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Statement on
Private Bank Lending to Lesser Developed Countries and the
Implications for the Insurance Fund,

Presented to the
Subcommittee on Financial Institution Supervision,
Regulation and Insurance of the
House Committee on Banking, Finance and Urban Affairs..., March 24, 1977.

United States House of Representatives

by

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March 24, 1977

Mr. Chairman, we welcome the opportunity to appear before your Subcommittee to report on the insurance aspects involved in private bank lending to lesser developed countries (hereafter LDC's). We appreciate being asked to participate in a discussion of this topic which has broad public policy implications, and we share the Subcommittee's concern that any significant change in the scope of operations of domestic banks has implications for the insurance fund. On the basis of the information we review as a matter of course, we believe that recent commitments to LDC's pose no real danger to the over-all stability of the U.S. banking system.

I would like to make some general observations regarding the debt problems of LDC's and the implications for the stability of the U.S. banking system. The rapid expansion of credit extension by American banks to LDC's has been well publicized. Recognizing that there apparently is no universal agreement on the precise definition of an LDC*, Chairman Burns has recently indicated $45 billion, a not insignificant amount, as the total indebtedness of non-oil LDC's to American banks at the end of 1976. The apparent reasons for the movement by U.S. banks to lend to LDC's are many and varied. It has been asserted that a demand for credit by LDC's, as well as other countries, was fueled by continued, large current account

*Apparently no one definition fits for all LDC's. Several world organizations are responsible for defining the term -- The Development Assistance Committee (DAC), the International Bank for Reconstruction and Development (IBRD), the International Monetary Fund (IMF), and the United Nations (UN). Each organization maintains its own list of LDC's as well as the qualifications that serve to classify a nation as such. There is an apparent move to distinguish between oil and non-oil LDC's.

deficits. Another important factor is said to be the need for new funds to refinance maturing external debt. Furthermore, it is claimed that since balance of payments financing needs have outpaced the amounts available from international institutions and official national sources, private international lending has rapidly increased in importance. Finally, it is argued that growth in international lending was stimulated by relatively high domestic liquidity and a concomitant slack in domestic private loan demand. Whatever the reasons, the fact of the matter is that international financing, including loans to LDC's, by American banks has increased dramatically in the recent past. We agree that the situation warrants an increased sense of caution on the part of insured banks in their international banking activities, and such caution does in fact appear to be surfacing.

In the cautionary vein, it is asserted that it may be a mistake to view loans to the LDC's as homogeneous. Thus, it is argued, that what is seen as "the world debt problem" is in fact a series of individual problems which should be examined on a country-by-country and loan-by-loan basis. While there is merit to these assertions, it may also be significant to aggregate the loans of individual countries to gain a sense of their dimension and to identify whether, and, if so, how the problems in one country may interface with the problems of other countries.

With respect to the propriety of viewing loans to LDC's as homogeneous, it may be useful to review briefly the distribution in recent years of U.S. bank claims on private organizations and official institutions in less developed countries and the terms of payment on these claims. The claims mainly include loans, acceptances, collections outstanding, and deposits. At year-end 1976, non-OPEC LDC's accounted for roughly one-quarter of foreign claims of U.S. banks. These countries can be categorized as high, medium, and low-income LDC's on the basis of the World Bank classification scheme. The high income LDC's, those traditionally regarded as the more credit-worthy category, accounted for over eighty-percent of all U.S. bank claims on non-OPEC LDC's. These figures remain essentially unchanged from year-end 1975.

The overall picture is that relatively few of the largest American banks have substantial commitments to LDC'S. However, these commitments are by and large with the higher-income, traditionally more credit-worthy LDC'S and are in a relatively liquid form. Although the dollar volume of losses on international loans appears to have increased recently, the ratio of losses on international loans generally remains lower than for domestic lending. These patterns appear essentially unchanged from 1975 experience, indicating that the vulnerability of U.S. banks to default on debt payments by LDC's has not worsened over the last year in an overall sense. It is true that large current-account deficits persist in several LDC's. Nevertheless, adjustment processes were begun in 1976 in many of these countries to correct serious balance of payments deficits and shortages of foreign exchange reserves. These programs range from monetary and fiscal adjustments to multilateral debt rescheduling agreements. The foregoing leads us to believe that recent commitments to LDC's do not pose any real danger to the overall stability of the U.S. banking system.

Although the Corporation is the insurer of member as well as nonmember banks, we only directly supervise and regularly examine insured nonmember banks. Historically, relatively few banks under the direct supervision of the Corporation have been active in international banking. Available evidence indicates that the situation may be changing. In preparation for such eventuality, the Corporation has for the past several years undertaken various types of training opportunities, both internal and external, for selected personnel on the concepts and operations of international banking. We have near completion for use by our field personnel major revisions to our report of examination, with appropriate instructions, dealing with the review and examination of international and foreign banking by State nonmember insured banks. As a final step, the Corporation needs and will provide written guidelines for use by our examiner personnel in examining the international banking activities of banks under our direct supervision. Furthermore, we have recommended to the Congress, both in 1975 and 1976, legislation to give the Corporation additional supervisory powers over the international activities of State nonmember insured banks in Bills S.2233 and HR9742 in 1975 and S.895, which was introduced in March of this year.

Our data indicates that only seventeen insured nonmember banks have offices overseas aggregating 40 offices in all, 39 of which are mere shells and one of which is bona fide branch office. The bona fide overseas branch office is examined on site by the Corporation and the records of "shell" branches are examined during the regular examinations of the head offices, where the accounting and credit functions of the "shell" offices are performed.

A thorough review of the data on the seventeen insured nonmember banks with offices overseas reveals a negligible amount of loans to LDC's. In the most extreme case of default on all the loans to LDC's held by these insured nonmember banks, the viability of none of the institutions would be impaired.

I would now like to turn to the review process of reports of examination of insured banks conducted by Washington staff personnel of the FDIC and briefly summarize what is being done in that regard. It is, I believe, important to keep in mind that the primary supervisors for member banks are the Comptroller of the Currency and the Board of Governors of the Federal Reserve System. It is also important to note that the great bulk of banks engaged in international and foreign banking are national or State member banks. Finally, although we are fully cognizant of the impact that the condition of national and State member banks has on the insurance fund, it should be remembered that the Corporation does not regularly examine nor does it otherwise directly supervise those banks. The Corporation is largely reliant upon the information and data furnished by the Comptroller and the Federal Reserve in order to evaluate whether and how national and State member banks may affect the insurance fund.

One of the Washington staff's functions is to review and determine the condition of all insured banks through the analysis of the most recent reports of examination available and, where appropriate, to identify as problem banks those that are found to pose a more than normal risk to the Corporation's insurance fund so that they may be more closely monitored and/or otherwise supervised. Reports of examination for State nonmember insured banks are promptly forwarded to the Washington Office from the Corporation's respective fourteen regional offices after completion of the examinations. The Comptroller and the Federal Reserve, for their part, have agreed to furnish their reports of examination and some other data on member banks to our Washington staff so that we may stay abreast of the condition of such banks and their possible affect on the insurance fund.

Reports of examination of national and State member banks which are the subject of special supervisory efforts by the Comptroller or the Federal Reserve are reviewed as soon as received. In addition, bank examination reports for national and State member banks of $100 million or more in size, which are not the subject of special supervisory efforts by the Federal Reserve or the Comptroller, are regularly reviewed and analyzed. It is, of course, the banks in the $100 million or more size category which engage in virtually all of the international banking activity conducted by American banks. Finally, our staff also reviews at least once every 3 years the most recent examination report provided us by the Comptroller and the Federal Reserve for national and State member banks of less than $100 million in size. We believe that this oversight process of examination reports furnished to the Corporation by the Federal

Reserve and the Comptroller, coupled with our direct supervision of State nonmember insured banks, has served to keep the Corporation reasonably well informed as to the international activities of all insured banks, including, of course, their activities with LDC's.

An integral part of the examination process is the determination by an examiner of whether or not the bank under examination has any concentrations of risk. The purpose is to alert management and the supervisor to the incipient and ongoing hazards of failure to diversify risk. Usually credit concentrations are viewed in relation to total capital and reserves, and the benchmarks used, depending on the circumstances, range from 10% to 25% of total capital and reserves for an individual concentration. A review of the reports of examination for State nonmember insured banks, as well as a recent survey of the Corporation's fourteen regional offices, indicates that, with the exception of two banks, there are no insured nonmember banks in the $100 million or more size category that have any concentrations of credit to individual LDC's. With respect to the two that have concentrations, neither bank reaches the $250 million level in deposit size and, based on our analysis, neither is unduly threatened by the presence of such concentrations. Furthermore, a review of FDIC Washington staff analyses of examination reports furnished to us by the Federal Reserve and the Comptroller, as well as our own information on State nonmember insured banks under our direct supervision, indicates that for 102 commercial banks* with $1 billion or more in deposits at year-end 1976

*69 are national banks, 22 are State members, and 11 are State nonmembers.

(the vast majority of which are national or State member banks) there are no concentrations to individual LDC's in any of these banks which would seriously threaten their viability.

As is well known, the last few years have been traumatic ones for the United States banking industry. The worst recession since the Great Depression of the 1930's, combined with double-digit inflation, imposed great strains on the banking system. More bank failures occurred in 1976 than in any year since 1942. The eight largest bank failures in the FDIC's history took place in the 39-month period between October 1973 and December 1976, failures of banks whose assets aggregated over 3 1/2 times as many assets as in all the other insured banks that have been closed during the entire history of the FDIC. While I'm certain all would agree that the shock waves coincident with such bank failures would have been better avoided, there are, from the insurer's standpoint, significant benefits and valuable experience to be gained from these events. As a result of our recent experiences, the Corporation is satisfied that it has the capability to deal satisfactorily with large bank failures. For example, in the case of Franklin National Bank, the largest bank failure in the history of the FDIC, the most recent appraisal of the remaining Franklin National Bank assets indicates that collections from these assets are expected to allow full recovery of the amounts due to the Federal Reserve Bank of New York and the FDIC. In other words, based on that appraisal, it appears that FDIC will suffer no loss from the Franklin National closing and the Board of Directors of the FDIC concluded last year there was no need to establish a reserve for losses on account of the Franklin Bank failure.

In short, the FDIC has successfully met the test which recent events have thrust upon it. Unquestionably, to meet the test required massive action on an unprecedented scale by FDIC. The concept of a "clean bank" purchase and assumption transaction, one in which the take-over bank purchases only good assets from the estate of the failed bank, with the FDIC substituting cash for the assets not taken by the take-over bank, has been applied in the past 3 years by the Corporation to larger banks. By doing so, the Corporation has removed from the banking system between October 1973 and December 31, 1976, over $3.7 billion of questionable assets, including all the worst assets of all the failed insured banks. This represents a substantial removal of poor quality assets from the banking system.

Just as important as the "clean bank" purchase and assumption approach has been the Corporation's determination to attempt to arrange a purchase and assumption in each failed bank situation, rather than pay depositors their insured amounts. This approach, and our ability to implement it not only in all large bank failures but in nearly all failures regardless of size, has contributed significantly to customer confidence in the banking system. Only three banks whose total deposits aggregated only about $18 million were paid out in 1976. In sum, it has been demonstrated that the insurance fund has the strength and vigor to cope with unusually severe and complicated problems arising from the closing of large banks.

As indicated previously, we believe that our current procedure of reviewing reports of examination of State member and national banks furnished by the Board and the Comptroller has served to keep the Corporation reasonably well informed as to the impact on the insurance fund of international activities by national and State member banks. However, recent developments would seem to warrant a reassessment of our posture in that regard, particularly with respect to the possible need for additional data and information on the subject by the Corporation. For example, the rapid expansion of international lending and concern about the external creditworthiness of some countries, which have been large borrowers in international credit markets, has intensified interest in and the need for additional information on the external debts of countries. In addition, perhaps the Corporation should be in a position to compile and analyze data regarding the aggregate loans by insured American banks to LDC's on a country-by-country basis in order to ascertain better if any concentrations exist which might also affect the insurance fund. These are all relatively new areas of supervision to the Corporation, demanding new and different means of performing an oversight function which has not been needed up to now, but may be needed in the future. At a minimum, the Corporation should have more current operative facts. Closer coordination and exchange of information among the three Federal bank regulatory agencies on matters relating to international banking seems in order. To that end, procedures may be needed whereby the Comptroller and the Federal Reserve will furnish the Corporation copies of all reports and other data obtained or generated by the staff of the two agencies in connection with the international activities of national and State member banks. We at the FDIC are also considering staffing our office with persons trained in the field of international banking and, thus, able to analyze, in a meaningful way, the information furnished and to focus on particular areas of concern to the Corporation. Armed with such data and information, the Corporation would be in a better position to assess the impact of international activities by insured banks on the insurance fund and to suggest perhaps to our sister agencies methods and practices whereby the supervision of international activities might be buttressed. These suggestions might take the form of recommendations to improve the content and/or to increase the frequency of reports submitted by U.S. banks. They also might include recommendations as to the processing of applications, the issuance of additional regulations, or even, in an appropriate case, the utilization of the enforcement tools available. In essence, at this stage the Corporation should be in a position to satisfy itself that it is fully informed as to the extent and types of practices, operations and investments engaged in by U.S. national and State member banks especially, and their related interests, conducting business in the international field and the risks coincident with those activities to the insurance fund.

We are confident that, with continuing and increased coordination among the agencies and prudence on the part of commercial insured banks, the risks associated with LDC borrowing can be effectively minimized.