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Treatment of Defaults on Loans Guaranteed by the Bank

Question: Should the Bank take up defaulted loans which it has guaranteed?

It has been contended that, as a matter of sound banking practice, the Bank should take up loans carrying its guarantee which have gone into default and on which it does not appear likely that service will be resumed. To do otherwise, according to this view, would be to obscure an impairment of capital and to result in heavy cumulative prospective calls on capital at times when some countries may have difficulty in meeting the calls. By contrast, a call on capital to meet an isolated default would in all probability be met by all countries in view of the relatively small amounts involved. It would seem that even this treatment of defaulted loans would require that considerable discretion be vested in the Bank in determining whether the default was permanent or only temporary and would admit of loans to defaulting countries out of the Bank's own resources to be used in meeting service charges which would otherwise go unpaid.

The opposing view is that serious practical difficulties (involving inequities to bondholders and debtor countries) would result from an attempt by the Bank to take up defaulted loans which it has guaranteed. If the bonds are called and payment of interest is stopped from the date of call, the Bank might be considered to have defaulted on its guarantee. On the other hand, the Bank could scarcely pay all future interest at the time it takes up defaulted obligations. As a third alternative, the Bank might call the bonds and continue to pay the annual interest and amortisation charges. Under such conditions, however, no bonds would be tendered. Furthermore, it is doubtful whether bonds could be issued and sold to the public on which, in case of default, interest would cease and the obligation come due. Any bondholders who purchased at a premium in the market would be damaged by such action. The United Kingdom's proposal that, in the event of default, reserves shall first be drawn upon and that there should be, if necessary, then a pro rata call on capital would seem to afford adequate protection to public investors. As another possibility, the Bank might, at its discretion, offer to bondholders the option of redeeming their bonds at par (or at a small premium) or of continuing to service them.