APPENDIX C

PROPOSED RESERVE PROVISIONING FOR CREDITS TO COUNTRIES WITH SEVERE AND PROTRACTED DEBT SERVICING PROBLEMS

BACKGROUND

As part of the review of their procedures for supervising transfer risk in U. S. banks, the bank regulatory agencies have examined the methods used by banks to account for loans to countries with severe and protracted external payments problems. In the opinion of the agencies, present procedures do not always reflect the reduced quality of the credits to such countries and there is no uniformity among banks in their accounting for these credits.

Under current procedures, banks are required to review their credits to determine whether all or parts of particular loans should be declared "loss" and charged off or whether additional provisions should be made to the allowance for possible loan losses in light of such credits. This process has not worked well for credits that have been adversely affected due to country risk. In part, this has been because countries, unlike companies, do not declare bankruptcy and there are no established liquidation procedures to provide a valuation basis for such credits. Although some banks have made special provisions to the allowance for possible loan losses because of such credits, the treatment among banks has been uneven, indicating the need for a more systematic approach.

Even though credits to a country, absent repudiation, are not "loss" in the traditional sense, transfer risk problems can seriously impair the liquidity and earning power of an asset. Indeed, to the extent interest has not been paid that, by itself, diminishes the value of the underlying asset. The bank regulatory agencies believe that when the servicing of bank credits has been adversely affected over a protracted period of time due to a country's inability or unwillingness to service its international debts, the net carrying value of the affected assets should be adjusted in a bank's financial statements through charges to earnings and balance sheet provisions.

Since present procedures seem inadequate in this regard, the agencies propose to require banks to make special allocated provisions against certain assets that are found to be severely affected by transfer risk problems. The "allocated transfer risk provisions" (ATRP) would be separate from the general allowance for loan losses and would not be regarded as capital by the agencies. The reserves would be established by a provision against income. In the alternative, a bank would have the option to write off all or part of the loans that are subject to the special reserves and, consequently, reduce the amount of special provisions and reserve balances that would otherwise be required.

In connection with consideration of the special allocated provision proposal, the bank regulatory agencies also reviewed the agreement in 1978 for the examination of transfer risk in U. S. banks. This agreement created an interagency committee, the Interagency Country Exposure Review Committee ("ICERC"), to determine when assets should be classified due to transfer risk, and it provided guidelines to be followed in making those determinations. Experience in applying the procedures indicates a need to clarify and revise the categories and definitions used to identify credits adversely affected by transfer risk. The designation of assets experiencing debt service problems as "substandard" and "doubtful" will no longer be used in characterizing credit problems due to transfer risk. New designations to be used include a category termed "reservable." A "reservable" categorization would trigger the requirement for the ATRP.

An example of the proposed changes in the call report to implement these procedures is attached (Attachment A). A new "provision" item would be added to the balance sheet. The amount of the reserve item would be deducted from "gross loans" to arrive at "net loans." The reserve would be created by a charge ("provision") against income.

PROPOSED PROCEDURES FOR PROVISIONS ON CREDITS TO COUNTRIES CATEGORIZED AS "RESERVABLE"

(1) The new category "reservable" adopted by the banking agencies is defined as follows: A "reservable" categorization is warranted when a country has 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.

(2) An Allocated Transfer Risk Provision ("ATRP") is required for assets categorized as "reservable." The provisions are to be established by a charge to earnings. The ATRP is to be separate from the general Allowance for Possible Loan Losses and will not be included as part of the bank's capital funds.

(3) No ATRP provisions are required if the bank has already written down the credit by the requisite amount.

(4) Senior executives of the OCC, FRB and FDIC will jointly determine the amount and timing of the provisions after reviewing the report of the ICERC on the "reservable" categorization. The initial provision will normally be 10 percent. The transfer risk will be reviewed annually. Depending on the circumstances, additional reserves may be required. Additional provisions, if warranted, will normally be in 15 percent increments.

(5) The ATRP may be reversed when a credit is no longer categorized as being adversely affected by transfer risk.

(6) Any payment of interest on credits categorized "reservable" should be applied to reduce principal (or credited to ATRP) and not credited to income. The amount of the mandated ATRP may be reduced by the amount of any interest previously applied to principal.