

APPENDIX A

PROPOSED REVISIONS TO EXAMINATION PROCEDURES TO STRENGTHEN SUPERVISION OF COUNTRY RISK

In 1979, the bank regulatory agencies put in place new examination procedures for supervising country risk in U. S. bank portfolios. In retrospect, it is clear that these procedures did not have sufficient impact to temper adequately the buildup of concentrations of credit to foreign countries that were potentially vulnerable to external debt service problems. The proposed changes are designed to integrate more fully country risk considerations into the examiners' overall rating of the condition of a bank, to identify problem credits at an earlier stage, to include more specifically transfer risk in the analysis of the adequacy of a bank's capital, and to improve the presentation to a bank's management and directors of concerns of the banking agencies about large concentrations of country exposure.

Changes would be made along the following lines:

- (1) New categories will be employed for identifying credits that are not performing because of a country's debt service problems. These categories will replace the traditional classification categories originally designed for evaluating commercial risk, but also currently used for transfer risk, and would more clearly reflect the types of problems that arise due to transfer risk.
- (2) Credits in these new categories will be factored into the agencies' evaluation of a bank's asset quality and other measures of financial soundness.
- (3) Examiners will be required, under guidelines to be developed, to highlight certain large concentrations of credit in the examination report and in communications with the bank's directors.
- (4) Concentrations of country exposure subject to comment will be factored into the evaluation of a bank's capital adequacy. Banks with large concentrations of country exposure will be expected to have extra capital to support those exposures.
- (5) Bank managements will be expected to make systematic reports to their boards of directors on country exposures and country conditions.

New Categories for Reflecting Credits Adversely Affected by Transfer Risk

The traditional categories that were originally designed for evaluating commercial risk, i.e., substandard and doubtful, have not proved suitable for evaluating transfer risk. The following categories are designed to reflect more closely the types of problems that arise due to transfer risk.

The new categories and the definitions for each are:

Loss -- Indebtedness considered uncollectible and of such little value that its continuance as a bankable asset is not warranted--for example, repudiated debt. Such indebtedness shall be charged off and no longer be carried on the books of the bank.

Reservable — This classification would apply when a country had demonstrated protracted debt service problems. Evidence to that effect would include such factors as (a) full interest payments on indebtedness to banks had not been made for more than six months, (b) the terms of restructured indebtedness had not been met for over one year, (c) IMF or other suitable adjustment programs had not been complied with and there is no immediate prospect for such compliance, or (d) no definite prospects exist for the orderly restoration of debt service in the near future.

Debt Service Impaired — This classification would apply when (a) a country has been unable to meet its external debt service obligations and it has not yet adopted viable policies for restoring its debt service capabilities (or is not in the process of doing so), but is generally making required interest payments, (b) there is no evidence that the country will be able to negotiate a successful rescheduling with its creditors in the near future, and (c) the country has not adopted an IMF or other suitable economic adjustment program or is not adhering adequately to such a program.

Other Changes in Supervisory Procedures

The other changes under active consideration to strengthen supervisory procedures on international lending are: (1) the incorporation into a bank's asset quality rating of credits that fall within the categories just described; (2) the more forceful conveyance in examination reports of concentrations of exposure; and of credits to countries currently experiencing liquidity difficulties that have adjustment programs in place; and (3) the inclusion of concentrations of country exposure in the assessment of capital adequacy.

Implementation of these changes is complex and requires consideration of many technical factors. Details of these changes, including the criteria to be employed and the guidelines to be followed, are as a result still being developed and refined by the banking agencies. In addition, supervisory policies are being developed to insure that boards of directors are adequately reviewing and more fully supervising the international lending policies and decisions of their banks.