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Recent Trends in Commercial Bank Lending to LDCs: Part of the Problem or Part of the Solution?

John E. Mendez†

The international financial system has changed dramatically over the past ten years. Less developed countries1 (LDCs) have experienced increasing balance of payments deficits and continue to borrow quite heavily from commercial banks2 to finance those deficits. The LDCs and the commercial banks now are locked into a debtor-creditor relationship of unprecedented magnitude. Although until recently this relationship played an important role as a buffer to world economic crises and cycles and as a source of development capital, it now has great potential for catastrophe.

The bank-LDC relationship, while for the most part harmonious throughout the 1970's, now faces continual pressure from world events such as persistently high interest rates, military interventions, and recessionary cycles. This pressure has prompted the banks to adopt new lending techniques to maintain profits and prevent default. To the extent that these techniques allow the banks and LDCs enough flexibility to pursue their objectives, they help perpetuate the relationship. To the extent, however, that these techniques compromise both groups' mutual long-term interests, they add to the pressures already exerted by world events and may hasten the relationship's demise.

This Article surveys some of the problems that LDCs have encountered in adjusting their economies to reduce or eliminate their balance of payments deficits and describes the evolution of bank lending for LDC deficit financing. It then analyzes some recent trends in banking techniques used to reduce the risks involved with LDC lending. The Article concludes by examining the likely effect of these trends on the bank-LDC relationship and by suggesting some courses of action designed to ensure its perpetuation.

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1. These countries include such relatively more developed nations as Mexico and Brazil, as well as many less advanced countries around the world.

2. These are the private, non-governmental banks of different nations that have entered the LDC lending market.
I. The Growth in Commercial Bank Lending to LDCs

Over the past decade commercial banks have dramatically increased their loans to LDCs. The predominant factor in the increase in LDCs' demand for private loans has been the need to finance balance of payments deficits.

A. Balance of Payments Deficits and External Financing

A balance of payments deficit generally indicates that a country, at least temporarily, is living beyond its means by spending more for imports than it earns from exports. This overextension may or may not be due to forces within the country's control. For example, if an LDC is experiencing a deficit because it is pursuing an overly ambitious development program requiring increased imports, it can control the deficit by slowing development. On the other hand, if the deficit is caused by external economic forces, it is largely beyond the country's control.

Countries can pursue three basic courses of economic action to correct a balance of payments deficit. First, they can attempt to limit growth and the demand for imports. Second, they can attempt to increase export earnings by stimulating growth and sales. Third, they can postpone these difficult economic adjustments by financing the deficit through either the expenditure of finite reserves or external borrowing.

3. The "balance of payments" is the status of a country's international accounts. These international accounts are the balance of merchandise, i.e., total exports of goods less total imports, the balance of services (invisibles), the long-term capital account, and the short-term capital account. H. Gray, International Trade, Investment and Payments, 443-56 (1979). The purpose of monitoring these accounts is to determine a country's economic position in the international community. Different corrective measures may be required by the overall position of a country's balance of payments. Id. In general, a balance of payments deficit in one country is matched by a corresponding net surplus in other countries. Id. at 458.

4. H. Gray, supra note 3, at 458.


7. H. Gray, supra note 3, at 464; Staff of Subcomm. on Foreign Economic Policy of the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess., International Debt, the Banks, and U.S. Foreign Policy 40 (Comm. Print 1977) [hereinafter Staff Report].

8. H. Gray, supra note 3, at 464; Staff Report, supra note 7, at 40.

9. H. Gray, supra note 3, at 464; Staff Report, supra note 7, at 40.

Financing of balance of payments deficits is not the sole reason for LDC borrowing. Other purposes may include development financing and the accumulation of foreign currency reserves. See G. Abbott, International Indebtedness and the Developing Countries 165-71 (1979); J. Eaton & M. Gersovitz, Poor-Country Borrowing in Private Financial Markets and the Repudiation Issue 8-9 (Princeton Studies in International Finance No. 47, 1981); Solomon, Developing Nations and Commercial Banks:
Trends in LDC Lending

A country's ability to correct for a deficit by pursuing import restrictions or export expansion depends upon a number of factors, including its internal situation, the climate of the world economy, and the country's position in that economy. The country's internal situation is important in several regards. The strength or weakness of a country's political structure determines the demands or restraints its government can successfully impose on the populace. Its ability to satisfy the essential needs of the populace without imports is another factor determining the degree to which the government can impose import restrictions. Finally, the extent to which the country's economy depends on imports to produce exports or enhance internal development also determines the government's ability to pursue a policy of decreasing imports while expanding exports.

The climate of the world economy and the country's position in it also determine the country's ability to pursue corrective policies by dictating the extent to which it can affect the price and supply of its exports. Because LDCs' economies are at lower stages of development, they are more vulnerable than developed countries to the external forces which create deficits. In addition, since LDCs' standards of living are already comparatively low, and their export sales depend heavily on demand in the developed countries, their ability to correct deficits by reducing imports or expanding exports is limited.

Thus, many of the major causes of balance of payments deficits in LDCs are not within their control. Furthermore, LDCs are not situated equally with developed countries, or among themselves, to adopt corrective policies for balance of payments deficits. If economic adjustment cannot be made by decreasing imports or expanding exports,
an LDC will be forced to finance its deficits. If the cost of this financing is not within the LDC's present and future net export earnings, the inevitable result will be that its development resources, i.e., its future income-generating capital base, will be diverted to satisfy short-term needs. This diversion in turn will reduce future export earnings, and can contribute to a perpetual balance of payments deficit.

B. Commercial Bank Lending for LDC Deficit Financing

Prior to 1973 commercial banks played a limited role in LDC lending. Most credit came from public sources such as the International Monetary Fund and the International Bank for Reconstruction and Development, from bilateral government loans, or from the sale of government bonds. After the 1973 oil embargo, however, the huge increase in oil prices revolutionized the relationship between the banks and the LDCs.

The oil price increase created massive surpluses which the OPEC countries deposited in the commercial banks. The banks in turn sought outlets for these deposits at a time when corporate borrowing had been weakened by the depressed economy. They turned to the only borrowers willing to take on massive amounts of loans—the LDCs. At the same time, the oil price increase generated large deficits in the LDCs which exceeded the funds available from public creditors. The LDCs thus were eager to borrow from banks in order to finance their deficits and supplement development capital.

The bank-LDC relationship eased the impact of OPEC price increases by recycling surpluses to LDCs with oil-related deficits. The

18. See supra text accompanying notes 7-8.
20. See G. Abbott, supra note 9, at 166.
22. Solomon, supra note 9, at 332.
23. Id.
24. Id. at 331. In fact, LDCs had begun borrowing from banks during the late 1960's and early 1970's, when they enjoyed sustained growth and increased prices for their exports. This gave them favorable credit ratings and easy access to bank loans. In addition, changes in developed countries' regulation of corporate borrowing, together with increased government guarantees of LDC loans, helped create a favorable climate for LDC borrowing. Solomon, supra note 9, at 330-31; Dod, supra note 16, at 649-50; Aronson, Financial Institutions in the International Monetary System, 12 CASE W. RES. J. INT'L L. 341, 351-52 (1980).
25. See Solomon, supra note 9, at 331.
Trends in LDC Lending

conditions favoring the development of this relationship led the banks and LDCs to overestimate the long-term compatibility of their objectives, however. The LDCs' payment imbalances were thought to be temporary; as a result, difficult policy adjustments to restrict growth and domestic consumption were not made. Over the decade, this belief proved false as the world economy deteriorated and LDCs experienced increasing deficits. The amount of credit required by LDCs has increased and few loans have been repaid without further borrowing.

In the succeeding years LDCs have had limited success in implementing corrective policies to reduce their dependence on external financing. LDCs such as Poland, Nicaragua, and Zaire have experienced political turmoil leading to economic catastrophe and continue to depend on external financing. Other countries such as Jamaica and Rumania have not been able to expand exports or limit the demand for or price of imports and also continue to rely on financing. These latter countries could experience severe political unrest if reductions in imports were attempted. In addition, Rumania, Hungary, and other COMECON countries are showing signs of payment problems and have suffered reduced credit.

Political events also have played a major role in making certain LDC borrowers unwelcome in the credit market. For example, the revolu-

28. STAFF REPORT, supra note 7, at 49-51; P. DHONTE, supra note 6, at 45; see Regan, The United States and the World's Debt Problem, Wall St. J., Feb. 8, 1983, at 32, col. 3 (editorial by Treasury Sec. Donald T. Regan) [hereinafter Regan Statement].

29. Aronson, supra note 24, at 352; Dod, supra note 15, at 650, 653; A Nightmare of Debt, Economist, Mar. 20, 1982, at Survey 22-27; see STAFF REPORT, supra note 7, at 57; P. DHONTE, supra note 6, at xiii; Anderson, The Year of the Rescheduling, Euromoney, Aug. 1982, at 19, 21-22; Regan Statement, supra note 28. Estimates predicted that one of every two dollars borrowed in 1980 would be used to service outstanding loans. STAFF REPORT, supra note 7, at 51. If present conditions persist, it is estimated that by 1985 two of every three dollars will be used for this purpose. Dizard, The End of Let's Pretend, FORTUNE, Nov. 29, 1982, at 60, 78.


31. Id. at Survey 28, 35.


35. The imposition of austerity measures has led to political unrest in similarly situated countries. See STAFF REPORT, supra note 6, at 66-67 (Egypt and Peru).

tion in Iran resulted in a declaration of default, and the war over the Falklands between the United Kingdom and Argentina for a time threatened to precipitate an Argentinian default.

Other LDCs, such as Mexico and Brazil, in large part due to their abundant resources and higher levels of development, were able to service their debt without sacrificing development objectives. In fact, they continued to borrow throughout the 1970's to pursue ambitious development programs. When the world economy began to deteriorate in 1979, however, and the demand for their exports decreased, even Mexico and Brazil encountered serious difficulties in repaying their external debt. The additional borrowings they undertook throughout the 1970's have made these countries the largest debtors among the LDCs. Both are currently adjusting their economies to reduce deficits and avoid default on their loans. A default by either of these countries would have such widespread impact that it could result in the collapse of the international financial system.

Comparative figures illustrate the dramatic change in the bank-LDC relationship that has occurred over the last decade. The average current account deficits of the non-OPEC LDCs grew from approximately 1.75% of their gross national product (GNP) in early 1973 to approximately 6% of their GNP in 1981. The total long-term debt of LDCs from public and private sources grew from $87 billion in 1971 to an

37. See The Iran Crisis and International Law 55 (R. Steele ed. 1980) (bank responses to Iranian crisis); see also A Nightmare of Debt, supra note 25, at Survey 35.
39. See Staff Report, supra note 7, at 54.
41. See id.; Brandt Report, supra note 5, at 222. Some OPEC countries have pursued similarly aggressive development programs. These programs were initially financed by oil revenues, but when revenues declined, the programs were sustained in part by borrowings from banks. Arab Countries, Hurt by Slack Oil Prices, Increase Loans from Commercial Banks, Wall St. J., Dec. 6, 1982, at 30, col. 1 [hereinafter Arab Countries Increase Loans]; Banks Reduce Lending To The Third World Amid Rising Concern Over Debt Problems, Wall St. J., Jan. 19, 1983, at 34, col. 2.
43. See The Debt-Bomb Threat, supra note 42, at 43 (chart).
45. See The Debt-Bomb Threat, supra note 42, at 44; "We Are in an Emergency," supra note 40, at 31.
46. These figures are intended only as a comparative measure. Estimates of LDC debt and bank exposure generally have been inaccurate and unreliable. See infra notes 70-73 and accompanying text.
47. Dod, supra note 15, at 647 (chart).
estimated $524 billion in 1981.\textsuperscript{48} As of 1981 the LDCs owed approximately $90 billion to U.S. banks alone.\textsuperscript{49}

While total lending to LDCs has increased greatly over the decade, it has remained concentrated in the hands of a few LDC borrowers.\textsuperscript{50} For the most part, bank funds have been lent only to middle and higher income LDCs, while the lower income LDCs still depend primarily on public lenders for their external borrowing.\textsuperscript{51}

In the 1980's, the world economy is once again in the process of change. A worldwide glut has driven down oil prices and caused a decrease in OPEC-generated funds which can be re-lent by banks to LDCs.\textsuperscript{52} In fact, some OPEC countries have become net borrowers.\textsuperscript{53} Developed countries also have begun incurring large deficits, and have been financing them by borrowing in the private market, thus adding to the competition for bank funds.\textsuperscript{54} In addition, fears of LDC defaults and the declining profitability of LDC lending have driven some banks from the LDC market.\textsuperscript{55} In sum, bank loans for LDCs are now more difficult to obtain and are available only on much less favorable terms.

Government regulators in developed countries are reevaluating bank lending to LDCs out of fear of a potential collapse of the world financial system.\textsuperscript{56} They believe that such a collapse could be brought

\begin{itemize}
\item \textsuperscript{48} A Nightmare of Debt, supra note 29, at Survey 100 (chart). Other sources suggest a figure of $540 billion. Madeley, \textit{Banks at the Brink}, \textit{WORLD PRESS REV.}, Apr. 1982, at 39.
\item \textsuperscript{49} Atkinson & Rowe, \textit{Problems in International Lending: Are U.S. Banks Heading for Trouble?} Wash. Post, Mar. 14, 1982, at G1, col. 3.
\item \textsuperscript{50} STAFF REPORT, supra note 7, at 53-54.
\item \textsuperscript{51} For example, of the $456 billion of LDC debt outstanding in 1980, thirteen middle to upper income LDCs had accumulated $271 billion, and the remaining $184 billion was distributed among 137 other LDCs. Atkinson & Rowe, supra note 49, at G1, col. 3. More than $61 billion was concentrated in countries in Latin America and the Caribbean, with Mexico, Brazil, Argentina, and Chile together accounting for more than $52 billion. Id. at G2, cols. 2 & 4. See P. DHONTE, supra note 6, at 18-23; STAFF REPORT, supra note 7, at 53-55.
\item \textsuperscript{52} The oil glut has had mixed effects on the world economy. The cost of energy to oil importing countries is significantly lower, which has helped reduce their need for external borrowing. At the same time, however, lower revenues have reduced the OPEC surpluses which banks recycle to LDCs. Farnsworth, \textit{Oil Price Drop Puts Squeeze On Lending to Poor Nations}, \textsl{N.Y. Times}, Apr. 4, 1982, § 5, at 3, col. 1; Rattner, \textit{A Rosier Payments Outlook}, \textsl{N.Y. Times}, Mar. 13, 1982, at 31, col. 3.
\item \textsuperscript{53} Recycling \textsc{OPEC}’s Deficit, \textit{ECONOMIST}, Feb. 20, 1982, at 84; Arab Countries Increase Loans, supra note 41, at 30, col. 1; \textit{The Leverage of Lower Oil Prices}, \textsl{Bus. Wk.}, Mar. 22, 1982, at 66, 69.
\item \textsuperscript{54} In Western Europe, Some Countries Owe Big Sums to Foreigners, Wall St. J., Dec. 14, 1982, at 1, col. 6; Farnsworth, supra note 41, § 5, at 3, col. 1; see Solomon, supra note 5, at 361.
\item \textsuperscript{55} Ipsen, After Mexico, the Regionals are in Retreat, \textit{EUROMONEY}, Jan. 1983, at 58; Grant, \textit{The Stuffers Have Left, The Stuffers Remain}, \textit{EUROMONEY}, Nov. 1982, at 33; Witcher, Small Bank in the South Comes to Regret Entry into Foreign Lending, Wall St. J., Mar. 25, 1983, at 1, col. 6, 15, col. 1.
\item \textsuperscript{56} \textit{See A Nightmare of Debt}, supra note 29, at Survey 89-94; Solomon, supra note 9, at
\end{itemize}
on by wide-spread bank failures if any of the larger LDC borrowers were to default. LDCs and banks are calling for public organizations to take a larger role in the debt financing process as lenders, guarantors, and supervisors.

In addition, the number of renegotiations has increased as some LDCs have been unable to meet their obligations. There are also signs that banks may be more willing—or may be forced by their governments—to declare LDCs in default as the issue becomes more politicized.

Conditions in the developed world continue to limit prospects for the containment of LDC deficits. A major recession in the developed countries has caused a decrease in the demand for LDCs' exports and has depressed their price. In addition, some developed countries are responding to the recession by imposing import restrictions which have depressed further the demand for LDC exports.

The efforts of the United States and other developed countries to reduce inflation have added to LDCs' financial problems by causing persistently high interest rates. This has strengthened the U.S. dollar and depressed LDC currencies. Since most LDC loans are denominated in dollars, the cost of servicing them has increased.

339-41; P. Dhonte, supra note 6, at 51-53; see also Silkenat, Eurodollar Borrowings by Developing States: Terms and Negotiating Problems, 20 Harv. Int'l L.J. 89, 92 n.16 (1979).

At the present time, proposals are being considered to increase regulation of U.S. banks' international loans in order to prevent future crises and placate critics of the increase in IMF contributions. The Reagan administration and Congress fear that acceptance of increased IMF quotas without increased regulation of banks gives the impression of government "bail out." At the same time, authorities are concerned that overly stringent regulations would cause a sharp contraction in bank lending to LDCs and exacerbate the LDCs' liquidity problems. Senators' Plan Urges Fed Be Given Power To Restrict U.S. Banks' Lending Abroad, Wall St. J., Feb. 17, 1983, at 7, col. 2; U.S. Bankers Urge Increase In IMF Capital, Wall St. J., Feb. 9, 1983, at 26, col. 3; see generally Corse & Nichols, United States Government Regulation of International Lending by American Banks, in International Financial Law 85 (R. Rendell ed. 1980).

57. See A Nightmare of Debt, supra note 29, at Survey 89, 92-94.
58. See, e.g., Solomon, supra note 9, at 349.
59. Renegotiation describes situations in which the borrower cannot meet its obligations under the loan agreement and renegotiates or supplements the terms of the original agreement. Note, supra note 32, at 307 n.10; A Nightmare of Debt, supra note 29, at Survey 22-27.
60. Atkinson & Rowe, supra note 49, at 22, col. 2.
61. While the recession and falling oil prices have had some positive effect on prices LDCs pay for imports, the decline has not kept pace with the decline in prices LDCs receive for their exports. See G. Abbott, supra note 9, at 158-66; A U.S. Damper on World Recovery, supra note 13, at 126-28; Africa's Growing Pains, Economist, Oct. 10, 1981, at 88; Rattner, supra note 52, at 31, col. 3.
63. Dod, supra note 16, at 651; A U.S. Damper on World Recovery, supra note 13, at 126.
Trends in LDC Lending

correspondingly. In sum, a number of factors have combined to create a situation of increasing LDC balance of payment problems and decreasing bank funds available to finance them. In addition, the funds that are available are considerably more costly. Finally, world recession has decreased the LDCs' ability to adjust for deficits by increasing exports, while for some LDCs adjustments by reducing imports may not be politically feasible. Thus, development funds are being diverted and loans are being contracted on terms that LDCs are unlikely to be able to meet.

What once was considered a short-term imbalance is in fact a long-term, structural problem which requires far-sighted solutions. Responsible fiscal policies, including economic adjustment and prudent use of private borrowing, must be pursued by LDCs if they are to survive their mounting debt problems. At the same time, inflexibility on lending terms or an exodus of banks from the LDC lending market may cause the collapse of this already unstable relationship.

Banks, LDCs, public organizations, and governments all are seeking to modify the relationship so that it not only will continue to provide the LDCs needed credit, but also will reduce the risks banks presently face. It is unclear whether these changes can be introduced in such a way as to avoid the collapse of the present relationship.

II. Bank Techniques Used to Reduce Risk of LDC Lending

As a result of the increased pressures on the bank-LDC relationship, banks have sought to change their lending techniques in order to reduce the risk involved in LDC lending. These changes have focused on reducing the risk to individual lenders and on minimizing the possibility of default.

A. Techniques Used to Reduce the Individual Lender's Risk

Banks have modified a number of lending techniques in order to reduce their individual risk. Significant changes have occurred in the
areas of risk analysis and exposure limits, syndicated loans and sub-participations, loan terms, and the variety of lending instruments available.

1. **Risk Analysis and Exposure Limits**

Risk analysis is used to assess a borrower's creditworthiness before a bank extends credit. In addition, risk analysis is used to establish internal exposure limits on the total amounts a bank is willing to lend in particular countries.

While banks always have engaged in risk analysis, several analytical models recently have been developed to provide more accurate assessments. These models take into account such factors as socio-political circumstances, external debt positions, foreign reserves in relation to imports, energy vulnerability, and the relative levels of exports and imports.

Even though risk analysis has improved over the past decade, the reliability of the projections remains in doubt. One serious problem is the dearth of information available on LDC economies. Many LDCs lack the administrative staff and expertise necessary to accumulate accurate data for the analysis of past and future economic trends. Perhaps the best information comes not from the LDCs, but rather from international organizations whose functions include the monitoring of LDC economies. These organizations, however, often treat as confidential the specific information necessary for refined analysis and deny banks access to it.

In addition, regional banks generally have neither the capacity nor the resources to conduct sophisticated risk analysis. In the past they have joined loan syndicates with larger banks and have relied on the

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68. Different risk analysis models have been developed by such entities as the U.S. Export-Import Bank, the U.S. Comptroller of the Currency, and the money-center banks. Most banks and financial organizations have adopted variations of the major models or formulated their own. See id.; J. Baker, *International Bank Regulation* 35 (1978); A. Angelini, M. Eng & F. Lees, *International Lending, Risk and the Euromarkets* 124 (1979).
70. See, e.g., Ipsen, supra note 55, at 58.
71. A. Angelini, M. Eng & F. Lees, *supra* note 68, at 78 n.8.
72. Id. at 78; J. Eaton & M. Gersovitz, *supra* note 9, at 3; A Nightmare of Debt, *supra* note 29, at Survey 92-93.
Trends in LDC Lending

loan managers’ analyses.\textsuperscript{75} Since the larger banks have begun encountering difficulties with their LDC loans, however, regional banks have been reluctant to rely on information provided by larger banks and have been refusing to join new syndicates or refinance existing loans.\textsuperscript{76}

As a partial solution to this informational gap, a number of larger banks are forming an organization to collect and disseminate information needed to perform risk analysis.\textsuperscript{77} These banks hope to encourage continued lending by regional banks and prevent the crisis which could occur if a large number of regional banks were to discontinue their LDC lending.\textsuperscript{78}

In addition to analyzing the credit worthiness of particular borrowers, banks also reduce their risk with internal exposure limits, which establish a maximum aggregate amount that will be lent in any one country and thus diversify the group of borrowers whose loans are held in that bank’s portfolio.\textsuperscript{79} Since exposure limits are developed with the use of risk analysis, they are only as accurate as the risk analysis itself. In addition, if a bank allows its officers to exceed exposure limits, the limits’ effectiveness in encouraging prudent lending is compromised.

While risk analysis and exposure limits both are useful in establishing prudent levels of LDC exposure, overly conservative use of these techniques can be counterproductive. If banks set their limits at levels which reduce loans to LDCs faster than the LDCs can adjust to the reduction, the LDCs, unable to roll over enough of their loans, will encounter payment problems.

2. Diversification Through Syndications and Sub-participations

Banks reduce their individual risk in lending to LDCs through the use of syndicated loans and sub-participations. These techniques allow

\textsuperscript{75} Ipsen, supra note 55, at 62-63; Witcher, supra note 55, at 1, col. 6.

\textsuperscript{76} See Ipsen, supra note 55, at 58, 62, 64-65; Witcher, supra note 55, at 1, col. 6.

\textsuperscript{77} Ipsen, supra note 55, at 58; Witcher, supra note 55, at 1, col. 6.

\textsuperscript{78} Ipsen, supra note 55, at 58, 62; Witcher, supra note 55, at 1, col. 6. This organization may not sufficiently assuage the fears of the regional banks. See id., at 1, col. 6, 15, col. 1.

\textsuperscript{79} Internal exposure limits are established by banks as part of their internal lending review procedures. The limits are based on data obtained from the bank’s risk analysis. Some banks’ systems for generating exposure limits are described in A. ANGELINI, M. ENG & F. LEES, supra note 68, at 124-31. The United States Comptroller of the Currency has interpreted federal statutes to impose a limitation on banks’ exposure to individual public sector borrowers in foreign countries. See 12 U.S.C. § 84 (1976).

Congress currently is considering authorizing the Federal Reserve to establish exposure limits on a country-by-country basis. These limits would vary with the country’s ability to repay its debt. Current regulations do not limit lending to individual countries but rather require specific capital reserves for foreign loans. See generally, Corse & Nichols, supra note 56. The adoption of country exposure regulations would institutionalize present internal exposure limit practices. Senators’ Plan Urges Fed Be Given Power To Restrict U.S. Banks’ Lending Abroad, supra note 45, at 7, col. 2.

183
banks to hold smaller shares of loans, or to distribute parts of loans they hold, and thus reduce the size of the LDC loans in their portfolios.

Syndications divide a loan among a number of participating banks, and thus spread the risk among the lenders and diversify the individual banks' portfolios. The syndication is coordinated by a managing bank which solicits commitments from banks that have expressed interest in the loan. The management and commitment processes both entail additional fees.

From the borrower's point of view, the drawback of syndicated loans is the increased cost of borrowing caused by additional fees and expenses. There are, however, a number of benefits, in addition to the reduction of bank risk, which seem to offset the increased cost. These include: increasing the pool of lenders by reducing participation amounts, thereby allowing smaller banks to join the loan; and providing the borrower with the expertise of a managing bank which is hired to organize the syndicated loan.

Sub-participations are also used to divide up a large loan among a number of banks. In a sub-participation, a bank holding a loan in its portfolio will sell to one or more banks parts of the loan and the right to receive the payments from it. Some sub-participations provide that they can be resold to the selling bank if the borrower does not pay on the loan, but most do not. Sub-participations usually are for short terms and often involve loans that have been held by the selling bank for a number of years and are close to being repaid. Disposal of part of these loans allows the selling bank to free its capital base and obtain new loans.

While the sub-participation technique has its origins in the 1960's, only recently has it gained respectability among the large banks. Its popularity has increased because of the decline in the number of smaller banks willing to participate directly in syndicated loans, which

80. See Johnson, Banks will go on lending to the LDCs, THE BANKER, Nov. 1981, at 27. For further description of syndicated loans, see A. Angelini, M. Eng & F. Lees, supra note 55, at 86. See also Silkenat, supra note 45; Ryan, International Bank Loan Syndications and Participations, in INTERNATIONAL FINANCIAL LAW 25 (R. Rendell ed. 1980). The syndication market is currently contracting due to the departure of regional banks from the credit market. See supra note 44 and accompanying text.
81. A. Angelini, M. Eng & F. Lees, supra note 68, at 86.
82. Id. at 84, 87.
83. Id.
84. See Witcher, supra note 55, at 1, col. 6.
85. Silkenat, supra note 56, at 90 n.8.
87. Id. at 41.
88. Id.
89. Id. at 39.
90. Id.
Trends in LDC Lending

in turn has forced the larger banks to hold increased portions of the syndicated loans they manage. Thus, an active secondary market for syndicated loan participations is being created.

Even with its new-found popularity, sub-participation remains sensitive and unpublicized, because banks do not want to give their borrowers the impression that their loans are not worth retaining in the banks’ portfolios. In addition, because of the relatively recent development of this market, a number of legal issues concerning the banks’ rights on default remain unsolved.

3. Adjustments to Lending Terms

Banks have made a number of adjustments to lending terms which have shifted market risk from them to the LDC borrowers and have increased the economic burden of LDCs’ external debt. These changed terms include floating interest rates, shortened maturities, and up front fees.

Although fixed interest rate terms were common until the early 1970’s, floating interest rates are now used in most LDC loans. These terms shift the risk of interest rate fluctuation to the borrower. As a result of this shift, the LDCs encountered large increases in the cost of servicing their debts during the period of high interest rates in 1981 and 1982. Recently, however, interest rates have declined and eased somewhat the onerous effects of the variable rates.

Shorter loan maturities reduce bank risk in two ways. First, by shortening the time that the loan principal is outstanding, the overall risk of loss to inflation and default is reduced. Second, shorter loan maturities reduce the time that a bank is bound by the loan’s interest margin and thus reduce the risk of the loan’s becoming relatively unprofitable.

91. See id. at 40, 41.
92. Id. at 39.
93. Id. at 40.
94. Id. at 41.
95. Floating interest rates in LDC loans are calculated in two steps. First, a formula in the loan agreement is used to arrive at the London Interbank Rate, the “LIBOR” or “base” rate, for a given interest period. The “margin” or “spread,” a percentage in excess of LIBOR fixed by the loan contract, then is added to the base rate. Silkenat, supra note 56, at 94; see Mitchell & Wall, The Eurodollar Market: Loans and Bonds in INTERNATIONAL FINANCIAL LAW 53, 62 (R. Rendell ed. 1980). The average spread above LIBOR on LDC loans between 1973 and 1981 ranged from approximately 0.8% to 1.6%. A Nightmare of Debt, supra note 29, at Survey 77 (chart). As the LIBOR rate fluctuates to reflect banks’ increased capital costs, LDCs bear higher interest on their loans.
96. The interest rate for 3-month Eurodollar loans was 13.63% on December 31, 1981, 10.00% on October 27, 1982, and 9.38% on December 8, 1982. Facts and Figures, Euromoney, Jan. 1983, at 136.
97. Bank profits on loans are determined by the margin fixed in the loan agreement. See,
While banks have found shorter maturities attractive, they are one of the major reasons many LDCs face severe problems in servicing their debt. A significant part of LDC debt has been incurred in order to finance economic development, which requires a long gestation period. Shortened maturities on these loans do not provide LDC economies sufficient time to use the borrowed development capital to generate additional earnings to meet principal repayment schedules. The result has been an increase in the number of LDCs requiring renegotiations of their loans.

Finally, banks also have reduced their lending risk by recovering more of their costs and profits early in the loan term by charging new and increased fees. Syndicated loans are accompanied by various "up front" charges, the more common of which are commitment, management, participation, and agent fees. These fees are in addition to interest and other charges normally involved in borrowing and are assessed whenever a loan is rolled over or refinanced. Their net effect is to increase banks' immediate profits and LDCs' cost of borrowing.

It is difficult to determine whether the overall effect of these adjustments in loan terms has resulted in net benefit or detriment to LDCs. On the one hand, it can be argued that banks would not have continued to lend to LDCs without these adjustments in lending terms, and that LDCs thus benefit from continued access to the private market. Further, reduced risk and added profitability have increased the pool of banks willing to lend. On the other hand, increased costs have added significantly to the LDCs' debt burden. In addition, un-restrained access to private markets on these terms has been seen by some

e.g., Ellington & Schiffman, After Polish Crisis, International Banks Seek Lower Risks, Higher Interest Fees, Wall St. J., Mar. 2, 1982, at 34, col. 1. While floating interest rates reduce the risk to banks of increased cost of funds, profits on loans are not protected. Margins vary widely from loan to loan, creating for banks the risk of being bound to a long-term loan at an uncompetitive margin rate. This risk can be reduced by lending over shorter terms. See P. Dhonte, supra note 6, at 46; see also Atkinson & Rowe, supra note 30, at 63.

99. Id.
100. See Johnson, supra note 80, at 29.
101. A. Angelini, M. Eng & F. Lees, supra note 68, at 87-88.
102. Id. at 84.
103. See generally id. at 86.
104. Johnson, supra note 80, at 29; A Nightmare of Debt, supra note 29, at Survey 77-78.
105. The Brandt Report stated that:

[T]he heart of the debt problem is that a very large proportion of funds are lent on terms which are onerous for borrowers from the point of view of both the repayment capacity of the projects they finance and the time debtor countries need to correct structural imbalances in their external accounts.

Brandt Report, supra note 5, at 223. See also C. Hardy, supra note 98, at 17-18, 45-48.
Trends in LDC Lending

as facilitating irresponsible policies on the part of both banks and LDCs.106

4. Innovative Debt Instruments

LDCs have not had ready access to the Eurobond market.107 Recently, however, some middle income LDCs have been able to make inroads into this market by offering innovative debt instruments.108 These innovative LDC instruments, which include Euronotes, commercial paper offerings, and floating rate notes, are characterized by such features as variable interest rates, medium-term maturities, smaller face amounts, and wide distribution among a broad variety of lenders.109

These types of debt are likely to become more common as fears of bank overexposure increase. They have many of the benefits of syndicated loans, plus the additional advantage of innovative features designed to attract different types of lenders.110 Their broader distribution, like that of syndicated loans, serves to spread the borrowing among a greater number of lenders, including regional banks and nonbank investors, and thus diversify the lenders' risk.111

B. Bank Techniques to Prevent Default

Banks also have adopted techniques which concentrate on the pre-
vention of default as a means of reducing risk. These techniques include loan renegotiation, conditionality, cross default arrangements, and government influence.

1. Renegotiation

Loan renegotiation usually becomes necessary when a country's foreign reserves and export earnings are insufficient to cover the cost of imports and debt service, placing the country on the verge of default. To prevent default, creditors renegotiate the loan by providing additional loans or extending the time for repayment.

LDCs can attempt to renegotiate loans from any of their three sources of credit: the IMF, governments, and banks. Renegotiation can involve rescheduling and refinancing. Rescheduling entails extending a debtor's repayment schedule and is generally preferred by government lenders. Refinancing entails providing new loans to pay off old ones and is preferred by banks because it allows them to earn additional fees.

When an LDC seeks to renegotiate its loans, it usually begins by approaching the IMF. The IMF assists in evaluating the LDC's economic problems and establishing a program of corrective policies which usually includes access to the IMF's credit facilities. Government and private creditors often insist on IMF involvement before they agree to renegotiate an LDC's loans.

If necessary, the LDC then will approach its government creditors, whose meetings on LDC payment problems have come to be known as the Paris Club. Government lenders use what often is called the "short leash" approach to renegotiation, which provides credit relief


113. A Nightmare of Debt, supra note 29, at Survey 41.

114. P. Dhonte, supra note 6, at 36; D'Arista, Private Overseas Lending: Too Far, Too Fast, in Debt and the Less Developed Countries 70-71 (J. Aronson ed. 1979).

115. P. Dhonte, supra note 6, at 35-37.

116. G. Abbott, supra note 9, at 208-09; Note, supra note 32, at 307 n.10; P. Dhonte, supra note 6, at 35-37.

117. See A Nightmare of Debt, supra note 29, at Survey 27.

118. Note, supra note 32, at 311, 321; A Nightmare of Debt, supra note 29, at Survey 27. See infra text accompanying notes 136-57 (IMF conditionality programs).

119. J. Eaton & M. Gersovitz, supra note 8, at 56; Note, supra note 32, at 322; see infra text accompanying notes 136-57.

120. See A Nightmare of Debt, supra note 29, at Survey 27. The Paris Club and its procedures are described in P. Dhonte, supra note 6, at 35-37; A Nightmare of Debt, supra note 29, at Survey 27. Some of the problems now facing the Paris Club are presented in Ollard & Sington, The Unique Club of Michael Camdessus, Euromoney, Aug. 1982, at 52, 54.
Trends in LDC Lending

restricted as to both the loans which can be renegotiated and the periods for which they can be extended. This embodies the belief prevalent in developed countries that debt relief is not a proper form of foreign aid, and that LDC loans should be viewed strictly in terms of a commercial relationship. In addition, Paris Club members generally insist that no other creditors receive more favorable terms than they, and that renegotiation with bank creditors be pursued concurrently.

The last group of creditors to be approached generally will be the banks. Like the Paris Club, banks use the short leash approach and therefore restrict the scope of renegotiation, preferring to reconvene if settlements prove inadequate. The renegotiation process used by banks is unstructured, in part because of their desire to discourage its use. The problems this lack of structure fosters are exacerbated by the sheer number of banks involved in any LDC renegotiation.

The initial decision in bank renegotiations is the selection of the loans to be included in the process. Three basic principles then guide the renegotiations. First, the banks must reach approximate unanimity with respect to any final agreement. This is required by cross default arrangements among creditors. Second, in order to prevent loans from becoming non-performing assets, postponement of interest payments will rarely be permitted. Third, because of conditions es-

121. G. ABBOTT, supra note 9, at 191-92; see C. HARDY, supra note 98, at 46.
122. C. HARDY, supra note 76, at 46-47; see G. ABBOTT, supra note 9, at 189-94, 249; P. DHONTE, supra note 6, at 42.
123. Note, supra note 32, at 321 & n.93. For a discussion of such a "most favored debt clause," see Wood, supra note 111, at 4.
124. See A Nightmare of Debt, supra note 29, at Survey 27.
125. P. DHONTE, supra note 6, at 40. Some problems with the short leash approach are discussed in C. HARDY, supra note 98, at 46.
126. No formal debt renegotiation procedure includes the commercial banks. Multinational financial institutions have been lending to sovereign debtors, including LDCs, since World War II and have more experience with renegotiation than commercial creditors. Note, supra note 32, at 307-08.
127. For example, the Polish renegotiations involved 501 banks. A Nightmare of Debt, supra note 29, at Survey 27-28.
128. In deciding which loans to include in renegotiations, creditors must decide whether short-, medium-, or long-term loans will be included, and in some cases whether bonds also will be renegotiated. A Nightmare of Debt, supra note 29, at Survey 28. A similar decision must be made by the Paris Club members. C. HARDY, supra note 98, at 21.
129. See infra notes 158-62 and accompanying text.
130. A Nightmare of Debt, supra note 29, at Survey 28. This principle has been waived partially in at least one case, that of Nicaragua. C. HARDY, supra note 98, at 34.

At the present time, LDC loans are carried on banks' balance sheets at their historic cost. Because sometimes there is no realistic expectation that a given LDC loan will be repaid fully, a more accurate appraisal of its value is the projected stream of future income it will produce. Taylor, Accounting for Rescheduled Loans, Euromoney, Nov. 1982, at 31, 33. Reforms in bank accounting and disclosure practices regarding LDC loans currently are being considered by federal regulators and Congress. Dizard, supra note 29, at 75; Regulators Plan Tighter Control of Foreign Loans, supra note 106.
established by the Paris Club, banks cannot obtain better terms than Paris Club members when government loans also are being renegotiated.131

To discourage renegotiation, government and bank creditors have resisted formalizing renegotiation procedures.132 Because the payment problems of LDCs often recur, however, ad hoc approaches to renegotiation serve only to compound the LDCs' difficulties.133 In addition, the insistence of government and bank creditors on restricting the scope of the arrangements results in repeated renegotiations.134 As a result of the restrictive and unstructured nature of this process, it is not uncommon for loan renegotiations to begin shortly after, or even before, agreement regarding prior years' debts has been reached.135

2. Conditionality

Programs of conditionality impose economic austerity measures on LDCs and thereby reduce the risk of default on their loans from banks.136 Under a program of conditionality, the IMF and the LDC formulate and impose austerity measures after considering the LDC's social, political, and economic circumstances.137 These measures are

131. See supra note 94 and accompanying text.
132. See, e.g., Note, infra note 32, at 308, 330.
133. Ad hoc approaches to renegotiation often have been attacked as inefficient and disruptive. See, e.g., UNCTAD, Selected Issues Relating to the Establishment of Common Norms in Future Debt Reorganizations at 3, U.N. Doc. TD/AC.2/9 (1977); G. Abbott, supra note 9, at 234-37; Note, supra note 32, at 322-23.
134. G. Abbott, supra note 9, at 190-91.
135. See, e.g., Poland to Sign Accord Today to Delay Debt, Wall St. J., Apr. 6, 1982, at 39, col. 2. Banks have an incentive to renegotiate frequently because the process can be quite profitable. See A Nightmare of Debt, supra note 29, at Survey 36; Note, supra note 28, at 316 n.62.
136. The term "conditionality" appears to derive from the "conditions" which the IMF may impose in granting access to its credit and assistance facilities. See J. Gold, Conditionality (IMF Pamphlet Series No. 31, 1979) [hereinafter cited as IMF Pamphlet No. 31]. The imposition of IMF conditionality programs was not supported by the banks until fairly late in the 1970's. Until then, banks had tried to perform the IMF's function without enlisting its aid. See Staff Report, supra note 7, at 63; Note, supra note 73, at 453-54; Note, supra note 32, at 319 & n.77; Payer, Commercial Banks and the IMF, multinational monitor, Apr. 1980, at 3, 15. The IMF contends that the circumvention of its policies only served to delay and frustrate necessary adjustments to the LDCs' economies. See IMF Pamphlet No. 31, supra, at 16; J. Gold, International Capital Movements Under the Law of the International Monetary Fund (IMF Pamphlet Series No. 32, 1977).
137. In fact, there are two distinct levels of conditionality. Only the second level of conditionality is of significance here.

First level conditionality does not require compliance with a program of economic performance criteria. It is invoked when loans are made from special IMF credit facilities or from a country's IMF reserves. When a borrower requests a stand-by agreement entitling it to use resources in its first credit tranche (its first level of borrowing), it must submit a letter of intent setting forth the economic policies it intends to pursue, and how access to IMF facilities will further the implementation of these policies. Generally, approval of a first tranche loan is automatic. Gold, Balance of Payments Transactions of the International Mon-
Trends in LDC Lending

intended to correct the LDC's balance of payments deficit within a specified time period—usually one to three years. The more commonly used measures include: currency devaluation, restrictions on subsidy programs and other government spending, modification of wage and price controls, ceilings on expansion of credit by the central bank, and limits on additional external borrowing.\textsuperscript{138}

Conditionality is imposed when an LDC seeks IMF assistance, either voluntarily or at the insistence of its bank creditors. An LDC may voluntarily seek the assistance of the IMF in order to gain access to its lending facilities, expertise, and influence with private lenders.\textsuperscript{139} The LDC's agreement to adopt a program of conditionality is often a precondition to gaining access to these facilities.\textsuperscript{140} Alternatively, an LDC's bank creditors may require that it seek IMF assistance and accept conditionality as a precondition to renegotiation or continued lending.\textsuperscript{141} By requiring IMF conditionality programs, banks enjoy the benefits of the IMF's corrective policies, which improve an LDC's ability to service outstanding debt.\textsuperscript{142}

In formulating a program of conditionality, the extent to which the LDC's economy and balance of payments have deteriorated determines the severity of the corrective measures.\textsuperscript{143} The programs are intended to be flexible, however, and can be modified if necessary.\textsuperscript{144} If an LDC fails to comply with an established program, access to IMF resources will be discontinued until new consultations are completed and an

\textit{et al.} Fund in \textit{International Financial Law} 237, 242-44 (R. Rendell ed. 1980). For an example of a stand-by agreement, see \textit{J. Gold, Financial Assistance by the International Monetary Fund} 46 (IMF Pamphlet Series No. 27, 1979) \textit{[hereinafter IMF Pamphlet No. 27].}

The IMF has adopted guidelines strengthening the requirements of the first level of conditionality because they were perceived to have been inappropriate for dealing with borrowers' long-standing economic imbalances. Guitian, \textit{Fund conditionality and the international adjustment process: the changing environment of the 1970's}, \textit{Fin. & Dev.}, Mar. 1981, at 8, 11. The IMF's rationale is the same as that put forth in opposition to continued bank lending to LDCs: unrestricted bank loans, like IMF loans with little conditionality, allow LDCs to delay adopting necessary economic adjustments. \textit{See id.} Moreover, because the first level of conditionality does not require adjustments to the LDC's economy, it is unacceptable to other creditors seeking to gain the benefit of IMF involvement in the country's payment problems. Creditors generally insist that the borrower seek funds from the upper credit tranches or from special facilities which require mandatory programs of conditionality. \textit{See A Nightmare of Debt, supra} note 29, at Survey 41.

\textsuperscript{138} Guitian, supra note 137, at 11; \textit{see also} Kincaid, supra note 33, at 18-21.
\textsuperscript{139} Payer, supra note 136, at 15; Guitian, supra note 137, at 8-11.
\textsuperscript{140} IMF Pamphlet No. 27, supra note 137, at 19.
\textsuperscript{141} \textit{J. Eaton} & \textit{M. Gersovitz, supra} note 9, at 36; IMF Pamphlet No. 31, \textit{supra} note 136, at 14.
\textsuperscript{142} Note, \textit{supra} note 73, at 453.
\textsuperscript{143} IMF Pamphlet No. 31, \textit{supra} note 136, at 16.
\textsuperscript{144} \textit{See, e.g.}, Kincaid, \textit{supra} note 33, at 18-21.
agreement is reached.\textsuperscript{145} An LDC's loan agreements with its bank creditors also may provide that non-compliance with an IMF program would suspend further bank credit until a new arrangement is reached.\textsuperscript{146}

Past experience has shown that conditionality imposes political, economic, and social costs on the borrower. These costs can prove to be too high for some LDCs.\textsuperscript{147} In some cases the LDC abandons the program or attempts to circumvent the process by borrowing the needed funds from private sources.\textsuperscript{148} In such cases, because effective economic adjustments are not made, the LDC's continuing deficits must be financed by increasingly larger borrowings.\textsuperscript{149}

If an LDC continues to finance its deficits without taking corrective measures, it eventually will exhaust its credit and then will be forced to turn to the IMF and other public lenders for assistance.\textsuperscript{150} In the meantime, the internal and external economic well-being of the LDC may have deteriorated such that drastic remedial measures will be required. The IMF maintains that these measures often are more severe than those which would have been necessary had IMF assistance been requested in the first instance.\textsuperscript{151}

LDCs repeatedly have called on the IMF to relax conditionality because of its harsh effects on their citizens.\textsuperscript{152} This causes a dilemma for the IMF and for LDCs with access to bank credit. On one hand, the IMF encourages countries to seek its help as soon as balance of payments problems occur.\textsuperscript{153} If the more onerous requirements of conditionality were to be relaxed, LDCs might be more willing to turn to the IMF before their economic problems became critical. On the other hand, conditionality now has become a strong link between LDCs and both public and private creditors.\textsuperscript{154} If it is made more lenient, creditors will incur greater risks in LDC lending, which will either increase the cost of loans or decrease the amount of funds available to LDCs—

\textsuperscript{145} IMF Pamphlet No. 31, \textit{supra} note 136, at 25.

\textsuperscript{146} \textit{Id.} at 14.

\textsuperscript{147} \textit{See infra} note 152 and accompanying text.

\textsuperscript{148} Adede, \textit{supra} note 9, at 243-46.

\textsuperscript{149} \textit{See id.} at 245.

\textsuperscript{150} IMF Pamphlet No. 31, \textit{supra} note 136, at 16; C. HARDY, \textit{supra} note 98, at 42.

\textsuperscript{151} IMF Pamphlet No. 31, \textit{supra} note 136, at 16; C. HARDY, \textit{supra} note 98, at 42.

\textsuperscript{152} For cases in which implementation of programs of conditionality has led to political unrest, see Kincaid, \textit{supra} note 33, at 18-21; \textit{Staff Report}, \textit{supra} note 7, at 66-67; Solomon, \textit{supra} note 9, at 344-46; Note, \textit{supra} note 32, at 326-28. \textit{See generally} IMF Pamphlet No. 31, \textit{supra} note 136, at 14; C. HARDY, \textit{supra} note 98, at 41-42.

\textsuperscript{153} \textit{See supra} note 151.

\textsuperscript{154} \textit{See Note, supra} note 73, at 453.
Trends in LDC Lending

funds which the IMF does not have the capacity to replace.\textsuperscript{155}

The IMF has not been totally unresponsive to LDCs, however. In 1979 its executive board adopted new guidelines aimed at relaxing some aspects of conditionality.\textsuperscript{156} Significant changes include: an increase from one to as many as three years in the period within which LDCs must meet the goals set in conditionality agreements; the establishment of a policy requiring greater consideration of a country's domestic social and political objectives; a limitation of the conditions imposed on the LDC to those absolutely necessary to meet the goals of the agreement; and the adoption of improved procedures for reviewing and modifying programs.\textsuperscript{157} The movement toward less stringent conditionality is likely to continue, despite the need for the program's positive effects on LDC lending.

3. Cross Default Clauses

Cross default clauses also are used to prevent default and now are widely included in LDC loan agreements with public and private creditors.\textsuperscript{158} A cross default clause usually provides that a default on any of the LDC's loans constitutes an event of default under the loan containing the clause.\textsuperscript{159} As a result, should an LDC default on one of its loans, any creditor having such a cross default clause in its loans could declare them in default.

The effect of cross default arrangements, at least in theory, is to link the LDC's loans together, so that it does not have the option of selectively defaulting on any one loan and must treat all creditors on an equal basis. A cross default arrangement thus holds as collateral the LDC's ability to borrow by making too costly an LDC's default on any one loan, if as a result it may be declared in default on all other loans and thereby lose all its credit.\textsuperscript{160}

Should an event of default occur on a loan included in a cross de-

\textsuperscript{155} See IMF Pamphlet No. 31, supra note 136, at 15; Staff Report, supra note 7, at 64 (benefits to private lenders).

\textsuperscript{156} IMF Decision No. 6056 (79/38), Mar. 2, 1979, reprinted in 1979 IMF Annual Report, at 136-38; see Guitian, supra note 137, at 11; IMF Pamphlet No. 31, supra note 136, at 15.

\textsuperscript{157} IMF Decision No. 6056, supra note 156.

\textsuperscript{158} See Silkenat, supra note 56, at 100; Logan, Term Loan Agreements, in International Financial Law 19 (R. Rendell, ed. 1980); Wickersham, Rescheduling of Sovereign Bank Debt, INT'L FIN. L. REV., Nov. 1982, at 8, 10.

\textsuperscript{159} Another cross default clause sometimes used creates an event of default on the loan it governs, if an event of default (as opposed to a declared default) occurs on one of the LDC's other loans. This type of cross default clause is not widely used because of its restrictiveness. See Carroll, The Worst Clause in the Euromarket, EUROMONEY, June 1981, at 90.

\textsuperscript{160} Cross default arrangements are used not only among private lenders, but also among public and private lenders. In these cases, a default on a private loan could trigger default on an IMF or government loan, or vice versa. Panel Discussion: Refinancing of Third
fault arrangement, if the lender declares a default, it can precipitate a race among creditors to set off or attach assets available to secure payment on their loans. Should a creditor choose instead to negotiate with the LDC and not declare a default, it would sacrifice whatever priority over assets it might have obtained. In most cases a race to seize assets would be counterproductive since it would cause all loans declared in default to become due immediately and would close all lines of credit to the LDC. In any event, there seldom would be enough assets outside the LDC to satisfy fully all the creditors' claims. Renegotiation is usually the only alternative which offers some chance of satisfying most banks' claims.

Once a default has occurred, any creditor protected by a cross default clause could provoke a chain of defaults. As a result the terms of any renegotiation could be disproportionately influenced by banks with relatively smaller exposure whose interests might diverge from those of banks with greater exposure. Thus cross default clauses, while useful in preventing selective default, could profoundly destabilize renegotiation should default occur.

4. Government Influence

Banks also use the influence of their governments to prevent default by requesting them to pursue foreign policies intended to either assist or threaten a troubled LDC. The means banks use to solicit governmental cooperation range from informal contacts with legislators to formal petitions for assistance from the political department in charge of foreign affairs. These approaches vary according to differences in the structure of government and the governmental access provided special interest groups.

The policies which banks may seek to have implemented also vary. In some cases direct grants, reductions in trade barriers or other forms

World Debt, 5 SYRACUSE J. INT'L L. & COMM. 269, 278 (1978); see Note, supra note 73, at 456.

161. Wickersham, supra note 158, at 10; A Nightmare of Debt, supra note 29, at Survey 35-37.

162. For example, a bank with several billion dollars at risk may be forced to follow the hard line pursued by a bank with only a few million at risk. See Witcher, supra note 55, at 15, col. 1 (importance of regional bank's cooperation in averting Mexican default). Of course, the extent to which a creditor is at risk will affect greatly its willingness to compromise with its debtor. See, e.g., U.S. Bids Rumania Pay Overdue Grain Debt, supra note 34, at D1, col. 1.

163. For example, informal bank contact influenced President Carter's decision to block Iranian financial assets in the United States and abroad during the Iranian hostage crisis. See Gordon & Lichtenstein, The Decision to Block Iranian Assets—Reexamined, 16 INT'L LAW. 161, 177-78 (1982). For an example of formal bank contact with the U.S. government, see U.S. Bankers Urge Increase in IMF Capital, supra note 56, at 26, col. 3.
of foreign aid are sought in order to stabilize an LDC’s economy and thereby ensure its continued creditworthiness. In other cases, if an LDC’s government has become hostile or aloof toward its creditors, banks may seek to have their governments threaten political or economic sanctions if the LDC shirks its obligations. The policies which governments may adopt on banks’ behalf can range from informal discussions with LDC governments to formal legislative acts.

These interactions between banks and their governments pose difficult questions concerning their propriety. To the extent that a government is unwilling to allow its banks to suffer major losses from LDC lending and modifies its policies to reflect that concern, banks have significant influence on the government’s foreign policy. Furthermore, government assistance of this type may foster reckless banking practices by giving banks a false sense of security from the belief that the government will “bail them out” by acting as a debt collector or by providing emergency aid to the LDC.

At the same time, however, the banks’ ability to call on their governments for assistance undoubtedly provides them with confidence to continue lending to debt-ridden LDCs. To the degree that these new loans are required to prevent default by LDCs on their outstanding loans, the use of government influence by banks may be a necessary evil.

164. The recent increase in IMF quotas, although indirect, is an example of how U.S. governmental action in aiding LDCs has been enlisted by banks. Clark, Treasury’s Donald Regan Finds It Isn’t Very Easy to Sell ‘Damaged’ Goods, NAT’l J., Jan. 29, 1983, at 208, 211; Madison, Out of the Closet, Nat’l J., Jan. 8, 1983, at 79. A similar example is the pledge by central banks of the developed nations to stand behind their banks in crises. See, e.g., STAFF REPORT, supra note 7, at 26.

165. The freeze of Iranian assets during the hostage crisis is an example of how U.S. governmental action has been enlisted to punish borrowers. Legal Repercussions of the Freezing of Iranian Assets and Loans, INT’L CURRENCY REV., Dec. 1980, at 27; Gordon & Lichtenstein, supra note 163, at 177. Military force also has been used in some extreme cases. Wood, supra note 111, at 5; see Strange, Debt and Default in the International Political Economy, in DEBT AND THE LESS DEVELOPED COUNTRIES 7-26 (J. Aronson ed. 1979).

166. The relationship between banks and government is one of mutual dependence; governments from time to time also have extracted concessions from banks. For example, the governments of the U.S. and U.K. recently successfully requested that their banks continue to lend to different countries. Bossing the Markets, supra note 26, at 9.

167. Issues arise both as to the effects of the relationship on the banks’ governments, see P. DHONTE, supra note 6, at 50, and as to the effects it has on the borrowing government, see id.; Panel Discussion: Refinancing of Third World Debt, supra note 160, at 279.


170. Id. at 31-35.
III. Searching for Common Ground

As external financing of LDC balance of payments deficits has increased, the long-term interests of the banks and LDCs have converged. Banks now have considerable amounts of loans outstanding to LDCs and are vulnerable to LDC economic crises. At the same time, LDCs have become dependent upon continued bank credit to maintain and enhance their economic development. Since LDC prosperity ultimately depends on development, banks and LDCs have a common interest in perpetuating the debtor-creditor relationship.

This relationship is not completely harmonious, however, and recent trends in bank lending techniques are deepening the conflict. Naturally, banks seek to maximize profits and minimize risk, while LDCs seek to obtain funds on the most favorable terms possible. The more difficult issue, however, arises from the central role that bank lending now plays in LDC development. Capital for LDC development traditionally has come from export earnings or from grants and concessional loans from public creditors.\(^{171}\) The amount supplied by these sources over the past decade, however, has not been adequate to meet the LDCs' increasing needs.\(^ {172}\) Therefore, the LDCs have come to rely on continued bank lending to supplement development capital.

Because the LDCs' balance of payments deficits originally were believed to be temporary, the provision of funds on commercial terms seemed to be a suitable interim solution. As underdevelopment has persisted, however, deficits have proven to be a long-term problem. By diverting scarce development capital to pay for short-term loans, existing external debt has become an additional barrier to development.\(^ {173}\) The bank-LDC relationship has begun to deteriorate as economic recession and reduced LDC growth have persisted. Lending techniques adopted in response to these conditions can either facilitate bank lending and preserve the precarious relationship, or increase the LDCs' debt burden and cause a catastrophic contraction of credit.

A. The Impact of New Lending Techniques

Some of the techniques that banks have adopted to diversify further their LDC portfolios have proved beneficial to both banks and LDCs without causing additional strains in their relationship and therefore should be encouraged. The sales of syndication interests and sub-par-

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171. G. ABBOTT, supra note 9, at 185; BRANDT REPORT, supra note 5, at 221-29.
172. See, e.g., BRANDT REPORT, supra note 5, at 224-25.
173. See, e.g., G. ABBOTT, supra note 9, at 187.
Trends in LDC Lending

Participations in loans, together with the proliferation of innovative debt instruments, have helped banks diversify by permitting smaller participation amounts and enlarging the pool of lenders. As a result, many LDCs have been able to gain access to new and larger capital markets.

More accurate risk analysis and internal exposure limits also have been positive additions to banks’ lending techniques. They have provided necessary controls on lending, which in the long run benefit banks by curtailing excessive lending risk and benefit LDCs by preventing unmanageable debt burdens. If used too conservatively, however, these techniques could complicate existing problems by causing an excessive contraction of credit for LDCs.

Banks’ actions to influence their governments’ policies have proven beneficial by persuading certain developed countries to adopt foreign policies more accurately reflecting the needs of LDCs. To the extent that these foreign policies have helped stabilize the deteriorating economies of some LDCs, they protect the strategic interests of these developed countries and assist the LDCs.

Other lending techniques, however, have had extremely negative effects on the bank-LDC relationship. By tightening the terms on which LDCs must borrow, banks have forced a diversion of funds from development to the servicing of loans. In addition, the short leash approach to renegotiation has resulted in inadequate settlements and perpetual renegotiation. Finally, banks’ emphasis on overly ambitious programs of conditionality has hampered some LDCs’ development by causing economic and political disruption.

The diversion of capital caused by these lending techniques reduces the LDCs’ development base and limits their ability to correct deficits and repay loans. A better approach would recognize the long-term requirements of the development process and formulate a more flexible relationship.

The changes in lending techniques are symptomatic of the severe pressures on the bank-LDC relationship brought about by the significant role banks now play in LDC development. Modification of those techniques having a negative effect on the relationship may not be sufficient to avert a crisis. Political and economic events beyond the control of the LDCs threaten to overtake them and disrupt their credit relationship with the banks. Longer-term solutions are needed to ensure the continued viability of the relationship.

B. Long-Term Solutions

Banks should recognize the important role they play in LDC devel-
opment and the detrimental effects their policies can have on it. In order to maintain the LDCs' present development base, banks must extend maturities on loans and renegotiation agreements to take into account the protracted time required for LDC development and its vulnerability to world economic cycles. One solution would be to index the maturities on large loans according to the growth in LDCs' GNP. This would permit LDCs to service their debt at a pace commensurate with the development of their economies and would keep development from backsliding in times of economic weakness.

Haphazard and inefficient approaches to renegotiation must be abandoned in favor of a more orderly process. One solution would be to establish a neutral body to act as mediator in renegotiations between LDCs and their creditors. A body such as the International Center for the Settlement of Investment Disputes\(^\text{174}\) could serve as such a mediator. The existence of a specialized forum would aid in the accumulation of expertise and the development of efficient procedures. This would minimize the disruptions and expense caused by renegotiations and bring predictability to an otherwise uncertain process.

The flow of development capital from LDCs must be stemmed in order to ensure an adequate development base. To this end, LDCs must take steps to provide regional banks and non-bank creditors with better information. Voluntary disclosure will help reestablish goodwill and assist larger banks in attracting other lenders to the market. In addition, LDCs should abandon ideological rhetoric calling for actions inconsistent with their role as creditworthy debtors.\(^\text{175}\) LDCs should also seek to reduce their dependence on external debt by encouraging foreign equity investment. To this end LDCs must implement foreign investment policies consistent with the needs of private investors. Developed countries and multinational organizations can assist in this process by promoting investment treaties and other devices intended to encourage and protect investors.\(^\text{176}\)

Finally, the LDC development base must be diversified sufficiently


\(^\text{176}\) One promising step in this direction is the present U.S. initiative to adopt bilateral investment treaties with LDCs in order to encourage private sector investment.
Trends in LDC Lending

to protect it from volatile economic cycles. To accomplish this, LDCs and developed countries should adopt policies aimed at encouraging investments which enhance the LDC's development base, but do not already represent a significant portion of its existing industry.

C. The Need for a Long-term Perspective

The bank-LDC relationship is at a crucial juncture: commercial banks, LDCs, and indeed the global financial system all depend on its continued vitality. The only hope for a solution to the LDCs' debt crisis lies in the elimination of their balance of payments deficits, which is dependent in turn on their long-term economic development.

Many of the lending techniques adopted in response to the deepening financial crisis have increased the LDCs' debt burden and decreased the capital available to them, while others have helped to maintain or enlarge the lending pool. Appraised in terms of their contribution to LDCs' long-term economic development, lending techniques insensitive to LDCs' economic situation may indeed retard the growth necessary for the support of long-term economic development, however much they may encourage lending by offering banks high short-term profits. The ultimate stability of the world financial system thus requires that banks assess their lending techniques not in terms of their short-term attractiveness, but rather in terms of their effectiveness in promoting LDCs' long-term economic growth.