Bankers’ Dilemmas: Private Cooperation in Rescheduling Sovereign Debts

Charles Lipson

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By CHARLES LIPSON*

I. INTRODUCTION

DURING the 1970s, the less developed countries started borrowing substantial sums from commercial banks in the Eurocurrency markets. Although this borrowing began well before the Arab oil embargo, its pace accelerated markedly in mid-decade, after oil prices had quadrupled and export earnings collapsed. Economic growth inevitably slowed worldwide, but heavy borrowing still allowed creditworthy LDCs to pursue significantly higher growth paths than those of Europe and North America.¹ The associated deficits were financed, in large part, by commercial credit.²

Much of this credit was extended to state-owned enterprises, which grew steadily while foreign direct investment lagged. In effect, one form of foreign capital was substituted for another.³ Since the new funds could be used quite flexibly, this substitution of loans for direct investment gave state managers substantially more control over domestic economic

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¹ From the late 1960s until 1983, the less developed countries consistently grew faster than the industrial countries. The biggest contrast was in 1975, when O.E.C.D. economies actually contracted slightly while those of less developed countries grew by approximately 4%. Between 1973 and 1979, Gross Domestic Product (GDP) in LDCs rose by 5.2% annually, and even faster (5.6%) among so-called middle-income oil importers. Advanced countries, by contrast, adjusted much more rapidly to the new factor prices and grew by only 2.8% annually. World Bank, World Development Report 1984 (New York: Oxford University Press, for the World Bank, 1984), 11-12, Table 2.1, Figure 2.1.


activity and more control, at least initially, over the articulation between the national and the world economy.

There was, as we know, a terrible reckoning. It came in the early 1980s after a second oil crisis, another deep recession, and soaring real interest rates. Since Eurocredits had been extended on floating rates, interest obligations rose rapidly, both absolutely and relative to export earnings. The terms of repayment were, of course, fixed contractually and were unrelated to national economic performance. They became increasingly onerous as interest rates rose and export earnings fell.

Still, when international credit was initially provided, it seemed to offer state planners more autonomy and wider choices than direct investment. State managers could choose the sectoral distribution of funds, and could emphasize capital-intensive infrastructure projects. They were no longer dependent upon the investment choices of multinational firms. Nor did the foreign loans carry the implications of external control and dependence so often associated with direct foreign investment. Or so it seemed at the time.

But in a moment of crisis, when fixed repayment schedules are beyond reach, international loans offer only hard choices and little discretion. The debtor typically needs some breathing space: postponement of principal payments falling due over the next few years, and perhaps an infusion of new funds to keep interest payments current. In return, creditors want some assurance that, if they do renegotiate, they will be repaid promptly. They want some evidence that the debtor country can earn more foreign exchange and that it intends to meet its new repayment schedule. They have demanded, and received, agreement from debtors to undertake severe austerity programs.

In practice this means that the troubled debtor must approach the International Monetary Fund (I.M.F.) for conditional balance-of-payments support. To secure this support, a member country must reach agreement with the Fund on its future economic policies and performance targets. Actually, as far as both debtors and creditors are concerned,

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4 In 1977, the developing countries paid nearly $40 billion in interest and principal. By 1984, that figure had quadrupled. Interest payments by the 25 largest borrowers rose from 10% of export earnings to 25%. Another 11% of export earnings went to repay principal, so that by 1984 debt-service represented well over one-third of total export earnings. The rise in this debt-service ratio was most marked between 1980 and 1982. IMF Survey, January 7, 1985, p. 3 (table); International Monetary Fund, World Economic Outlook (September 1984), revised projections by I.M.F. staff, Tables 35-36.


6 Negotiations between Argentina and its major creditors demonstrated that the banks
the I.M.F.'s own credits are far less important than its approval of the proposed austerity measures. Without such approval and the continuing oversight that goes with it, the creditors (both public and private) simply will not reschedule sovereign debts.⁷

This critical status has given the I.M.F. some leverage in dealing with banks as well as with debtors. By refusing to sign a stabilization package, the Fund could effectively sabotage any agreement between the creditors and the debtor, and thus jeopardize the creditors' interests. It has used this threat, as we shall see, to provide residual coordination for banks—reinforcing the banks' own efforts to renegotiate their loans and to provide new credits to the impoverished debtor.

As the stakes in rescheduling have risen—with the biggest borrowers on the brink of default—the whole process has become more contentious. It is clear that loans to Third World borrowers entail losses; no one would value them at par. What has been unclear is who will bear these losses. That is what the fighting is really about—between creditors and debtors, between creditors and their monetary authorities, and among the creditors.

The debtors, most notably Argentina, have resisted the I.M.F.'s recommendations to reduce domestic demand and increase net exports. They have done so because I.M.F. programs are politically painful, usually requiring currency devaluation, deep budget cuts, limitations on new domestic credit, and suppression of real wage growth. The debtors have pushed instead for concessions on their outstanding obligations: below-market interest rates, longer grace periods for repayment, and postponement of several years' principal payments rather than merely one or two.

Creditors have refused to make significant concessions on interest rates, since that would not only lower bank earnings but would also acknowledge that a portion of the debt was uncollectible. They have made concessions, however, on other issues. Now that the first wave of "crisis reschedulings" is over and economic austerity programs are in place, creditors are willing to restructure debts over longer terms. They are less insistent on penalty rates and renegotiation fees, and more attentive to the problems of resuming economic growth. The smaller

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⁷ Obviously, this informal requirement can apply only to member countries of the I.M.F. Since most states of Eastern Europe are not members, the creditors' oversight of economic programs there is inevitably weaker and less institutionalized. Commercial lenders have understandably sought to widen I.M.F. membership to include these states.

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require fully approved stabilization programs, not simply statements about "significant agreement with the I.M.F." or substantial progress in negotiations. Wall Street Journal, August 16, 1984, p. 27, and August 17, 1984, p. 16.
creditors have accepted the new terms proposed by larger banks—as they apply to outstanding debts. What they have not always accepted so easily is the obligation to provide new funds as part of the rescheduling package. Their reluctance to make new, “involuntary” loans has meant tougher and more prolonged bargaining among creditors.

In view of the severity of these problems, most observers have focused on the immediate and overriding policy issues: the stability of Western banking, the economic and political impact of I.M.F. stabilization programs, and the prospects for institutional reform. In the process, other important issues have been neglected. Little effort has been made to explore the strategic interaction of the various actors—their goals, their calculations, and the institutional framework within which bargaining takes place.

As a result, we have overlooked the whole issue of how, and why, creditors manage to cooperate. Yet cooperation among creditors has been the very basis of recent international debt management. Large money-center banks, relying on their own prior ties and institutional arrangements, have devised common positions to preserve the value of their foreign assets. And they have secured ratification from reluctant smaller institutions.

The task of rescheduling is a complicated one, involving hundreds of international banks and a wide array of financial assets. Aside from the technical difficulties of rescheduling so many types of financial instruments, there is no simple harmony of interest among creditors. Private banks have different exposures, different ties to each borrower, and vastly different roles in international banking. Moreover, when a joint solution is finally proposed, individual banks may be reluctant to

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provide their share of the cost. They have ample opportunity to threaten
defection from proposed common actions, and plausible incentives to
do so.

In spite of these obstacles, creditors have shown a striking capacity
to accommodate their differences, to reach joint negotiating positions,
and to carry out rescheduling agreements. This capacity for joint action,
so central to debt negotiations, needs to be explained and its limits
explored. The limits to private, voluntary cooperation help to explain
the changing role of international institutions in the debt crisis.

The widespread problems in servicing international debts also raise
broader issues about the security of foreign capital. Are the rules con-
cerning its proper treatment now changing? In the case of direct in-
vestment, for example, the rules have already changed dramatically. In
the late 1960s and early 1970s, traditional legal standards were replaced
by quite varied national treatment. Major oil fields and mineral conces-
sions were nationalized with little compensation, long-term contracts
were nullified, and manufacturing industries were subject to more ex-
tensive regulation. This was more an assertion of economic sovereignty
than a general assault on foreign capital: tough policies in some sectors
were often combined with enticements to invest elsewhere. But whatever
the intent of these policies, they have had a profound impact on national
economic development, the organization of multinational firms, and the
relationship between LDCs and the world economy.

But what of the standards for loan capital? Do wholesale debt re-
negotiations imply that the rules and procedures are changing now, as
they already have for direct investment? The question is whether new
standards and expectations apply. To answer that, we need to examine
the fundamental features of debt restructuring and to consider the rules
and principles at issue.

II. ORGANIZING A DEBT RESCHEDULING:
The Critical Role of Big Banks

"The basic restructuring deal, domestic or international, is struck by
a few big banks," according to one participant in many such deals.
"They then present it to the rest of the creditors, who have to agree
after the fact." This statement implies that cooperation among private
banks is two-tiered. There is an inner core of true international giants—

10 Charles Lipson, Standing Guard: Protecting Foreign Capital in the Nineteenth and Twen-
11 My analysis of debt rescheduling is based on extensive confidential interviews with
bankers and public officials from the United States, Western Europe, and Latin America.
banks like Citibank, Lloyds, Chase, and Dresdner—who assemble large-scale syndicated loans and maintain affiliates in major markets around the world. It is they who lead the debt reschedulings. Smaller creditors are asked to ratify the agreement, not to haggle over its terms. This hierarchy among banks is central to debt rescheduling.

In effect, there are two games among banks in a rescheduling. In the primary game, large banks bargain with each other to set the terms. (They simultaneously bargain with the debtor, but that is another story.) The large banks thus establish the level of new funding to be provided and its apportionment among existing lenders, the rates and fees they will charge, the grace period before principal repayments must begin, the amounts of principal amortization to be postponed, and so forth.

In the secondary game, the large banks seek ratification by smaller creditors. Consent from these smaller participants is required to modify existing loan contracts that can no longer be met on schedule. Small creditors must be prevented from calling (or seriously threatening) a loan default, which could induce other creditors to invoke cross-default clauses and jeopardize the stakes of all lenders. In addition, if any new credits are needed, all creditors must be persuaded to provide their share. Thus, while small creditors do not negotiate the terms of rescheduling, their assent is vital to its success.

The major banks are well placed to win such approval. In the course of ordinary business, they work extensively with other banks, both large and small. The leading international banks share the risks of sovereign lending through syndications, and, when problems arise, sit together on creditor committees. They are heavily engaged in cross-depositing through the interbank market, and they provide a range of financial services to each other and to smaller institutions. Smaller banks—in Amsterdam, Toronto, or Dallas—may manage Euromarket syndicates occasionally, but far more often they simply buy international loan participations from the larger institutions and initiate their own loans only when existing clients need to finance exports or to expand abroad.12 They also depend upon larger institutions for correspondent services.

These financial relationships permit both reciprocity and retaliation, and facilitate policy coordination. They are especially important because there is no formal institution for rescheduling. All agreements are ad

12 These so-called smaller banks vary widely, ranging from regional American banks with extensive international interests to local institutions that only rarely have contact with the international capital market. A descriptively richer, less stylized account would capture this variety. My point here is to differentiate the large banks, which become intimately involved in debt crises, from the hundreds of banks with lesser stakes and little choice in final arrangements other than to ratify or reject them.
hoc. Such informality would seriously impede agreements if banks could not rely on their existing ties to foster cooperation.

Cooperation is further encouraged by the vast asymmetries in bank size. A small group of large international banks is able to negotiate the basic rescheduling package in which each has a powerful individual stake. Once these large banks are jointly committed to a rescheduling package, their size and their importance to other banks plays a critical role in assuring broad ratification.

Using these self-reliant arrangements, commercial lenders have successfully rescheduled international debts since the 1960s. Over the past several years, they have done so with increasing frequency and for increasingly large debts. In the process, many elements of debt restructuring have become routinized.13

In a typical case, a debtor, unable to pay promptly, approaches one of its largest creditors and asks for changes in the schedule of amortization payments. In addition, the debtor will probably seek an infusion of new credits to help meet any interest arrearages or other immediate obligations. The leading commercial creditor, a major bank like Citibank or Dresdner, then consults other lenders and, if they are convinced a rescheduling cannot be avoided, pulls together a committee of the largest creditors.

These procedures may sound straightforward, but they are slow and complicated, even in the early stages. Like all other features of debt rescheduling—from the ad hoc arrangements controlled by creditors to the commercial interest rates that are charged—they certainly do not encourage debtor states to seek relief. The first signs of trouble are usually a slow buildup of arrearages or a reluctance of some banks to roll over maturing credits. According to an I.M.F. staff study of reschedulings in the late 1970s, negotiations did not usually begin until a year or two later, when the need for a rescheduling had become obvious. The talks themselves then took another 18 months or more.14

This pace has accelerated in the 1980s, even though the number of reschedulings has increased significantly. The reason may be that the

13 Debtors have sometimes urged the establishment of a permanent forum to deal with debt problems, and have raised the issue as part of the North-South dialogue. Creditors have always rejected this demand, fearing that debtors might control the institution, and that its presence would only encourage more pleas for rescheduling. M. S. Mendelsohn, Commercial Banks and the Restructuring of Cross-Border Debt (New York: Group of Thirty, 1983), 14.

gravity of some cases, and the combined impact of so many problems, compels immediate attention. Delays can be dangerous since many banks will not voluntarily renew their maturing short-term credits once a problem has been recognized. The process is similar to a run on a bank—but this time it is a run by the banks. Thus, creditors may be forced to act quickly, first to stop a hemorrhage of short-term capital, and then to piece together a debt restructuring. There are, however, real limits to how quickly banks can act, even with their full attention devoted to the problem. The Mexican rescheduling of 1982, for instance, took several months—and it was swift compared to reschedulings for Brazil and Argentina.

Once the key creditors acknowledge that a rescheduling is necessary, the first important step is to select a creditor committee. The composition of this committee is important: its members must not only agree among themselves; they must also convince other creditors to support the final agreement. In view of the strong regional and national ties among banks, this “political” function of the creditor committee implies some geographic diversity among its members. Smaller creditors, who are not on the committee, are typically members of national banking networks and purchase syndicated international loans through money-center banks in their region. If they prove reluctant to endorse the agreement, they will be contacted first by these money-center banks with whom they have regular dealings. These financial relationships and communicative networks are thus important in ratifying any loan rescheduling.

After a creditor committee is in place, the first order of business is to collect financial data covering the composition and maturity of debts as well as the economic status of the borrower. The major creditors must then establish common negotiating positions and reach agreement with the troubled debtor.

The whole process requires a good deal of trust among the key creditors. Take the problem of data collection, for instance. Although some debtors have reliable figures on their own indebtedness, their economic performance, and their essential financing needs, many do not. No one agency may be in a position to control, or even to know, just how much the various state-owned enterprises, bureaucratic agen-

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15 That, at least, is the typical sequence. There are variations, however. In 1982, Mexico approached the U.S. Treasury, the Federal Reserve, and the I.M.F. before going to private bankers. Its reserves had declined so precipitously that a large credit was necessary immediately—and only the U.S. government could arrange a multi-billion dollar loan so quickly. More commonly, debtors work simultaneously with official and private creditors to arrange two separate rescheduling packages.
cies, and local governments have borrowed over the years. Levels of short-term borrowing are even more difficult to track and control. A complete audit is possible, of course, and has been necessary in rare cases of complete financial disarray. But an outside audit is both costly and slow, and time is usually at a premium. Moreover, the prospect of foreign auditors rummaging around a state’s capital and demanding documents might well stimulate nationalist fears, raise questions about the corrupt use of funds, and otherwise complicate the rescheduling exercise. Ideally, the banks would prefer access to I.M.F. data. The Fund has the best independent figures, collected from member governments and checked on periodic staff missions. But such data are not generally made available to commercial banks. The Fund wants to maintain confidentiality in its dealings with members, so it only shares less sensitive information and aggregate data.

Faced with these constraints, banks must rely heavily on their collective resources. In calculating how much “new money” they need to put into a rescheduling package, the banks work back and forth between their own figures and those supplied by the debtor. They arrive at partial debt totals by adding up their assets in the debtor country, plus those they have sold to other institutions. They ask others to report on various types of loans they have made to the debtor country.

There are some incentives for individual banks to underreport these commitments. The reason is that, if new (involuntary) credits are needed, they will invariably be calculated as a pro rata share of previous commitments. In calculating the “new money” package, the creditor committee will tell all banks to contribute a fixed percentage (say, 7 percent) of their outstanding loans on a particular date.

A date well before the rescheduling is selected because some banks, sensing imminent trouble in the debtor country, swiftly reduce their own exposure. What is prudent for the individual lender, however, only

16 A debtor’s best information about its total obligations probably comes from its regulation of foreign exchange. Local borrowers have to register their foreign debts with the exchange-control authority in order to repay them with hard currencies.

Not all countries have such controls, however, and those that do may not adequately cover short-term trade obligations. Terry Karl’s analysis of oil-rich borrowers concluded that their “controls over foreign debt were generally weak; accountability for short-term loans was virtually non-existent.” She argues that in many cases foreign borrowing was simply a “mechanism to disguise the mismanagement, misallocation, or self-serving utilization of public monies.” Karl, “The Paradox of the Rich Debtor: The Foreign Borrowing of Oil-Exporting Countries,” unpub., American Political Science Association Convention (Chicago, 1983), 32.

17 The debtor may, on its own, hire an investment bank to collect such data and to advise it in negotiations with commercial banks. The best-known of these advisors is actually a troika of investment and merchant banks acting jointly: Warburg’s, Lazard Frères, and Lehman Brothers Kuhn Loeb.
exacerbates the collective problem posed by the debtor’s illiquidity. Hence, the creditor committee picks an early date for purposes of calculating exposure. It thus attempts to limit the divergence between individual and collective rationality. In domestic bankruptcies, U.S. law does the same thing, requiring that creditors return assets collected within ninety days of bankruptcy.

Negotiations about the level of involuntary lending and its apportionment among banks are difficult and prolonged. Some banks maintain that specific types of lending, such as bearer bonds, ought to be excluded from the totals. In addition, there are disputes between banks that have bought and sold loans. Was the seller to be responsible if the loan went sour? Which bank will have to count the loans as part of its prior commitment? And what about loans to foreign companies (such as Caterpillar Tractor in Brazil) that may be guaranteed by the American parent company? Are such loans to be counted? Throughout these negotiations, individual banks try to limit their exposures and thus to minimize the new funds they must provide. What banks do not do, according to specialists, is simply misrepresent their assets.

What is the basis for such trust and, more generally, for cooperation among the major private creditors in a rescheduling? Our answer must begin by looking at their stakes in the various disputes, the choices they confront, and the probable consequences of their actions.

The largest creditors share two overriding characteristics:

1. They have a lot at stake relative to other creditors, measured both in terms of their capital base and the prospective impact on operating profits.

2. They are permanent fixtures in international banking.

Let us consider each in turn.

Not surprisingly, the largest international banks are also the largest creditors in Latin America and East Europe. What is less obvious is that their exposure has been high relative to their capital base and annual operating profits. This high relative exposure is particularly important because, as one senior banker told me (in the language of modern business schools), “the risks increase non-monotonically with exposure.”

High exposure threatens, in successive order:

— a net loss for the quarter;
— a net loss for the year;
— a run on the bank by major depositors; and, finally,
— bank failure.

Even the less drastic outcomes imply lower share prices and may threaten
a bank's senior management. Because of their high exposure, then, large banks have a compelling interest in successful debt restructuring. Failure to complete such a rescue could lead to a write-down of assets and charge-offs against operating profits (if loan loss reserves have to be increased, or if federal regulators require that interest income be treated less favorably). Indeed, there are perverse incentives to throw good money after bad—lending even to the worst risks rather than voluntarily accepting lower short-term earnings.

Thus, in their negotiations with each other, major creditors cannot easily threaten to walk away from rescheduling talks or to write off assets with real underlying value. These hard-line tactics are plausible, however, for smaller creditors, who would suffer much less from a failure to reschedule, and whose withdrawal or obstinance could impede a settlement. They aim to secure more favorable terms, or even a buy-out of their assets by larger creditors, by threatening to sabotage an overall settlement. For the largest lenders, such a threat would be suicidal and is not credible.

Yet a major bank's stake in a particular rescheduling is hardly its only consideration. It does help to explain why the biggest West German banks led the East European reschedulings, where they were heavily committed, and why they sometimes met resistance from New York banks with smaller exposures and fewer trade links. For the same reason, it is the heavily exposed U.S. banks that have led the Latin American reschedulings and the less vulnerable European banks that have been more reluctant to accept the terms and procedures. Despite these differences, the giant banks have hammered out common positions and have lined up support from smaller banks in their own areas. The reason is that, aside from having a stake in Poland or in Mexico, a large bank perceives itself to be an international bank with longstanding ties to other major institutions and permanent interests in the stable operation of international capital markets.

The fact that key creditors are "permanent players" frames the meaning of their participation in individual debt reschedulings. They have ongoing relationships with sovereign borrowers. They arrange loans and hold deposits for state agencies and local firms, and, in some larger markets like Brazil, they may even operate domestic banking networks. They expect to resume voluntary lending to large LDC economies in the future, and to participate profitably in their domestic growth. They cannot walk away from a rescheduling and maintain these ties—and they say so frankly.

Moreover, they are permanent players in international capital markets
and expect to keep working closely with other major financial institutions in a variety of ways. These banks know that they will meet repeatedly at the negotiating table and will participate in each other’s future syndications. Although they must compete aggressively in booking loans, they also recognize their shared interest in arranging “workouts” for troubled debts. Equally important in terms of fostering cooperation, they are linked by a dense network of financial ties, so there is ample room for reciprocity and retribution.

These synchronic and dyachronic links among the key actors do not preclude tough bargaining over the terms of rescheduling, or individual efforts to reduce loan exposure. The complexity of the issues, the different stakes of individual banks, and the different national regulations governing each institution all leave plenty of room for disagreement and conflict. In the Mexican case, for example, there were at least 25 distinct types of loans outstanding, and different banks held quite different portfolios. Should they all be treated alike?

Sorting out such issues and achieving a rough parity of sacrifice is a central problem in creditor negotiations. In general, the hardest bargaining among banks is over

- the kinds of obligations to be included in the rescheduling;
- the levels of new money to be put in; and
- the length of the amortization period.

The difficult issue of the debtor’s future policies is removed from these negotiations. The creditors simply insist on I.M.F. conditional lending and economic supervision. Beyond that, the creditors’ overall aim is to avoid write-downs if possible, to preserve the present value of their assets, and to eliminate any negative impact on operating profits.

Two points stand out in the bargaining among creditors. One is the need to minimize transaction costs. There is a compelling logic, well understood by the actors, to finding a formula to handle the diversity of bank assets. The basic norm is that all assets should be treated alike. This norm has “the great advantage of speeding negotiations,” as one banker told me—adding that the amounts to be rescheduled “are too large to leave in limbo.” Said another, “exceptions would take endless time.” This strong emphasis on uniformity—with only a few standardized exceptions and qualifications—has several advantages, according to one experienced negotiator. It not only minimizes negotiating time in the first rescheduling for any country, but makes subsequent rounds much easier. By creating a clear standard, it also eases negotiations with other debtors. Thus, the major Mexican rescheduling of 1982 provided

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18 Joseph Kraft, *The Mexican Rescue* (New York: Group of Thirty, 1984), 44.
a set of guidelines and legal documents that served as a template in subsequent Latin American reschedulings. Finally, the emphasis on uniformity also appeals to "simple-minded equity among banks," as one negotiator put it, and so makes it harder for individual banks to hold out for special treatment.

It is true that some financial assets are treated differently—but they fall into well-defined categories. Officially guaranteed loans are handled, quite understandably, in negotiations of creditor governments (known informally as the Paris Club). Individually held bonds are exempted because they are widely disbursed, and because each holder has legal rights to petition for default if payments are not made as scheduled. Short-term trade credits extended by manufacturers are not included because they cannot be monitored. Likewise, only a concerted and continuous effort can sustain the levels of very short-term credit provided through interbank lending to countries such as Brazil. Monitoring these commitment levels is difficult, and many banks try to extinguish such credits as they mature. In short, there are surveillance problems and legal obstacles to any comprehensive restructuring of sovereign debt. Still, as one bank lawyer told me, when one considers the diversity of assets, "the uniformity of treatment is striking."

A second point is that even though the key creditors have overwhelming incentives to cooperate and no individual incentives to defect, they do not necessarily prefer the same point of agreement. The main reason for this difference, aside from varying loan commitments to particular debtors, is the regulatory context of the parent banks. German banks, for instance, have legally hidden reserves against loan losses; U.S. banks do not. Moreover, American banks are legally required to downgrade the status of loans that have not paid interest within the past 90 days. Serious arrearages thus affect American bank profits immediately, and may affect the price of bank shares. No other country has such statutes and regulations.

These regulatory differences help to explain why large German and Swiss banks would prefer to handle arrears by capitalizing the overdue interest. That is, they would prefer to add the overdue interest (or some portion of it) to the outstanding principal. For most continental banks,

19 The bond question also suggests just how difficult it is to establish a common baseline to calculate new, involuntary commitments. In the major Mexican rescheduling, creditors finally agreed to increase their outstanding commitments by 7%. But according to Kraft, the entire banking systems of Japan, France, and Switzerland objected to the proposed baseline. "The Japanese claimed they had not made loans to Mexico but [had] acquired promissory notes from US banks. The Swiss said the Mexican numbers included many sales of bonds which were supposed to be excluded from the rescue operation." Ibid., 52.

20 Huff (fn. 14), 51-52.
such treatment does not require approval by the board of directors and would not require new funds to be raised by Euromarket subsidiaries. Moreover, it is obviously a simple way to handle the problem and would minimize negotiating time in restructuring troubled debts.

U.S. banks, on the other hand, would suffer immediate losses from such a policy since they would have to reclassify these loans as non-performing. In view of these regulations, American banks demand that interest payments be kept current and that new funds be supplied to the debtor to meet these needs. Since these new funds are a loan, albeit an involuntary one, the interest is in effect capitalized. But the new funds have to be raised from hundreds of creditors—an arduous process. The advantage for American banks is that, unless the regulators disapprove, the new loans can be treated as ordinary assets and the interest payments as income, even though they are really being financed by the banks themselves. Indeed, since interest rates are set above the banks' cost of funds, and since additional fees are charged, the lenders' profits appear strong—on paper.

These differences over interest capitalization have been resolved in favor of the U.S. banks, leaving the Europeans slightly aggrieved. The reason for this outcome is straightforward. Larger European banks do not suffer badly under the current arrangements and could not credibly threaten to defect from them. They can argue, at best, that the arrangements are so complicated that they do not work well and may break down in the future if smaller banks refuse to provide new credits. Large U.S. banks would, however, suffer sharp and immediate losses from any explicit and large-scale capitalization of interest. Constrained by their regulatory setting, and by the financial markets' close scrutiny of their operating profits, these banks have resisted any alteration in the treatment of overdue interest. If pushed, they can plausibly claim that they would rather see a particular debt restructuring fail than accept this new and costly arrangement as the pattern for the future. They can also argue, again quite convincingly, that other American banks would reject any such solution and would halt negotiations if necessary. In short, the large American and European banks are playing a coordination game that leaves one group aggrieved because the other is precommitted.

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21 Some Europeans have asked, in exasperation, why the U.S. regulators do not change the 90-day rule on overdue foreign loans. In fact, the Comptroller of the Currency has been flexible on loan classification where the law allows. The Federal Reserve Board has supported this posture. They do not want to impede reschedulings. But they would face an uproar if overdue loans from Argentina or Mexico were treated differently from overdue loans to local factories or farms. There is, quite understandably, an equity issue here. Moreover, no regulator would want to introduce different accounting principles to handle foreign and domestic assets, performing or nonperforming.
The Americans are locked into a strategy that yields their most preferred outcome. The aggrieved Europeans are stuck with their second-best outcome because any shift in their strategy will produce disaster unless the United States also changes to accommodate them. But that is just the point: the Americans are committed to the status quo.

The larger point to be emphasized, however, is not the conflicting preferences about the form of new credits, but the capacity of large private banks to coordinate effectively in cases of troubled debt despite their differences, and despite their vigorous competition as Euromarket lenders.\textsuperscript{22}

\section*{III. Ratifying a Rescheduling: The Role of Smaller Banks}

If we expect large banks to cooperate with each other because of their heavy commitments to sovereign borrowers and because they are permanent fixtures in the Euromarkets, we would expect to find the holdouts and mavericks among the smaller banks with fewer international links. That is exactly where they are to be found—among the regional banks in the United States, and among the Arab, Italian, Spanish, and consortium banks.

Essentially, the aim of holdouts is to reduce their exposure without any loss of asset value.\textsuperscript{33} Lenders who conduct little international business may see obvious benefits in cutting back their exposure in cases of troubled debt. For them, the costs of providing additional funds are not offset by any long-term ties to the beleaguered borrower. Nor are small lenders especially concerned about maintaining their reputation as reliable partners in international syndications. They may also argue that their exposure is small and that the rescheduling package can easily be completed without them.

Large banks respond that successful holdouts have serious ramifica-

\textsuperscript{22} This role of large creditors in managing debt problems is not new. Armando Saporri, in his analysis of medieval Italian merchant-bankers, concludes that "their solidarity is shown by their behavior when their debtors went bankrupt. The best-established business house in the city assumed the handling of the bankruptcy for all the other companies without charge, whether they had business ties with them or not. It managed the case in court, dealt with the trustees, signed the agreement, and then divided the expenses pro rata among the creditors, giving each the net sum obtained." Armando Saporri, \textit{The Italian Merchant in the Middle Ages}, trans. Patricia Ann Kinnen (New York: W. W. Norton, 1970), 15.

\textsuperscript{33} While all holdouts want to reduce their exposure without cost, some are especially insistent. Typically, these are banks with already-weak balance sheets and few international ties. To book additional low-quality, illiquid assets is relatively expensive and risky for them and contributes little to their main business. That is why the toughest battles over new Mexican credits have been with banks in the southwestern United States. Already saddled with bad energy debts, their loans to Mexico were usually undertaken to support local trade and were never intended to be long-term assets.
tions. They immediately reduce the debt relief available to the borrower. More important, if other creditors demand equal treatment, they may imperil the entire rescheduling. As a result, holdouts are resisted aggressively by major creditors and, if the restructuring is sufficiently important, by national monetary authorities in the United States and Europe. This emphasis on the uniform treatment of creditors—that each should contribute a pro rata share—is a basic norm of debt renegotiation. As Richard Huff, an analyst working for the Comptroller of the Currency, observes,

One reason for interbank discord, beyond the normal commercial rivalries of this intensely competitive business, has been the fear that debt relief advanced by one creditor might simply be used to pay off someone else, thus leaving the debtor’s financial position unchanged. . . . Thus the doctrine of “fair treatment” has emerged as the guiding principle of debt-restructuring negotiations: each bank is expected to participate in debt relief (either new funding or rescheduling) in proportion to its existing exposure.²⁴

But while “uniform participation” is a central tenet of rescheduling, “the enforcement of that doctrine,” is, as Huff notes, “no easy matter.”²⁵ Some banks may object to the terms of rescheduling, but more often they simply want to avoid the burdens of new, involuntary loans. At first glance, these holdouts would seem to be in a strong bargaining position. Their leverage, like that of small creditors in general, derives from their contractual rights as lenders and from the larger banks’ greater need to complete the rescheduling. They are not legally required to supply any new credits, and their consent is needed for changes in the repayment schedule of existing loans. Since the exercise of these rights could sabotage a rescheduling or slow its progress, a smaller lender can strategically withhold its cooperation in an effort to extract concessions.

Another source of leverage for smaller creditors is the threat to call a formal default. Since all international loans contain cross-default clauses, some observers have suggested that a single such default could start a prairie fire.

The rationale behind this assertion is that there are no bankruptcy procedures for sovereign states, and no orderly procedures to establish the priority of creditors’ claims.²⁶ The first creditor to attach assets can

²⁴ Huff (fn. 14), 51.
²⁵ Ibid.
²⁶ I am indebted to Douglas Baird, James Fooreman, and Cynthia Lichtenstein for their discussions of the legal issues. See “Symposium on Default by Foreign Government Debtors,” in The University of Illinois Law Review (No. 1, 1982), particularly articles by Reade H.
claim them in subsequent judicial proceedings. It does not have to share
the proceeds with other lenders unless it has agreed to do so in loan
contracts. Thus, if a debtor falls behind in payments, individual creditors
may be tempted to declare default and establish the priority of their
claims. This prospect, it is said, could turn an arrearage or technical
default into a wild rush of default declarations, as each creditor scram-
bled to protect itself against the others. An outcome that no one really
wants could thus be encouraged by the absence of institutional barriers.

Such fears have been considerably exaggerated, however. First, it is
difficult to get even one syndicate to call a default when major creditors
object. Voting in these matters is always weighted by each lender’s share
of the loan, so the larger lenders are well placed to block any move they
oppose. Second, in nearly all cases, major creditors would object because
a default would cost them dearly. There are few substantial assets to
seize, and the confrontation would jeopardize other ties to the borrower
(and to other creditors if they objected). Any real hope for repayment
depends upon export earnings and capital imports, which would be
slashed by a formal declaration of default. Thus, even if a few smaller
syndicates did declare default and did sue for assets, larger lenders would
still be reluctant to invoke their cross-default clauses. They would be
reluctant, that is, unless the debtor had violated basic principles of
international finance by declaring unilaterally that it would not pay. To
invoke cross-default clauses in less extreme circumstances would be to
lose all control over the restructuring process and to move into an
unexplored and risky world.

There is clear confirmation of this reluctance: very few defaults have
been called despite widespread arrearages. The only significant use of
cross-default clauses occurred during the freeze of Iranian assets, when
syndicates led by Chase Manhattan Bank declared defaults.27 Some other
declarations followed, and some American creditors did move quickly
to attach assets. Morgan Guaranty even managed to attach Iran’s share
of the Krupp steelworks in Germany.28 But European commercial banks

Ryan, Jr., “Defaults and Remedies Under International Bank Loan Agreements with Foreign
Sovereign Borrowers—A New York Lawyer’s Perspective,” pp. 89–132; Bruce W. Nichols,
“The Impact of the Foreign Sovereign Immunities Act on the Enforcement of Lenders’
Remedies,” pp. 251–64; and Frank D. Mayer, Jr., and Michele Odorizzi, “Foreign Govern-
ment Deposits: Attachment and Set-Off,” pp. 289–304.


28 On the disorderly process of attachments, where the first creditor to the courthouse
ends up with the assets, see Robert D. Steele, ed., The Iranian Crisis and International Law
(Charlottesville, VA: John Bassett Moore Society of International Law, 1981), Panel II:
“Commercial Aspects of the Iran Crisis: The Asset Freeze.”
(and their monetary authorities) were furious at what they considered precipitous and unnecessary action by U.S. banks. They refused to join the rush. Directors of the Dresdner Bank, for instance, publicly announced that they would not call Iranian loans in default. Even in this case, then, the cross-default clauses did not produce a “domino effect” reaching beyond the control of key creditors.

The larger banks are nevertheless concerned about such “domino effects” and about the bargaining leverage they give to smaller banks. As a result, legal counselors for large banks have begun drafting syndicated loan contracts that establish better obstacles to “hair-trigger” defaults. They allow longer grace periods to cure the effects of technical defaults (ten days, perhaps) and may exempt failures to meet payment deadlines when the fault is a technical one beyond the debtor’s control. There has also been some change of legal language, limiting cross-defaults to cases in which other loans have actually been accelerated (thus excluding cases of technical default where an acceleration might occur but has not been called). Finally, the newer loan contracts typically require a higher percentage of votes to call a default. It is now common to ask for approval from banks holding two-thirds of any syndicated loan. This gives large banks a more effective veto and protects European banks against overly aggressive actions by their New York counterparts.

Creditor committees are also organized to deal with banks that would threaten a default or impede restructuring. They usually include international banks based in the United States, Britain, Germany, Japan, Switzerland, France, and Canada—a group large enough to cover major national banking networks, but small enough to operate effectively. In the Mexican rescheduling, for instance, the Bank of Tokyo was assigned responsibility for other banks in Asia, while the Bank of Montreal handled banks in Canada. Lloyds was assigned not only banks in Britain and Ireland, but also those in other areas traditionally linked to British finance: Greece, Turkey, the Middle East, India, and Australia. Each U.S. member of the advisory committee took responsibility for ten American regional banks, and then asked each of these to take responsibility for ten more. These elaborate arrangements were necessary since hundreds of banks worldwide held loans to Mexico. The creditors had to be convinced that their interests were represented in the negotiations.

30 Kraft (fn. 18), 26–27. The role of large regional banks in reschedulings has gradually increased. They typically serve as conduits of communication between the largest international banks and smaller regional banks. This role, which does not entail sanctioning the smaller banks, gives the large regional banks an opportunity to voice their own concerns.
and well served by the final agreement. If additional persuasion was needed, that, too, could best be done by a bank with local connections, both financial and political.

Large creditors have proved willing to do this kind of arm-twisting, if called upon. Shirking the individual costs has not been a problem on creditor committees for several reasons. First, the costs of dealing with holdouts are not especially high. They mainly involve lost management time. If mutually profitable banking relationships are somehow threatened, it is usually a minor matter for the larger bank. Second, the most heavily committed creditors have strong individual incentives to bear these costs in order to complete the rescheduling package in which they have so much at stake. Third, there are routine ways of assigning "holdout banks" to larger creditors (based on location and business ties), so any evasion would be obvious to other members of the creditor committee and costly to the bank's reputation.

Ultimately, large creditors are willing to pay the price of dealing with holdouts because these costs are integral to serving on creditor committees. And serving on such committees is valuable to larger banks. It offers them the chance to shape the terms of debt rescheduling, and thus to protect their own asset positions. It also offers them direct contact with senior officials from debtor countries, which can be useful for banks with ongoing business there. And it yields information about policy trends and economic performance in the debtor, and about other banks' attitudes. All in all, it is an opportunity for sustained contact with other large financial institutions, and a chance to be identified clearly by all banks as a responsible major actor in international credit markets.

These arrangements among major creditors are crucial to the secondary game of ratifying the new debt package. The creditor committee first concludes a draft agreement with the debtor. If the stakes are large enough, it may then present the agreement to other creditors in a series of regional meetings, which feature presentations by the debtor's senior economic officials. After the smaller creditors have communicated their concerns, the creditor committee completes the final document. It then telexes all creditors, informing them of the terms and requesting ratification plus their share of any required funds. The deadline gives them little time to assess the agreement, and none to organize a united opposition. Most small and medium-sized creditors simply accept the terms as presented. A few may not—probably hoping that a major creditor will offer them private concessions.31

31 On rare occasions, a banker will object to a deal on principle. Such a stand is not easily overturned by the usual economic pressures on outliers. One domestic example is a small
There are seldom objections to restructuring loans that are already outstanding. The revised terms typically include healthy margins for the lenders (at least 1 percent above their cost of funds, and sometimes considerably more) and perhaps fees and commissions. Some recent deals have offered European banks additional incentives, such as the chance to convert their dollar loans into other currencies (which eases funding for non-American banks).

The difficult issue is the provision of new money. Here, too, the packages have been shaped to encourage participation. Some banks have asked for, and received, permission to allocate their new (involuntary) loans to borrowers of their choice within the debtor country. This option allows them to maintain banking ties to old clients and to select assets with less risk. Recent packages have also included a small margin of safety; if all banks contribute their share, the loans will be slightly oversubscribed. There is considerable pressure on the smallest banks to contribute; but if they cannot be persuaded and decide simply to write off their old loans, they are no longer allowed to obstruct the rescheduling. What is essential is that the agreement cover virtually all the outstanding credits (but not necessarily every small lender). Rescheduling thus requires full participation by medium-sized banks, which have millions of dollars in outstanding loans and which contribute a significant portion of any new funds.

For any bank to hold out is a perilous and lonely course. “There is a pretty firm unwritten, unspoken rule against buy-outs,” one international bank lawyer told me. “The only exceptions I know of involve risk participants in letters of credit who had not already put up funds.” A London syndications manager put the matter more bluntly: no banks have been bought out of a rescheduling. “If we did that,” he said, “that would be the end. [The rescheduling] would unravel like a cheap sweater” as other smaller creditors stood in line for the same deal.32

The larger banks could, of course, offer a less visible carrot to holdouts than buying out loan participations. They might simply offer to pay higher rates on the holdout’s correspondent deposits. This arrangement would be private and would directly affect the small bank’s earnings.

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32 Nevertheless, there are occasional rumors of such buy-outs, and they cannot be ruled out entirely. What is clear is that any such arrangements must have been minor and highly confidential. They have not led to any significant erosion of the norm of uniform treatment for creditors.
Bankers with whom I have spoken deny the existence of such deals, but it is impossible to rule out side payments completely.

In any case, the stick is much more prominent than the carrot. There are strong sanctions that can be used against a bank that refuses to contribute to a refunding. A Euromarket syndications manager noted that such a bank would be blacklisted in international banking. Since this sanction might not hurt some smaller banks, which rarely participate in international lending anyway, additional pressures on their domestic operations may be necessary. The focus, in the first instance, is on the holdout’s immediate banking relationships. Senior officials at the smaller bank, who were not necessarily involved before now, may be contacted by senior management of a money-center bank and told of the problem’s importance to the larger institution. If this is insufficient, the larger bank could stress the difficulties that the smaller bank would experience in buying domestic loan participations and using other banking services. Even if alternative institutions could supply these services (and they might hesitate), few banks could easily contemplate the severance of such correspondence services. Moreover, since many banking arrangements involve close relationships with other financial institutions, a bank can be hurt if it becomes known as an unreliable partner in difficult situations. Larger banks are well placed to spread this damaging news. The reputational effects in banking are even more important than in other businesses since, as one portfolio manager told me, “banks are the very products of imperfect information; if information were perfect, you wouldn’t need banks [because investors and savers would contract with each other directly]. The channel of that imperfect information is other banks, so the penalties of being frozen out are very great indeed.”

The essential idea here is to isolate the few holdouts and then use their immediate banking relationships to point out the error of their ways and the costs they might entail. *The whole point is to break down the large secondary game, involving hundreds of banks and considerable opportunities for free-riding, into a series of bilateral games pitting a few small holdouts against major money-center banks.* These arrangements imply that noncooperation is transparent; that defectors may be discriminated against in the future; and that the asymmetry of bank size permits effective, low-cost sanctions.

IV. THE LIMITS OF PRIVATE COORDINATION AND THE EVOLUTION OF INSTITUTIONAL ARRANGEMENTS

Smaller creditors, recognizing their weakness, seldom hold out. If some do, and if the rescheduling is a significant one, the national mon-
etary authority and other interested political figures may become involved. A lawyer working on the Mexican rescheduling describes the process as follows: "One by one, we identified the hard cases. We pinpointed their argument or excuse for not going along. Then we brought the appropriate pressure to bear—sometimes from state or federal regulators; sometimes from figures in the local community; sometimes from other bankers."

Thus, even though commercial loans are largely rescheduled by the lenders themselves, they still may require backing from governmental authorities to eliminate the last significant holdouts. Cooperation among banks does not occur in complete anarchy. Central banks, particularly the Federal Reserve Board and the Bank of England, do put pressure on holdouts when the stakes and risks are high. Their power derives from their regulatory control over bank operations and, in a larger sense, from their centrality to the financial system as a whole.

But the role of governmental authorities in dealing with creditors should not be exaggerated. It is best understood as a supplement to private pressure in major cases. It plays little role in rescheduling smaller debtors, and has only an indirect impact on banks outside the United States and the United Kingdom. Not only are commercial banks effective in their own efforts to cooperate, but the Federal Reserve is constrained by its legal mandate, its governmental role, and its limitation to American banks and their international operations. And within the United States, it cannot command banks to make involuntary loans or provide guarantees against losses, even informally. Nor is it charged with supervising bank assets or insuring bank liabilities; those tasks are assigned to the Comptroller of the Currency and the Federal Deposit Insurance Corporation. Finally, unlike many foreign central banks, it maintains some distance from major banks, relies heavily on laws and formal regulations, and often assumes an adversarial role in implementing its policies and regulations, as do the banks themselves. While it has quietly favored cooperation among banks in dealing with major debtors, its role has largely been one of support for the efforts of major private creditors. A much more important role for the Fed and for other central banks has been to provide emergency financing for the largest debtors—a task that private creditors simply cannot perform.

Recently, the I.M.F. has also played a role in creditor relationships. It demanded, and received, pledges of new private loans to Mexico before it would sign a stabilization agreement in 1982. I have argued

33 Kraft (fn. 18), 53.
elsewhere that the evolving role of the Fund as well as that of central banks can best be understood as incremental reforms designed to overcome gaps in cooperation among creditors.35

There are several such gaps. I have already noted the banks' problems in collecting timely, comprehensive data. Private banks are now attempting joint action on this front. Working through the new Institute for International Finance in Washington, they hope to improve their data on short-term debts, maturity distributions, prospective financing needs, and emerging credit problems. But, inevitably, the I.M.F. and the World Bank will continue to have superior data. The problem, as far as the lenders are concerned, is to develop ways to share this information without violating confidential channels for its collection. Better knowledge of short-term debts is especially important since the rapid buildup of such claims often indicates a deterioration in the debtor's current account and an inability to borrow over the longer term.

Second, the procedures for private bank coordination, no matter how effective, are slow—even when the need for swift action is apparent. Although many negotiating procedures are routinized, each new rescheduling must be organized from scratch. Specific details, such as the composition of creditor committees, must be arranged anew for the first round of rescheduling. (They can be repeated, much more efficiently, in subsequent rounds with the same debtor.) A variety of technical issues must be sorted out and the outstanding debt figures cumulated. Although some negotiating norms such as "equal treatment" have developed and do speed discussions, large debts invariably require months of negotiation.

Private lenders are thus virtually helpless if capital flight and the inability to roll over short-term debts combine to produce a real financial crisis. Nor is the I.M.F. authorized to step in and provide swift emergency funding. Only national central banks and treasuries are capable of organizing multi-billion dollar credits quickly. They have done so individually (as the Fed and the U. S. Treasury did for Mexico), and jointly (as the Bank for International Settlements did for Brazil). Although these "bridging" loans were intended only to meet short-term financing needs until an I.M.F. program was in place, such actions, together with mounting concerns about the quality of international bank assets, drew national monetary authorities much more deeply into Third World debt problems than ever before.

Finally, there have been growing doubts about the ability of large

banks to secure cooperation from all creditors. The sheer size and number of reschedulings have strained their resources. They have also killed the market for voluntary Third World lending, and diminished the taste of many smaller banks for further international activities (eliminating, in the process, an important reason for banks to provide forced loans).

These doubts, combined with the massive scale of Mexico's debt problem, produced a dramatic policy shift at the I.M.F. In November 1982, the Fund's Managing Director, Jacques de Larosière, took the unprecedented step of establishing mandatory levels of forced private lending before the I.M.F. would sign a stabilization agreement with Mexico. This bold action, repeated in the Brazilian case, was a turning point in the treatment of sovereign debt. It staked out a new leadership role for the Fund, and a new relationship between the Fund and private banks.

But one should not infer from the I.M.F.'s larger role that private cooperation had broken down. It had not. Rather, the I.M.F. (with U.S. approval) saw an opportunity to improve the chances for success in a rescheduling where the stakes were unusually high. The Mexican case was a particularly difficult one for private creditors, not only because of its size, but also because it involved so many small banks in the Southwest—banks that lacked ties to international capital markets and had already suffered heavy losses in energy lending. But the task of the I.M.F. was not to supplant large creditors in organizing the private banks; it was to reinforce the banks' own claims against potential holdouts. The Fund, in effect, worked through the existing structures of private finance and ultimately relied on the banks to deal with holdouts and problem cases. Indeed, the Fund had no direct contact with holdouts and no real leverage over them. Rather, it reiterated the norm of equal participation and raised the stakes if banks failed to cooperate in providing new credits.

It is clear, in any case, that the private coordination of creditors has some gaps and weaknesses. The transaction costs are high. It is difficult to mobilize substantial credits quickly. And there are incentives for one-shot players to defect. These problems have fostered a larger role for public institutions and some incremental changes in the creditors' own procedures. These small steps do not involve fundamental concessions on outstanding principal or debt service and do not ensure that LDCs have access to future capital exports. As a result, these informal and largely privatized arrangements may not be flexible enough to survive the next global recession.

To lower transaction costs, creditors have begun to accept longer
restructuring programs. In order to provide incentives for tough stabilization programs, they have rewarded successful austerity with improved terms (though not with concessionary rates). Once again, the case of Mexico has paved the way. A 1985 agreement, covering half of Mexico's foreign debt (about $49 billion), spreads the payments that originally fell due between 1985 and 1990 over 14 years. The interest rate will be 1.125 percent above the London interbank rate. This rate is significantly lower, and the term much longer, than previous rounds of restructuring. It is likely to set a precedent.\footnote{New York Times (national ed.), February 4, 1985, pp. 21, 25; Wall Street Journal, April 1, 1985, p. 26; Euromoney (March 1985), 164.}

As noted earlier, large banks are also edging away from their prior insistence on unanimity, which required that even the smallest banks provide a proportionate share of new funds. The European banks and the I.M.F. never favored this all-inclusive approach, since it is costly and time-consuming and focuses on a trivial percentage of the overall package. To demand unanimity is to allow minor actors to impede the agreement. To demand less, however, might lead other banks to seek similar treatment and thus undermine the stability of rescheduling. That, at least, has been the concern of leading U.S. banks. In practice, recent agreements have not covered every small bank, and the effects of non-participation seem to be contained. Allowing some banks to avoid new funding, as in the most recent Mexican negotiations, has not affected larger lenders—at least not yet.

The shadow of the future may be important here. "You don't need 100 percent bank cooperation in refunding if you are not doing it again," said one Euromarket syndication specialist. "Mexico is likely to get voluntary funds [in the near future] so there is no reason to rope everybody in." Note, however, that Mexico's economic improvement gives the large banks additional incentives to contribute their share.

The real problem is that many debtors face long periods of austerity, with little hope of reentering international credit markets in the next several years. The next recession in the United States and Europe will undoubtedly create even more serious problems for debtors, jeopardizing their revised payment schedules and perhaps requiring write-offs on a broad scale. This apprehension forms the backdrop for rescheduling exercises in the mid-1980s.

Such bleak prospects make debt restructuring much harder. Weak incentives for international lending make it increasingly difficult to convince smaller banks to lend funds involuntarily. It is still an open
question whether their refusal will eventually spread and destabilize the rescheduling process. So far it has not.

These changes in the terms and procedures of rescheduling are not striking, but they do indicate some evolution.\textsuperscript{37} The latest major changes came at the height of the debt crisis, in 1982 and 1983, when gaps in private cooperation threatened the banking system as a whole. It was only then that central banks made emergency loans to key debtors while the I.M.F told commercial lenders what levels of new credit it required. What is happening now is that lenders are slowly moving away from urgent confrontations with debtors and from crisis management, to longer-term restructuring.

Private coordination, despite its limitations, has been remarkably successful in restructuring dozens of troubled debts, involving hundreds of banks. In this endeavor, basic principles have been preserved regarding the debtor’s obligation to pay interest promptly and the responsibilities of successor governments to service previously contracted debts. The banks have repeatedly acknowledged the need to reschedule troubled debts, but never the borrowers’ right to restructuring, much less to concessionary terms. They have sustained the principle, long supported by official creditors, that any changes in debt service must be mutually agreed upon and cannot be imposed unilaterally by the debtor. Furthermore, by refusing to reschedule without an I.M.F. stabilization agreement, the banks have effectively extended to the international arena a basic requirement of domestic loan “workouts”—that any involuntary lending must be accompanied by substantial changes in the borrower’s policies, including austerity measures. Finally, despite all the economic problems associated with these loans, the private banks have negotiated remarkably hard-nosed deals, including penalty interest rates in some cases. They cannot avoid some economic losses: no bank would buy the existing loans to Brazil or Poland at face value. But the banks’ rescheduling procedures have done nothing to erode the values further. Taken together, the coordinated activities of private creditors have sustained the value of their assets under trying circumstances and have provided a significant measure of security for the internationalization of capital.

\textsuperscript{37} Other small changes could also be cited. Consultation between the creditor committee and the large regional banks has been improved and formalized. Moreover, all banks have used the economic recovery to write-down some bad debts and provide more reserves for future losses. The stronger balance sheets undoubtedly add to their leverage in negotiating with sovereign debtors.