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LDC Lending After the Crisis

In August 1982, Mexico announced that it was imposing a repayment moratorium on the debt it owed international banks. This announcement has had a profound and lasting impact on the market's assessment of the risks involved in lending to less developed countries (LDCs). And although the debt servicing capabilities of Mexico and other LDCs have improved significantly since then, private lenders generally remain cautious about providing new financing to the developing countries that are perceived as "troubled." Moreover, bond financing has all but dried up as a source of funds for these riskier LDCs, forcing them to rely on private bank loans more heavily now than they did before August 1982. This *Letter* examines these changes in lending patterns and suggests several reasons commercial banks have been providing virtually all of the limited supply of new private financing to LDCs in recent years.

The role of private lending

Prior to the 1970s, external financing of economic development in LDCs primarily was provided by governments of industrial countries and official multilateral agencies. Private external financing was more limited and generally took one of two forms: direct equity investment in plant and equipment and international bond finance. Commercial bank loans, in contrast, were limited to short-term trade finance.

Beginning in the early 1970s, however, both the external funds raised by developing countries and the proportion supplied in private markets mushroomed. For example, in 1970, less than half of the \$25 billion in external debt outstanding of Latin American countries was provided by private creditors. By 1982, private creditors held approximately 70 percent of the \$175 billion in external medium- and long-term debt of Latin American countries, according to the Organization for Economic Cooperation and Development (OECD).

Moreover, bank loans, as opposed to bonds, provided the largest share of this private financing.

Of the new private external debt raised by Latin American debtors between 1977 and 1982, bank loans accounted for 84 percent and bonds accounted for only 16 percent. As a result, U.S. commercial banks' loans outstanding to all LDCs rose from \$81 billion in 1977 to \$162 billion in 1982.

Diminished private lending

Mexico's debt moratorium in August 1982 and the general LDC repayments crisis that ensued changed the nature of private lending to LDCs. (See *Letter* of May 6, 1988.) Specifically, private lenders' perceptions of the risks involved in lending to LDCs changed for the worse and international financial markets began to distinguish more sharply among LDC borrowers according to their creditworthiness, discounting deeply the outstanding obligations of the most troubled debtors.

As a result of increased concern for risk, the supply of new funds for these troubled LDCs plummeted. According to data published by the OECD, new medium- and long-term bank lending to the 15 troubled LDCs specified in the 1985 Baker Plan fell from \$26 billion a year between 1978 and 1982 to \$10 billion after 1982. International bond issuance by these countries fell even more sharply, from an average of \$4 billion to \$0.2 billion a year over the same period.

Rising reliance on loans

Thus, as the pace of private lending to LDCs slowed, troubled debtors' reliance on bank loans increased. As a proportion of total external funds raised by troubled LDCs, bank loans rose from 84 percent in 1982 to 99.5 percent in 1987. This is in contrast to the industrial and more creditworthy developing countries' *growing reliance* on international bond issuance over this period. Apparently, as creditworthiness declined, the troubled countries lost their ability to tap the international bond market and instead had to rely relatively more on bank loans for external funds. In fact, statistical analysis confirms that a country's reliance on bank lending is *negatively re-*

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lated with its creditworthiness and that after 1982 access to bond finance diminished, particularly for the more troubled borrowers.

There are a number of possible reasons that bank loans have tended to become more important to borrowers as credit risk has increased. Three of these—"involuntary lending," banks' relative advantages in loan rescheduling, or workout situations, and regulatory distortions—are discussed below.

Involuntary lending

Some have advanced the argument that the increased reliance on bank lending among troubled LDCs is due to involuntary lending; that is, banks were "forced" to provide additional funds to protect existing investments. A failure to provide modest amounts of new funds to cover debt service requirements would have forced troubled borrowers into default. In the end, according to this argument, bankers would have recovered a much smaller proportion of their original investment had they chosen not to reschedule outstanding obligations.

There is considerable evidence to support this view. Only a small proportion of "new" lending to LDCs after the crisis represented a net increase in the amount of borrowed funds available to those countries. Most of this lending actually involved maturing obligations that were being rolled over and/or rescheduled, and in most cases, the net new funds were sufficient only to allow the borrower to meet a portion of its outstanding interest obligations. Moreover, the major lending syndicates had to enforce "fair-share" rules to come up with the needed funds. Even so, lending was considered inadequate, inducing Treasury Secretary Baker to establish a formal plan for concerted lending to the fifteen major troubled debtors.

Thus, the involuntary lending explanation is consistent with the international lending patterns we have observed for banks. However, it is not entirely satisfactory. A number of troubled LDCs also had bonds outstanding prior to the crisis. On the basis of the involuntary lending explanation, the two groups of lenders—the bondholders and the banks—could be expected to respond similarly to the debt crisis. Yet the two appear to have responded quite differently. Nearly all ac-

counts of the management of the debt crisis suggest that it was the bank lenders and not the bondholders that were involved in debt rescheduling and extensions of new credit. As noted earlier, bond financing became nonexistent after the crisis for certain countries.

Why did the banks respond differently to the debt crisis than did the bondholders? Assuming that neither the bankers nor the bondholders were willing to "throw good money after bad," bankers must have had some inducements to continue lending that bondholders did not have. Two explanations come to mind. First, bankers may have had superior information on the ability of LDC debtors to repay, and/or superior ability to obtain repayment. Second, bank lenders may have had regulatory incentives to lend that were not available to bondholders.

Banks' relative advantage

A number of economists have argued that for certain types of borrowers bank loans have advantages over bonds as a source of funds. Broadly speaking, borrowers and investors (that is, the ultimate lenders) use two types of financial instruments to transfer savings—bonds (direct finance) and bank loans (intermediated finance). The choice between the two will depend on the instrument that provides borrowers with the cheapest source of funds and investors with the highest return net of the costs of collecting and maintaining payments records and continuously monitoring the borrower's financial condition.

This framework can be applied to international lending. For some borrowers, particularly the industrial countries and the developing countries with no history of balance-of-payments difficulties, the costs of monitoring are relatively modest since default risk is negligible. Consequently, these borrowers generally will have ready access to bond finance.

For other borrowers, particularly those developing countries with histories of political instability and sluggish economies, close monitoring may be necessary because the risk of default is much higher. These borrowers will find bank loans a cheaper source of funds because banks typically have access to information on payments activity and payments flows that enables banks to monitor and work with troubled debtors, and ulti-

mately, to seize assets more cheaply than can bondholders.

This relative advantage argument helps to explain why, once the debt crisis erupted and investors became more concerned about the probability of default on the part of at least some of the LDC debtors, there was such a pronounced shift away from bond finance in those countries: with increased default risk, banks' superior ability to work with troubled debtors became even more valuable to investors.

Regulatory environment

At the same time, there are a number of factors specific to banks' regulatory environment that may have encouraged banks to lend to LDCs prior to the crisis, and to continue lending to LDCs after the crisis. One such factor is reserve requirements. U.S. banks are subject to reserve requirements on funds they raise abroad and invest domestically. Thus, when U.S. banks were faced with an influx of foreign deposits from OPEC countries in the 1970s, they tended to look abroad for investment opportunities to avoid the reserve tax on these deposits. The growing demand for external financing among LDCs provided ready investment opportunities.

Moreover, underpriced deposit insurance and other subsidies (whether implicit or explicit), by underwriting some of the risk banks undertake, may have given banks greater incentive (than bondholders) to lend to LDCs both prior to and after the crisis. The increases in explicit deposit insurance coverage from \$15,000 in 1968 to \$100,000 in 1980 increased the value of the insurance subsidy during this period and added to banks' incentive to take on risk. Likewise, the way in which the bank regulators handled several major bank failures during this period may have created a perception that the government was underwriting a larger proportion of the risks banks were undertaking.

Given banks' attempts to avoid reserve requirements, as well as the inducements to risk-taking provided by deposit insurance and other subsi-

dies, it is not surprising that a very large share of the private lending to LDCs even prior to the crisis took the form of bank loans as opposed to bonds. After the repayments crisis erupted, the way in which bank regulatory agencies and official multilateral agencies such as the International Monetary Fund accommodated the loan rescheduling and workout process may have reinforced the perception that LDC lending was being subsidized. For example, regulators allowed banks to record most LDC loans at book value as long as there was a "reasonable" prospect that the bank would be repaid at least its principal investment. As a result, banks were not required to record capital losses on LDC loans even though the market value of those loans declined precipitously following the 1982 crisis. By allowing this sort of "capital forbearance," bank regulators may have provided some inducements to continue lending.

Complementarity

The available evidence on lending to LDCs cannot clearly distinguish among the various influences on bank behavior. It is likely that the need to preserve the value of outstanding investments through involuntary lending, the advantages of bank loans over bonds in workout situations, and the existence of regulatory distortions all have had an impact since they are not mutually exclusive and may even be complementary.

For example, part of the reason that the governments of industrial countries may have chosen to accommodate bank lending to LDCs may have been that, in the event of a crisis, bank lenders have a relative advantage in monitoring the borrower and in handling problem loan workouts. Moreover, multilateral organizations like the IMF may have encouraged continued lending and helped enforce fair-share lending rules because the amounts of funds provided otherwise would have been inadequate. Thus, the three influences on bank behavior could have been, and probably were, mutually reinforcing.

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