw short-term export financing and trade credits.

It is in this context that commercial banks' leverage might be addressed.

Mostly, for understandable reasons, they want out, and as close to par as possible. They want to reduce their exposure and certainly do not want to increase their risk, even if by so doing the loans are deemed "current." Understandably, banks would like others to assume or purchase old loans at as high a price as possible and guarantee that debt service on new credits will be credit risk free. They look for a nod to some creative accounting, a relaxation of regulatory pressures, and for ways to "spread out" the loss over a period of time. In short, banks want increased leverage. They may, moreover, be well on the way to achieving it from the substantial reduction of LDC exposure to their capital, from the fact that some have already provisioned against the loans, from sales of loans or swaps, and from recent financial engineering that permits them to delay, mask or amortize their losses over time. These developments remove the pressure to lend. Moreover, from an LDC point of view, they reduce the pressure to make painful macro-economic change as the LDC realizes that "new" money is not likely to be forthcoming. At the same time, however, as a political exigency, LDCs will frequently seek to benefit from a perceived "loss capacity" in the banks, which they will seek to convert into some form of short-term debt relief.

Nonetheless, while financial engineering and provisioning can reduce the pressure to reschedule or supply funds, the need to receive interest remains. Most likely the present value of that projected interest stream has not been fully discounted from the market price of LDC debt. Stated another way, so far the market price of LDC debt primarily reflects the potential loss of principal at maturity, not the risk of non-payment of interest if unaccompanied by lending to make those payments.

Without a reasonable certainty of debt service, the prospect for "securitization" is not positive. Basically, securitization is a method to arrive at an accounting result, and cannot fairly be said to address the "debt problem" unless that problem is defined quite narrowly, i.e., how to report commercial bank earnings. Certainly at some price LDC debt can be repackaged and sold, but, for a number of reasons, it is not likely to be meaningful.

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For example, the amount of provisioning or writeoffs, as noted, reflects primarily the probability that a portion of the principal will not be paid. It does not reflect market value as it does not reflect the assessment of the risk of nonpayment of interest to the new buyer. Buyers do not expect to have to put up new money to receive interest on their discounted purchases. Nor do they expect to have to share, pro rata, any interest received with those who did not assign or sell their loans.

As for large money center banks switching into equity, the amount is not likely to be substantial. In the context of the amount of debt outstanding, the equity markets are small. In addition, there are considerable political considerations, particularly if the equity is in basic industry, raw materials, commodities, or minerals. The equity solution smacks of colonialism and is fraught with future political uncertainty. Debt for equity swaps with local counterparties are more acceptable, but are not likely to be substantial in volume.

Regulatory agencies should be troubled by moving debt from banks into institutions over which they have little control—pension funds, insurance companies, speculators, buyers of "junk bonds." These institutions can precipitate a much different, less predictable and more

volatile financial scenario if debt is not serviced. These buyers do not reschedule. It is not likely they will be as malleable as commercial banks when it comes to providing new money packages for the good of the "financial system." Of course, if non-bank holders of securitized paper were placed in a preferential or collateralized position, a development that would reduce the probability of their triggering a default, this assuredly would be counter-productive to facilitating the new bank flows needed for growth. By the same token, financial engineering that would, in effect, subordinate the claims of the new securitized buyers to the old holders or to those who provided new funds, would, to say the least, make the paper somewhat difficult to sell.

The loans themselves are evidenced by complex legal agreements whose provisions significantly affect the rights of assignees of the creditors. These provisions generally are not yet well known. Moreover, LDCs that are not now servicing debt unless accompanied by new flows are not likely to service contractual debt issued at par, at a rate of, say, 9%, where the new purchaser has purchased at a discount resulting in an effective yield of 18%—a speculative investment by a party who did not provide the funds to the LDC in the first place. If there is a loss to be borne by banks, LDCs will likely require that the corresponding gain be theirs in the form of lower debt service on the securitized asset. Clearly the LDCs have the leverage to prevent that gain.

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Finally, I doubt whether the major banks can take the income hits that would be explicitly recognized upon resale or assignment of their holdings at prices reflecting the debt service risks.

## THE LDCs: A CONSTITUENCY

Of course, the LDCs, like the banks, make up a constituency as well. Here there are political pressures both to service and not to service debt. In developing countries factions in and out of power find many solutions unacceptable, particularly those that contemplate full debt service linked to the highest marginal cost of funding in a currency over which they have no control. Those costs are borne by poor people often living at the margins of existence in countries with fragile political systems.

On the other side of the coin, significant pressures also exist to service debt to obtain new capital for high priority projects and to maintain even modest growth. Exports must be financed, industries retooled, infrastructure put in place and short-term export credit financing maintained.

If an LDC fails to service debt, those short-term credits are at risk. If these are not maintained, the country shuts down. Thus, LDCs, too, are under painful pressures, facing basic choices that affect their viability as sovereign nation states.

The choices are not easy. From the LDC perspective, a significant part of the problem in the past, and even now, lies outside their borders and relates to matters over which they have no responsibility and little control: 1) Protectionism in the West has hurt. It has made it difficult to export, earn dollars and service debt. 2) High real dollar interest rates have increased their costs and their capacity to grow. And over the last year, nominal rates have fluctuated over 250 basis points, with prospects of higher costs as market participants, increasingly non-U.S., rethink how, where, and at what cost they should maintain their investments in U.S. dollars.

3) Sluggish growth in the West has reduced the demand for LDC products. A recession in industrialized countries would immediately shut off their capacity to earn the necessary foreign exchange to service debt. 4) A deterioration in terms of trade from a wide variety of circumstances in the 1980's produced falling commodity and mineral prices for exports, and, more recently, the rising costs of European and Japanese imports in U.S. dollar terms have reduced the generation of foreign exchange to service debt.

Heads of state in developing countries look upon these external matters as seriously affecting their financial and political capacity to pay. They are asked, nonetheless, to increase the pressures on their domestic society to service debt to money center banks. It is naive to assume that these pressures are painless or irrelevant. It is not useful to simply argue "a deal is a deal; you should have thought about it when you borrowed the money in the first place."

## INDUSTRIALIZED NATIONS: A CONSTITUENCY

The industrial countries are a constituency. They want to avert a financial crisis in which commercial banks

cannot raise equity capital or are considered questionable credit risks. Such a development would seriously damage the countries' influence as international powers.

The industrialized countries want to mitigate an economic crisis in which the underpinnings of government in LDCs, fragile at best, are threatened by an untenable choice: to meet all debt service in the context of no growth, with the resulting politically unsustainable transfer of wealth from poor to rich, or, conversely, to default, thus eliminating external inflows and increasing flight capital as a result of the absence of resources for infrastructure and development.

Clearly the industrialized countries also want to avert a political crisis. The politics—the concern for democracy and/or stability—is primarily a congressional/parliamentary concern (as well as of considerable concern to foreign ministries). But the fact is these constituencies, while potentially powerful players, are not direct participants. In the end, they are ambivalent in attitude and response to a problem in which domestic constituencies may have little concern for money center banks that have lent to "foreign" states which "dump" products in the markets of industrialized countries.

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While industrialized countries clearly want strong banks, they are not prepared to send a bail-out signal to domestic financial institutions except for very special constituencies. The U.S. Congress, for example, will take steps to support thrift institutions that provide finance for residential mortgages or for farmers. Not so for poor countries.

The fact is, money center banks are not a beloved constituency in a populist society. They could hardly marshal support for broad-based legislative action that might be perceived as holding them harmless, directly or indirectly, for imprudent lending, particularly to "foreigners." That type of support is probably politically unattainable. It will be categorized as a "moral hazard"—a perfectly fair, albeit selectively used, rationale for not obligating governments for the mistakes or failures of the private sector. Indeed, a World Bank capital increase will likely be under quite close scrutiny, as a substantial body of legislators in the U.S. will contend—and I believe without justification—that it would serve to "bail out" the banks, while others will contend that no capital increase is justified *unless* the bank uses its powers to "alleviate" the debt crisis.

Despite the lack of political support, however, industrialized countries also know they need economically strong LDC markets for their goods and services. These markets are vital as a means of reversing trade deficits and facilitating the opening up of new markets.

## THE MULTINATIONAL BANKS: A CONSTITUENCY

Finally, there is the constituency made up of the multinational banks. Multinational lending institutions are often asked why they don't address the problem through use of their guarantee power or by simply lending more. The reason is that congresses and parliaments are not likely to let those institutions do indirectly what governments will not, or cannot, do directly. Governments as a political matter find it quite difficult to draw the line as to who is "entitled" to guarantees, under what circumstances, and how much.

Further, international institutions are not primarily financed by governments. They are owned by governments. It is useful to recall who would be put at risk. The World Bank, for example, is owned by governments. These stockholders, however, have contributed but $5 billion of a $100 billion plus balance sheet. The great majority of the balance comes from bondholders—the private sector—who lend to the bank. These investors in long-term fixed rate bonds of the highest credit standing, issued in the tens of billions of dollars by the World Bank, do not currently lend on fixed term to commercial banks. They do not expect the World Bank to assume the risks taken or to be taken by commercial banks. Nor do they contemplate that the protection provided by callable capital, designed to protect them in the event of adversity, would be rechanneled or diluted in favor of commercial banks, which have far greater exposure than the World Bank does. But they would be prepared to support policies that leveraged the World Bank's capital if those policies encouraged new private financial flows, increased conditionality and thereby, overall, made the World Bank a stronger institution.

Finally, multinational lending institutions are not likely to provide credit enhancement, directly or indirectly, except as part of a package to provide new funds linked to

fundamental structural adjustment of LDCs designed to facilitate growth and development. And, of equal importance, they are likely to look to a certainty of private funding should those guarantees turn out badly, as will governments, which provide support in the form of callable capital, also look to the private sector as a funding source before a call on their capital is triggered.

Given the concerns of the various constituencies, it is clear why no "solution" has been forthcoming. Consider several reasons:

First, each constituency seeks to protect itself and shift pain elsewhere. As a result, negotiating postures are hard and visible.

Second, each constituency has significant power, but it is insufficient to dictate even the question to be addressed, let alone the power to assure its resolution. The LDCs do not have the leverage or power to encourage sufficient lending to facilitate growth.

Third, there is no mandate from either governments or the private sector to official institutions to act as broker in the dialogue between the constituencies. Official institutions cannot prudently bring much to the table. They can say "lend" to one constituency, "adjust" to the other. They as yet have not been vested with much more practical authority. And they are, correctly, quite concerned with their credit standing and financial viability.

Fourth, there is a little awareness of the constraints on official institutions, i.e., their constituencies.

Finally, most past "solutions" have been seen typically as ones in which everyone comes out whole, risks and pain are avoided, and losses are borne by someone else. These kinds of proposals do not get off the ground. They are either fantasies or modestly relevant, just as are those that simply allocate and quantify the loss by unilateral fiat. Most "solutions" to date seek not to balance risk, but to avoid it; not to share pain, but to remove it; not to mask or delay loss, but to eliminate it; not to confront reality, but to deny it. They are, in short, politically unworkable.

It may be useful to set out some objectives for what I mean by a "solution":

First, there is new lending to LDCs. By "new" is meant that amount which stems substantial negative cash flows, permits servicing of debt during periods of adjustment, supports reasonable growth and facilitates trade.

Second, LDCs remain politically viable. Whatever the "solution," it must not prompt a collapse of fragile democratic political processes in the country.

Third, banks continue to attract capital, with the prospect of earning a reasonable return, and can continue to diversify their activities with broad-based support for their own funding activities.

Fourth, the "solution" should not, in fact or by impression, be perceived as bailing anyone out.

Finally, it must be politically workable and practicable. That means accounting professionals, stockholders, legislators in industrialized countries, and a broad range of the body politic in LDCs find it fair.

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As noted earlier, there is no quick fix through financial engineering. Wise development programs are a sine qua non for progress. Nonetheless, financial engineering, having as its purpose not the creation of an accounting effect but the establishment of a politically workable structure acceptable to diverse constituencies, can be useful and productive. Specifically, such a "solution" is likely to be one in which there is a sharing of present pain for delayed contingent and "spread out" opportunity losses. Fundamentally, it would be designed to increase the comfort level of commercial banks and provide a sense of equilibrium of risk-taking among the constituencies. Each constituency would assume risks, but not the same kind of risk, at the same time.

A solution should attract new money without sending unwise signals. It should have political support in both industrialized and developing countries. In this context, the proposal below is designed to address these objectives. It does so by deferring certain commercial bank risk, by moving it to potential opportunity losses with a delayed and contingent liability, supported by the potential involvement of public institutions.

I have the following proposal:

A commercial bank lends new money, say, to Brazil, equivalent to a substantial fraction of interest due it, for 20 years based on a tranched and conditioned World Bank structural adjustment loan. The principal repayments are amortized, but with a substantial "balloon" after 20 years. The World Bank provides a put at par on all principal payments to the commercial bank, exercisable only after 20 years. The principal risk, therefore, is

credit-risk free. Assume that the commercial bank, after 20 years, exercises the put and receives par from the World Bank in exchange for the notes due from Brazil.

At this point, the commercial bank is obligated simultaneously to relend the same amount to a World Bank affiliate that immediately repays the World Bank and purchases for its own balance sheet the loans to Brazil. The commercial bank would receive the three-month T-Bill rate for the succeeding 20 years from the World Bank affiliate. Effectively, the commercial bank has switched its credit exposure from Brazil to a World Bank affiliate, a premier credit in the framework of a forty-year loan. Now the World Bank affiliate has Brazil on its books. The commercial bank has a "risk free" principal asset on its books because of the put to the World Bank. The World Bank and its capital base will support the put just as any other obligation of the World Bank.

The commercial bank's protection for receiving T-Bill rates from the World Bank affiliate is derived from the strength of the affiliate. The strength stems from the following:

First, an initial substantial World Bank investment, perhaps in part funded by the paid-in component of the next World Bank capital increase, and/or an investment by the institution from its liquidity, and possibly an investment by commercial banks.

Second, investments of such resources for 20 years in, say, U.S. government 20-year zero coupon bonds, during which period there would be no call on the affiliate's resources.

Third, a fee, for the put, for 20 years from the commercial bank.

Fourth, the spread between the cost of borrowing to the affiliate (should it choose to do so) and reinvestment of the proceeds in the credit markets.

Fifth, the spread profit over the three-month T-Bill rate provided to the commercial bank on the loan to Brazil after 20 years.

Finally, a lender of last resort facility or a rediscount window from the Group of Ten Central Banks, jointly or separately, should the build-up of earnings after 20 years be insufficient to pay T-Bill rates to the commercial bank in the event of widespread defaults to the affiliate.

The implications of my proposal are as follows: It reestablishes creditworthiness of Brazil for growth—tied to a World Bank adjustment package and tranched. In the process no principal is at risk for the commercial bank on new lending since it holds a World Bank guarantee through the put option. There is no risk to World Bank bondholders since Brazil is on affiliate books. The affiliate's strength is derived from the initial capital contribution of the World Bank, low-cost funding, and support, if needed, from government/central banks—a contingent intervention, only after 20 years.

Clearly the World Bank will require a capital increase to permit it to continue to make quality, high-priority loans conditioned on economic performance and to support the put.

Fundamentally, there is an opportunity loss to the commercial bank after 20 years if it chooses to exercise the put and receive the T-Bill rate. This in effect is a "penalty" rate, but one that has quite different accounting consequences as compared to a write-down. In effect, the commercial bank's "loss" is (a) delayed for 20 years; (b) spread out over the succeeding 20 years; and (c) in the form of an opportunity loss.

Certainly industrialized countries or selected central banks—Japan comes to mind as a responsible "backstop"—might agree to fund the affiliate, after 20 years, through a lender of last resort or rediscount facility. This would occur if the affiliate were required to pay T-Bill rates to their national commercial banks in the event (a) the LDCs do not service their interest obligations to the affiliate; and (b) the build-up over 20 years of the commitment fees for the put and the investment for 20 years of the initial capital contribution at a compounded rate of return is insufficient to permit the affiliate to meet its debt service obligations at the T-Bill rate to commercial banks. That event, however, would only occur in the event of a sustained default by many borrowers to the affiliate.

Thus, the risk to fund the affiliate "in extremis" is conditioned and delayed and would rest with highly industrialized countries whose domestic financial institutions are the most at risk. Such a situation would only result under conditions of widespread defaults by LDCs to the affiliate beyond the accumulated 20-year generation of earnings from capital and fees required to meet its obligations in years 20-to-40 to the commercial bank.

In effect the stockholders and bondholders of the World Bank are losing for 20 years the reserve build-up that otherwise would have been available if the initial investment were maintained at that institution. The stockholders of the World Bank, however, do not look to it for dividends. Its bondholders look at the callable capital and a quality ongoing financial and development institution to attract their support.

The framework described here is not *the* solution. There are variations and subtleties that could enhance effectiveness without damaging its underlying premise: A realistic awareness of, and sharing of, risk in different ways according to the requirements and needs of the various constituencies with a view to attracting sufficient funds to LDCs, to facilitate economic growth and political stability. ♦