



NEWS RELEASE

FOR IMMEDIATE RELEASE

PR-13-83 (2-17-83)

Library
FEB 24 1983

FEDERAL DEPOSIT INSURANCE CORPORATION

STATEMENT ON

INTERNATIONAL AND DOMESTIC IMPLICATIONS OF
U.S. COMMERCIAL LENDING TO FOREIGN GOVERNMENTS AND CORPORATIONS

PRESENTED TO *the*

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
UNITED STATES SENATE

of the Senate

BY

WILLIAM M. ISAAC, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

9:30 a.m.
Thursday, February 17, 1983.

Room SD-538, Dirksen Senate Office Building

*speech
bulletin
KDir/
stat
Spch
FDIC*

Mr. Chairman, I welcome this opportunity to present our views on the international financial situation. I will outline very briefly the nature of the global financial problems and their causes and then focus most of my remarks on remedial measures.

The Problem

Many developing countries have accumulated substantial indebtedness to the world's commercial banks. A number of those countries are having serious difficulties meeting repayment schedules. In many countries, public and private indebtedness to foreign banks has been or is in the process of being rescheduled.

A substantial portion of the indebtedness is owed to U.S. banks. The most recent figures indicate in excess of 35 percent of the developing countries' debt to commercial banks is held by U.S. banks, with the major share (over 20 percent) held by the large, multinational banks. For the larger borrowers, foreign debt and servicing requirements are very high relative to gross domestic product and export income. For example, the 1983 debt-servicing obligations of the four largest Latin American borrowers (Mexico, Brazil, Venezuela and Argentina) amount to about 120 percent of their projected export earnings. By any criteria, the situation is of concern.

In spite of the seriousness of the current global financial situation, we do not believe extreme pessimism is warranted. We may well be at the low point of both the domestic and international recession. An expanding world economy may cast many of today's world debt problems in a better light a few years from now. Moreover, the problems are now well recognized, and a dialogue among banks, creditor and debtor nations, and the international organizations has begun.

The Causes

While a number of factors are important in explaining how the current situation developed, they can be summarized as follows:

- Overly stimulative fiscal policies and accommodative monetary policies produced inflation in the U.S. and world economies over a sustained period and fueled the expectation of a continued rise in prices, particularly of commodities. The large oil price increases by OPEC exacerbated the situation for many nations.
- Banks saw opportunities for what appeared to be very profitable lending. Most credits were originated at a premium over LIBOR, overhead costs were low, and the default risk of lending to foreign governments and large foreign business firms was perceived by many banks to be minimal. Moreover, information concerning the financial condition of, and financing activities by, various nations was deficient, so banks were not always aware of just how much borrowing was occurring until after the fact.
- Banks were encouraged by many in their role as "recyclers" of OPEC surpluses to countries incurring payments deficits due to the large increases in oil prices. As a consequence, however, banks developed a significant credit exposure to the non-oil-producing developing countries.
- Bank regulators were insufficiently sensitive to the developing problems in foreign lending and failed to take firm steps to limit credit concentrations and the leveraging of bank capital.

These factors having set the stage, a combination of elements converted the potential problem into a reality. Depressed economic conditions throughout the world limited the growth in world trade and resulted in falling prices for primary products (the main exports of developing countries) instead of the continued rise upon which many lending decisions had been predicated. Oil-exporting developing nations, in particular, were placed in a precarious position relative to debt-servicing demands due to the decline in oil prices, a development that favorably affected oil-importing nations. Record high interest rates had an immediate, painful impact on borrowers because a large share of LDC lending was on a floating-rate basis. Finally, appreciation of the dollar raised the debt-servicing burden of countries with dollar-denominated debt.

It is difficult, and not particularly useful, to "blame" any group for the current international financial problems. There is plenty of blame to go around and the U.S. government must accept its share of it. In our judgment, however, it is far more important that we focus our attention on the steps that must be taken to relieve the present strains in the system and to decrease the possibility that similar problems will arise again.

In our opinion, the basic ingredient missing during the past decade has been "discipline." Governments throughout the world have not exercised discipline in the management of their financial affairs. Some banks may not have had much more discipline, but it would be difficult to make the case that they have had substantially less.

Possible Remedies

Short Term

The International Monetary Fund (IMF) can play an important role in stabilizing the present situation. The IMF is in a position to keep private and public lenders in line, to provide orderly expansion of credit where that seems appropriate and to insist upon the appropriate belt-tightening and other policy adjustments needed by debtor countries. It is extremely difficult, under the present circumstances, for private lenders to impose such discipline. Making additional resources available to the IMF, including raising the U.S. quota, would increase its ability to provide emergency funding to help bridge liquidity problems and to avert potentially serious international financial problems. Making additional funds available to IMF would not bail out or replace private debt; in the aggregate, the latter will increase. Banks will be required to stay in and be part of the solution. We support the proposal to increase the resources of the IMF because we believe it is a reasonable, balanced approach to resolving some difficult, immediate problems in the worldwide financial system. We are convinced, however, that this is only a short-term response and that more fundamental changes must also be made.

Longer Term

Some experts have questioned whether lending to foreign governments should be the responsibility of the private banking system. Others have suggested a statutory lending limit on loans to foreign countries. While it is understandable, under the circumstances, that these kinds of questions and solutions would be raised, we believe better long-term solutions are available. There is nothing inherently wrong with U.S. or other

banks making loans to foreign countries. They do involve special risks which argue for even more caution and prudence than one would find necessary with respect to domestic lending. However, if the loans are for the purpose of supporting economically-sound endeavors and are likely to be repaid as agreed at market rates, they can be highly beneficial to the U.S. and world economies and should not be discouraged.

The question is: how do we insure that the loans will be economically-sound? We believe the answer is to allow the market system to function with as little government interference as possible.

We are firmly committed to the preservation of a strong, privately-owned banking system. The free-enterprise system cannot function properly unless there is discipline, and we cannot achieve or maintain discipline unless we permit market forces to operate -- to reward the successful and penalize the unsuccessful.

Unfortunately, the present system of bank regulation and insurance unwisely inhibits the operation of the market and creates the wrong kinds of incentives. We currently have the worst of two worlds.

During the 1930s, we crafted a tightly-controlled regulatory environment to protect banks from competition. Product, price and geographic competition were highly regulated through interest-rate controls, entry restrictions, limitations on permissible activities and branching restraints. Bank regulators were assigned the responsibility of preventing bank failures, almost at any cost.

A deposit insurance system was developed to help restore confidence and stability and to protect depositors in the event of failure. Although the

deposit insurance system was originally designed to provide protection to only smaller, unsophisticated depositors, it has evolved into a system which is perceived by most people as providing full protection for all depositors and other creditors of our larger banks. Larger banks are perceived by most sophisticated creditors as being "failproof," at least in terms of depositors suffering a loss in the event of trouble. They believe we simply cannot and will not pay off the deposits of a large bank. They believe we will either prop up the bank with new capital or, at worst, merge it into another institution. In either case all depositors, insured and uninsured, would be made whole both as to principal and interest.

As a practical matter, the potential problems involved in paying off insured depositors in a large bank would be enormous. The administrative and logistical problems that would be involved in the FDIC's assuming control of a large bank, preparing checks for insured depositors and liquidating the bank's assets are difficult to even contemplate. Moreover, the uninsured deposits would be extremely large and would be tied up in a receivership for years, thereby causing substantial disruption throughout the economy. Finally, the franchise value of the institution would be lost, significantly increasing the cost of the failure to the FDIC.

For these reasons, a merger of a failed bank is ordinarily far superior to a deposit payoff. The problem is that under current law a merger cannot be accomplished without making all depositors and other general creditors whole.

The Congress has recognized the importance of this issue, particularly in a deregulated environment, and has requested the FDIC to present its recommendations for reform by April 15 of this year. I cannot tell you at

this time precisely what our recommendations will be, but I can say that we will almost certainly recommend that we be given the authority to arrange for the merger of a failed bank on a basis that does not make all general creditors whole. This may be the single most important reform that could be made to restore discipline in our banking system and insure that it will remain strong under private ownership.

We are not so naive as to place all of our faith in the market. During our first 150 years as a nation, we had a significant amount of unfavorable experience with an unregulated, uninsured banking system. We believe in deposit insurance, and we believe regulation and bank examinations are vitally important.

We are convinced, however, that particularly as interest rate controls and other restrictions on competition are eliminated, we must find new ways to control destructive competition and excessive risk-taking.

We could attempt to achieve that objective by hiring thousands of additional bank examiners and adopting countless new regulations. Such a system would be expensive, would stifle innovation and undermine many of the benefits we hope to gain from deregulation, and, ultimately, would probably not be effective in controlling the level of risk in the system.

We would like to supplement our supervisory system by bringing market forces into play to a greater degree. We must gradually, and in a non-disruptive fashion, move away from the notion that all large-bank liabilities have a federal guarantee behind them.

Disclosure

If the marketplace is to function effectively in controlling bank risk, it must be given sufficient information about the nature of that risk to make

an informed decision. The banking agencies have adopted new call report schedules to provide information on non-performing loans, interest-rate sensitivity and asset/liability maturity structures, and we will make this information public this year beginning with the June 30 report. That is a step in the right direction, but more needs to be done.

The Securities and Exchange Commission recently broadened disclosure requirements for bank holding companies with respect to loans outstanding in countries experiencing liquidity difficulties. It may be desirable to require banks to routinely report their loan exposures on a country-by-country basis, whether or not liquidity problems exist.

Special Reserves

If disclosure is to be effective, it must properly reflect conditions in the bank. If losses exist, they ought to be reflected.

Many banks have acted responsibly and provided specific reserves to reflect foreign loans at a realistic carrying value. Others have not. We believe that when severe and protracted problems warrant, banks should specifically reserve against certain loans. By requiring banks to reserve against these assets, earnings statements and capital accounts will be more realistic and dividend policies more disciplined.

In this same vein, we are also reviewing the accounting treatment of fees paid to banks at the time a loan is rescheduled. In some cases it appears these fees are being taken into earnings immediately. A more realistic approach would have the fees taken into income over the life of the restructured credit or perhaps even charged directly against principal. The agencies are currently reviewing this issue.

Conclusion

In conclusion, we believe the problems in the worldwide financial system, which have been developing over the past decade or so, are serious but manageable if the countries and bankers involved act responsibly. We believe this is occurring, as evidenced by the IMF proposal which we support.

In our judgment, it would be unfair and a serious mistake to attempt to assess the entire responsibility for the current situation against the banking industry. Bankers have been overly aggressive in some instances and mistakes have been made. They are by no means alone. The basic climate in which they were operating was created by government policies throughout the world. We cannot expect to maintain the banking system on a sound basis indefinitely unless we pursue sound economic policies throughout the major nations of the world.

The financial system is undergoing a virtual revolution. On the international side, banks have been operating for more than a decade on a major scale in a fast-paced, deregulated climate. Deregulation is rapidly becoming a fact of life on the domestic side as well.

Our regulatory and insurance systems were not designed to deal with the financial system as we know it today. In our judgment, the regulatory and insurance systems are not consistent with a deregulated banking environment and no amount of tinkering will make it so; they are in need of a major overhaul and the sooner they receive it the better.

I appreciate this opportunity to present our views and will be pleased to respond to any questions.