April 7, 1983

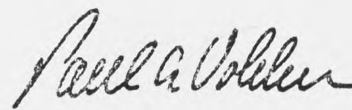
The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Chairman Garn:

As you know, the bank regulators have been working together to review the regulatory framework and supervisory approaches relating to foreign lending by U. S. banks. Enclosed please find a Joint Memorandum on international lending which summarizes our proposals on the subject. Along with the Joint Memorandum are four appendices covering some topics in greater detail.

We appreciate the opportunity for public discussion which Congressional hearings on this subject provide, and we look forward to any further consideration that the Congress and other interested parties put forward. We appreciate the urgency of action in this area in connection with the IMF legislation, and we will, of course, continue to work with you in the effort to improve public policies on foreign lending by U. S. banks.

Sincerely,



C. T. Conover | William M. Isaac | Paul A. Volcker

Enclosures

April 7, 1983

Joint Memorandum

Subject: Program for Improved Supervision and Regulation of Internationnal Lending

In recent years, the banking systems in the United States and abroad have extended large amounts of credit to foreign borrowers, including foreign governments. As a result of strained economic conditions worldwide, a number of countries, particularly in Latin America, have simultaneously experienced reduced foreign exchange earnings and external financing problems, thus helping to precipitate problems in servicing debt burdens built up over a number of years. As part of the necessary readjustment, many of the major borrowers have adopted economic stabilization programs approved by the IMF and involving, in addition to important domestic measures, both the restructuring of existing bank credits and the extension of a limited amount of new credit. This situation has raised concern that there should be in place strengthened supervisory and regulatory practices aimed at avoiding excessive concentrations of credit in foreign countries.

In response to these problems, the federal bank regulators have reviewed a number of suggestions for strengthening supervision and regulation of United States depository institutions engaged in foreign lending. Some foreign lending (e.g., that to private companies abroad) includes elements of credit risk analogous to domestic lending -- elements relating to the capacity and willingness of borrowers to generate resources from operations to repay debts. Lending to foreign governments (i.e., "sovereign lending"), while not entirely free of credit risk, is not subject to the same "market test" of potential insolvency. However, all foreign lending must take account of risks not present in domestic private or public lending, that is "transfer risk." Thus, overall "country exposure" is also a relevant concept for assessing the risks involved in foreign lending.

"Transfer risk" means the possibility that a borrower may not be able to maintain debt servicing in the currency in which the debt is to be paid because of a lack of foreign exchange. A bank's "country exposure" is defined as all cross-border and cross-currency claims and contingent claims on residents of the country, plus other credits guaranteed by residents of the country, less credits guaranteed by residents of other countries and net local currency assets of the bank's offices in the country.

As result of our review of the supervision and regulation of foreign lending, a five-point program has been developed. The objective of the program is to encourage prudent private decision-making in foreign lending that appropriately recognizes the risks while permitting the exercise of lender discretion in the funding of creditworthy borrowers both here and abroad. The proposed procedures reinforce two of the basic principles of sound banking — diversification of risk and maintenance of adequate financial strength to deal with unexpected contingencies. The program will help assure earlier recognition of potential international payments problems, encourage orderly responses to these problems, and provide for stronger reserves to meet adverse conditions when they infrequently, but inevitably, arise.

The five-point program consists of the following elements:

1. Strengthening of the existing program of country risk examination and evaluation;

2. Increased disclosure of banks' country exposures;

3. A system of special reserves;

4. Supervisory rules for accounting for fees; and

5. Strengthening international cooperation with foreign banking regulators and through the International Monetary Fund.

The program constitutes an integrated package -- none of the elements alone could accomplish the intended objectives. This memorandum summarizes the principal aspects of the five points. Separate appendices have been attached providing elaboration for some of them.

This program has been designed to create incentives for prudent lending but without establishing arbitrary obstacles to international capital movements or preventing the continuation of credit flows to credit-worthy borrowers. Depending upon particular circumstances, continued capital flows to basically credit-worthy countries in current strained economic conditions remains appropriate -- especially in the context of IMF-approved economic stabilization programs -- in order to encourage appropriate adjustment by borrowers to their problems, to maintain their capacity to service their outstanding debt, and therefore to preserve the integrity of existing bank assets. These considerations are, of course, not unique to international lending, but the scale of the lending to particular foreign borrowers means that broader considerations of the stability of the international financial and economic system are at stake as well; this fact is reflected in the role of the IMF and other official lending. The five-point program set forth in looking toward the future is designed to recognize these circumstances.

1. <u>Strengthening of Country Risk Examination and Evaluation</u>

As a first step, the federal banking regulators intend to strengthen their present program of country risk examination and evaluation basically established in its present form in 1979. Our review of the operation of this system indicates that increases in banks' country exposure have not in all cases been brought to the attention of high level management as explicitly and forcefully as they probably should have been. This

procedure can be made more effective by establishing clearer guidelines for examiners in formulating exposure warnings and for assuring that these warnings are considered at the policy-making level within bank management. Its more effective use should help to avoid risk concentration and to increase risk diversification.

As a separate part of country risk examination and evaluation, the federal banking regulators will also analyze a bank's capital adequacy in relationship to the level of diversification of the bank's international portfolio. Those institutions with relatively large concentrations of credit in particular countries will be expected to maintain generally higher overall capital ratios than those institutions that are well diversified. As part of this process, the banking regulators will further develop, as a reference point, standards for country exposure concentration as it relates to capital adequacy. Because banks vary in their current capital positions and other elements of risk exposure, the implications for the capital adequacy of any particular bank would have to be evaluated on a case-by-case basis.

In general, the characteristics of a bank's country exposure will be considered a factor to be weighed in the application of the capital adequacy guidelines used by the federal banking agencies. Thus, recommendations on capital levels as a function of country exposure concentrations will form an integral part of the overall supervision and regulation process. In accordance with their recommendations in this regard, the banking regulators will expect appropriate corrective action as necessary to conform to safe and sound banking practices, taking full account of the need for flexibility in some circumstances for responding to needs for additional credit as part of well-considered adjustment programs.

Additional details on the federal bank regulators' development of procedures to strengthen the supervision of country risk are contained in Appendix A.

2. Additional Disclosure

Experience suggests that the identification of increased country exposure and transfer risk based on a subjective analysis of economic factors, particularly in cases of larger countries, may not always take place at a sufficiently early stage so as to make adjustment in banks' lending feasible without jeopardizing service of existing debts or, indeed, disruptions of the financial system more generally. Disclosure triggered by subjective risk evaluation may aggravate the problem. However, more routine disclosure, centered around the concept of concentration, may strengthen other approaches, helping to bring appropriate marketplace discipline to bear on lending decisions.

Depositors and investors, through their individual decisions, will have the information to assess better the prudence of foreign lending and require greater risk diversification and adequate reserves as the condition for their increased deposits and investments in banks' equity and other securities. Banks will need to be prepared to defend policies leading to large and concentrated country exposure as a consequence of their continuing reporting requirements, and indeed considerable movement has been made in that direction by some institutions. The best current practice should be made more uniform. To that end, individual banks should make public disclosure of all concentrations of country exposure that are material.

Another step toward better analysis of developing trends in international lending is more frequent and earlier availability of aggregate data. To this end, reports on material country exposure should be submitted

to the banking supervisors quarterly, instead of semiannually as at present. In this connection, the banking supervisors will require that the reports be submitted more promptly than in the past so that the aggregate information on lending by U.S. banks can be made available to the public on a more current basis.

Additional details on the proposed reporting and disclosure requirements are contained in Appendix B.

3. <u>Special Reserves</u>

Another incentive for risk diversification and increased financial strength can be created through establishment of a system of provisioning against certain country exposures. When a borrower has been unable to service its debts over a protracted period of time, whether or not that borrower is a sovereign, it is appropriate to recognize the risks and the diminshed quality of the assets represented by these loans. Indeed, to the extent interest has not been paid, that by itself diminishes the value of the underlying asset.

It is prudent that the lending institutions establish specific provisions against such assets in order to reflect more accurately the current condition of the asset. Although some banks now make reserve provisions for such purposes, this approach should be more systematic. Such provisions would be deducted from current earnings and, to the extent required by regulation, would not be included in capital for regulatory and accounting purposes. The prospective requirement for reserving, with its attendant bottom-line earnings impact, should act as a cautionary element when the initial decision to lend is being made. Such reserve provisions would not apply to lending to a country where the terms of any restructuring of debt were being met, where interest payments were being made and where

the borrowing country is complying with the terms of an IMF-approved stabilization program.

Appendix C contains additional details on the proposed reserve provisioning for credits to countries with severe and protracted debt servicing problems.

4. Accounting For Fees

This program element would establish rules for accounting for fees charged in connection with international lending. Some concern has been expressed that so-called front-end fees, when taken into income in the quarter or year in which they are charged, provide an added incentive to seek out international loans in order to boost earnings immediately and, once this has occurred, to sustain past earnings levels. The general practice in the industry is, apparently, to treat a portion of these loan fees -- that part which is paid to all participating lenders -- as interest to be taken into earnings over the maturity of the credit and the remainder -- syndication fees -- as current income. However, specific practice apparently varies, and the more conservative practices may not prevail generally. Therefore, it would be desirable to assure uniform rules so that artifical incentives are not created for foreign lending. To this end, the regulators are prepared to establish rules to require that front-end fees be treated as interest except when they are identifiable as reimbursement of direct costs.

Appendix D contains an analysis of accounting for fees on syndicated international credits and an explanation of the proposed guidelines for such fees.

5. International Cooperation

Present problems in foreign lending are international in scope, and an effective program for limiting the potential scope for such problems in the future must be coordinated with bank supervisors abroad and with the activities and operations of the International Monetary Fund.

Coordination with overseas bank supervisors can help to avoid competitive inequalities, to assure equal treatment of lenders and borrowers, and to reinforce the effectiveness of U.S. programs. The bank regulatory agencies will seek understandings with foreign bank authorities to help achieve the objectives of risk diversification and strengthened financial condition that we have set for ourselves.

Similarly, the IMF can play a major role, particularly with borrowers, in avoiding situations involving excessive build-ups of credit, especially short-term credit. We intend to work in the following areas to improve information flows and to ensure a more effective IMF surveillance process:

1. In its consultations with member governments on their economic policies, the Fund should intensify its examination of the trend and volume of external indebtedness of private and public borrowers in the member country and comment to the country and in its reports to the Executive Board on such borrowing from the viewpoint of its contribution to the economic stability of the borrower. The IMF might also consider the extent or form that these comments might be made available to the international banking community and the public.

2. As part of any member's stabilization program approved by the IMF, the Fund should place limits on public sector external short- and long-term borrowing; and

3. As a part of its Annual Report, and at such times as it may consider desirable, the Fund should publish information on the trend and volume of international lending in the aggregate as it affects the economic situation of lenders, borrowers and the smooth functioning of the international financial system.

Consideration of Lending Limits

The foregoing program does not include the establishment of country lending limits. It was concluded that lending limits based upon objective criteria are likely to be too rigid. Such limits would fail to distinguish between countries capable of carrying substantial debt without significant transfer risk and countries where smaller amounts of debt still raise large transfer risk problems. On the other hand, lending limits based on subjective judgments that change over time are likely to have capricious and abrupt effects on flows of credit, imply a degree of foresight on the part of the regulators that may not be realistic, and be difficult to administer fairly while avoiding political complications. Finally, in view of the substantial exposures already incurred, a program of lending limits would not be workable except with a very long transition period that would tend to vitiate its credibility.

The problem that is before the international financial community today is one of maintaining a reasonable flow of international credit to allow time for orderly adjustment. As for the future, as levels of exposure decrease over time, the program of intensified regulatory surveillance and evalution of country exposures, additional disclosure, special reserves, rules for fee accounting, and improved international cooperation should prove sufficient to deal with build-ups of concentrations of international credit that might threaten a sound banking system.

Implementation Authority

The bank regulatory agencies' authority to define and prevent unsafe and unsound banking practices under their enabling statutes and the Financial Institutions Supervisory Act of 1966 could be used to implement the program outlined above insofar as they require regulatory action. A number of similar measures have been taken in the past utilizing this authority and the courts have generally sustained the banking agency actions. To be effective, the banking agencies must demonstrate a clear link between the established prudential practice and the safety and soundness of depository institutions -- a relationship that past experience indicates can be established in the area of international lending. In view of the existence of this authority it would not be desirable to establish rigid or inconsistent legislative rules that could limit the ability of the banking regulators to adapt the program as they gain experience with its implementation and could have the unwarranted and unintended effect of discouraging the international lending necessary to support world trade and economic recovery.