**Commercial Banks, Default Insurance and IMF Reforms**

*Duane W. Rockerbie and Stephen T. Easton*

This paper proposes to change the IMF – at least partly - into an insurance agency. The idea of insurance for debts is not new but known under the name CDS (Credit Default Swap) quite well at present. The main problem of CDSs remains unsolved. What would happen if a large percentage of insured loans defaulted - would the IMF have the money to cover the insured events? Or would it fare like AIG? However, as the paper focuses on syndicated loans, a way of lending nearly extinct, though very important during the 1970s and 1980s, sums involved might not be as substantial compared with total sovereign lending. However, it would remain a minority problem in the foreseeable future. Also one would need to ask why banks need it as long as they can build up loan loss reserves, as successfully done by European banks before 1982. Although the abstract speaks of "private lenders and banking groups" other passages obviously restrict the paper's target group to the banking community ("private banks to become IMF members", p.3, fn3, or p.6) – a clientele that arguably does not need it if using provisioning options properly.

The point that private lenders choose excessively risky investments because they think the IMF would bail them out shows a problem that can be overcome by charging for protection. One may assume banks to charge the costs of insurance to their clients, precisely in the way they have charged small spreads to be able to establish loan loss reserves. Banks switching from loan loss reserves to insurance payments could even use the money no longer necessary for provisioning. It is not clear why such charges should not be equally possible in the insurance case. The idea of additional payment beyond insurance payment (pp.6-7) is not convincing at all. Why apply a "deductible" to the lender, and increase total payments rather than simply net this out (no deduction, no extra money)? Nor is the free-ride argument for non-members convincing. One would have to assume that in case of insurance payments insured claims become the IMF's and go on existing. For the debtor there would then not be any effect of debt reduction. Incidentally, syndicated lenders solved this "problem" long ago very well. Negative pledge and sharing clauses have prevented other banks from free riding. "Costly legal action by a minority of banks in the banking group" was never a problem. On the contrary, "forced" or "involuntary" lending worked quite well. As – to the extent - the insurance scheme is not meant for other creditors (bondholders), these would not pay anyway, and any relief given after insurance is paid and debts are reduced would automatically accrue to them.

It must be doubted that IMF-insurance would discourage credit rationing. Portfolio theory suggests that no well managed bank would put too many eggs into one basket.

The basic idea of this paper – insuring sovereign debts - is definitely worth discussing. Whether one can propose the IMF as done is a legal question and a practical problem: allowing private entities to become members just like present member states might meet difficulties. Would, e.g., private banks vote on IMF-programmes? Of course, such problems could be avoided by opening an IMF window whose participants need not be (full) IMF-members, or just clients, or by giving the IMF a "daughter" institution. But that would have to be explained and elaborated. Practically, the IMF would both decide on whether to bail out a debtor via new drawings (earning money) or paying out insurance (losing it) – it seems courageous to assume that this could never become a conflict of interest.

Small errors: Baker and Brady Initiatives were not for IDA-countries (p.4). One might mention that Brady was not a buy-back at a market price (in the textbook sense) but the debt reduction of Brady countries was negotiated between debtor and commercial banks (with official “help”). Economically it was a (partial) insolvency rather than a buy-back.

One may doubt whether syndicated lending is an urgent problem now or likely to become in the near future. So it does not seem extremely topical – but topicality has changed over the years. In any case, some revisions and explanations might be helpful.