# The fourth wave of debt and creditors

The current wave of debt has not only altered the range of lending instruments, while simultaneously expanding the circle of debtors, but also introduced significant changes to the "club" of creditors and investors. The latter control (own) global financial assets, part of which, of course is "global debt". According to the Financial Stability Board (FSB), the total sum of financial assets held by governments, central and commercial banks, international financial institutions (IFIs) as well as non-banking financial intermediaries (NBFIs) reached $384 trillion at the end of 2017 (later data is not yet available) and has clearly significantly increased since. This figure really captures the imagination. It is four times greater than global GDP and is one of the most important signs of a financial bubble.

However, it is not so much about volumes as the structure of these assets, as in the case of global debt. Only 40% ($151 trillion) of this sum is attributable to traditional financial intermediaries – commercial banks that have controlled the financial markets for centuries. Now, in the new financial reality, NBFIs, pension funds and insurance companies dominate, as well as other financial institutions – investment funds, money market funds and other financial intermediaries – which number almost a dozen according to FSB classification. In the studied period the sum of financial assets controlled by NBFIs was estimated at $186 trillion, of which "others" accounted for $118.1 trillion. For comparison, the assets of the central banks of Board member economies were estimated to be about $30.1 trillion.

It is clear that the debt obligations of all forms and categories of borrowers occupy a prominent position in global financial assets (the IBRD estimates global debt to be $185 trillion; the FSB does not interpret this in assets). Meanwhile, it is well known that the investment declarations of institutional investors, which are mainly commercial banks, pension funds and insurance companies, contain clear rules, requirements and instructions regarding the "quality" of the assets where they are authorised to invest their clients' funds. Given the social function that this category of investors perform, it is logical to assume that their investment portfolios may contain only the most reliable and liquid financial assets. However, this is far from being the case today.

Here are some facts: in 2003, the asset portfolio of pension funds in developed economies did not, for example, contain emerging market debt bonds. This is now worth $2 trillion. For insurance companies this figure is $4.8 trillion. Whatever the reasons for this situation – the improved solvency of a number of sovereign borrowers and/or low interest rates (yield) of bonds of developed

country issuers – the financial stability of the two critical sectors of the global economy – pension and insurance – has become dependent on an extremely unreliable (or volatile, at least) source of finance: the sustainable development of emerging markets and the fulfilment by their borrowers of their obligations under numerous bond issues.

The novelty of the current situation also lies in the fact that the presence of “other” financial intermediaries on the debt markets plays an ever greater role. Although their financial assets are double the size of the combined assets of pension funds and insurance companies, the rules for monitoring, let alone regulation of the activities of "others” are still being formed. By the way, there is nothing surprising about this if we consider that only a couple of years ago the G20 adjusted the approaches to assessing the financial operations of the non-banking sector, moving them from “shadow banking” to “market-based finance”, as we have already discussed.

Participants in this financing, with the exception of insurance companies and pension funds, find themselves outside the perimeter of not only multilateral but also national supervision, at least to the degree that this is the case for global and national systemically important banks; although judging by the figures, the “others” have already become “systemically important”. In addition, these financial intermediaries are the most active in investing their clients’ funds in speculative-grade bonds, taking the same risks as corporate and sovereign borrowers, and funding, according to some estimates, up to 33% of the acquired assets from cross-border funding. In addition to this “challenge”, the regulators should add specific trade practices that are commonly used by NBFIs: the sale and purchase of currently fashionable indexes and the use of robots (artificial intelligence) to perform operations with financial assets. These practices are not harmless exercises: in pre-crisis situations they stimulate liquidity flight (in particular when financial bubbles burst) and cause plenty of inconvenience to financial and fiscal authorities.

Just like international organisations, national regulators did not immediately identify the threats from NBFIs and from the specific structure of their financial assets. For this reason, measures aimed at managing the threat to the stability of financial (debt) markets are only just being developed. It seems that the “Great Lockdown” has brought about significant adjustments to the approach by the authorities to resolving the issues in this area

At this stage, the United States Treasury and Federal Reserve are showing great ingenuity. The Coronavirus Aid, Relief ,and Economic Security Act (CARES) Act

that was signed into law by President Trump on 27 March 2020 introduced measures for supporting business entities, including the use of special facilities to provide public assistance to corporate debtors (including, of course, their creditors) that have been unable to service their debt obligations, including under bonded loans, due to the COVID-19 pandemic. However, when the act was initially being drafted and approved, it only dealt with issuers with investment-grade credit rating, but this was corrected a week after the Act was signed into law. At present, other borrowers can count on government assistance, including those who have never had an investment-grade rating but have regularly placed bonds in the US financial system.

In principle, Americans in 2020 are relying on solutions that were partially tested during the GFC and were used in such projects as the Term Asset-Backed Securities Loan Facility (TALF). At the same time, based on assessments of the current situation, new mechanisms are being introduced as a result of the growing fourth wave of debt. The same scheme is being used, a special purpose vehicle (SPV) proposed by the Treasury that will be capitalised through the state budget, the Federal Reserve will fund its operations (the responsibility of the Federal Reserve Bank of New York), and there will be strict rules for accessing the vehicle's funds (the business debtor operates in the United States, is taking measures to restore production, does not dismiss employees and does not pay dividends or make any other capital distribution).

The scale of the project is very impressive. The capital of two SPVs established to work with junk bonds (Main Street Loan Facility and Main Street Expanded Loan Facility) is $75 billion each. For SPVs dealing with investment-grade bonds, capitalisation is set at about $10 billion, which is unimaginable in any economy or jurisdiction other than the United States, as part of a financial stimulus policy to further increase public debt (in 2020, issued Treasury bonds could reach $4.5 trillion). This is all solid evidence that the risks of the fourth wave of debt growing into a "tsunami" in the United States are mainly based on the size and condition of corporate sector debt.

It is clear that this conclusion can also be applied to Chinese corporate debt and to a significant number of corporate borrowers from other developed economies and some emerging markets. The authorities in those countries are taking measures to ensure that the credit (debt) markets continue to play an intermediate role, which is not possible under current conditions without supporting the solvency of borrowers and the liquidity of the financial instruments that they use. As a result, there is a restart and increase in the scale of purchases

by the central banks of developed economies from secondary bond markets, by corporations and sovereigns. The balance sheets of these “lenders of last resort” already look unprecedented because of the volume of accumulated debt obligations. In early 2020, the volume held by the Fed, ECB and Bank of Japan exceeded $15 trillion, and had tripled in just ten years. How this new reality will behave at the final stage of the fourth wave of debt is still unclear.

Therefore, by taking measures to prevent mass debt defaults associated with the issue of debt bonds, the authorities in interested jurisdictions are following a well-worn path: funding such operations by issuing sovereign bonds or bonds from specially created institutions (vehicles) under state guarantee. Obviously, such operations will keep the debt markets afloat for a while. On the other hand, new sovereign borrowing is increasing public debt and actively “feeding” the fourth wave of debt. This is impossible not to notice. Moreover, other response measures are being taken, such as foreign exchange swaps between central banks. However, all these solutions are aimed at supporting liquidity and satisfying current and short-term obligations. They are not really associated with restoring the solvency of debtors and preventing their bankruptcy.

In this context, the authorities are focusing on the current domestic political and socio-economic situation. This has always been the case, including during the final growth stages of previous waves of debt. It is certain that those burdened with power are well aware of the lessons of previous crises. However, no measures have been taken to counteract credit expansion, apart from the work on successfully organising supervision over global systemically important banks. As IBRD experts have noted: during the last ten years, “the credit boom has not been accompanied by an investment boom”. As a result, the collapse of the fourth wave of debt will have to end in either a currency or a banking crisis, or a combination, supplemented by an economic recession with all the ensuing consequences. The current measures are intended to mitigate these consequences, and it would be completely irresponsible to say that little has been done. This is far from the case.

While all the scenarios and/or approaches to resolving the problems of lenders and investors in the corporate bonds sector are more or less clear (national bankruptcy laws may be used in addition to financial and fiscal measures), the prospects for determining the ways and methods of regulating the debts of emerging market countries and developing countries seem very uncertain. Despite vast experience in this field, the fact that the IMF and its regional counterparts have mechanisms designed to ensure global financial stability, the increase in the number of Paris Club creditor nations and the introduction of a clause in bond

documentation on collective actions by investors, a mechanism for restructuring sovereign debt remains a dream for experts.

For some time, global financial stability, which is determined by, among other factors, the state of sovereign debt sustainability, could be ensured by using IMF resources and regional financial security mechanisms, and by foreign exchange swaps of central banks. However, the resources that they hold (for example, the IMF has $1 trillion) is hardly sufficient considering the scale of the impending threat and the clear fact that dealing with the consequences of COVID-19 relies heavily on leveraging debt capital, i.e. policies that lead to increased public debt for all sovereign borrowers. We could expect, in the current circumstances, that the G20, which is at the heart of global governance, would start developing preventive measures to promptly halt the risk of non-payment (bankruptcy) of sovereign borrowers, who have already been "carried away" by the fourth wave of debt.

This is happening to a certain extent in terms of agreements to defer payments on sovereign debt owed by dozens of the least developed countries that mature by the end of 2020. However, when measured against the scale of the fourth wave of debt, this solution is just a small part, as it is only temporary relief of the debt burden of several tens of billions of US dollars. It is vital to go further and not repeat the errors of the early 21st century, when, after the Asian financial crisis, efforts aimed at creating a comprehensive sovereign debt restructuring mechanism failed. Against this background, the fact that the FSB, working on behalf of the G20, has already started to address the issues of risks associated with non-bank credit organisation operations is very encouraging. But what should be done about unmanageable sovereign debt, and how should the interests of creditors and investors be protected?

It seems that international (multilateral) efforts in this area must be divided between short-term, which we have ready discussed, and long-term measures. However, it is important to build on those initiatives and agreements that have found support but that, for a number of reasons, have not become part of the international financial architecture. There are at least three such systemic developments. Firstly, there are the Guidelines for Public Debt Management, the first version of which was put forward by the IMF and IBRD in 2001, and the second that was adopted following the collective efforts of G20 members during Russia's presidency of the club in 2013. Secondly, there are the G20 Operational Guidelines for Sustainable Financing endorsed by members in 2017. Thirdly, there is the agreement by the G20, also in 2017, on the principles to strengthen the resilience of national economies.

Based on best practice, these documents put forward recommendations that could potentially provide guidance on practical measures for all creditors and borrowers who are equally responsible for the accumulation of imbalances in the international monetary and financial system, including waves of debt and their consequences. However, these documents lack teeth: their rules and regulations are not legally binding on decision-makers, in particular regarding their own borrowing or lending to foreign debtors. The interdependence of national economies and markets means that this is a serious challenge that should be addressed as soon as possible.

In this context, multilateral development banks (MDBs) could, and clearly should, play a major role; in particular, regional banks that are much closer to sovereign borrowers than their global counterparts. Based on the position of their shareholders who do not require that MDBs make a profit from lending activities or pay dividends, these credit organisations, financial intermediaries, can pursue a credit policy that guarantees the productive use of borrowed funds and thereby cultivate rational financial behaviour by lenders and borrowers in accordance with the principles and standards set out in the previously mentioned documents. In addition, by relying on their advantages, MDBs can take on the role of a financial intermediary that can leverage in situations where other intermediaries are unable to owing to a lack of liquidity or regulatory requirements. The International Investment Bank recognises all these circumstances and is ready to work constructively with borrowers, including considering the threats and challenges that will arise if the pandemic spreads further in the countries of operation.