STATEMENT ON

REGULATORY AND SUPERVISORY APPROACHES
RELATING TO FOREIGN LENDING BY U. S. BANKS

PRESENTED TO the Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

BY

WILLIAM M. ISAAC
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

9:30 a.m.
Monday, April 11, 1983
Room 538, Dirksen Senate Office Building

Mr. Chairman, I am pleased to have an opportunity to present the FDIC's views on S. 502, the International Lending Reform Act of 1983 and on the regulation of foreign lending activities of American banks.

On February 17, 1983, I appeared before the Subcommittee on International Finance and Monetary Policy to discuss the international and domestic implications of U.S. commercial bank lending to foreign governments and corporations. The Subcommittee members made it clear they believed we should make some changes in our policies and practices in order to impose some discipline on the international lending activities of our banks to avoid a recurrence of the current dilemma. We concur in that view. The only real questions are how much restraint is required and how will the discipline be imposed. We are of the view -- for a variety of reasons which we discussed that day -- that the greater marketplace discipline must be brought to bear on bank risk-taking.

As I testified on February 17, we feel that until market participants, such as large depositors and other major funds suppliers, come to understand that their position is not 100% protected by the Federal government in the case of a large bank, marketplace discipline will be inadequate. We will soon submit a study to Congress which outlines our proposals for changing the manner in which we handle bank failures. While I will not dwell on the specifics of those proposals, I would report to you here that we consider those plans an integral part of any program to impose market discipline.

With respect to international lending activities of American banks, there are several areas in which we are prepared to act by regulation. With one exception, country lending limits, they track closely the thrust of S. 502. They involve disclosure of foreign exposures, accounting for fees, and the establishment of prudential reserves against certain foreign debts.

DISCLOSURE REQUIREMENTS

At present, certain banks are required to report semiannually on their foreign lending activities. This report, the Country Exposure Lending Survey, is used by regulators to track lending patterns of American banks. Two problems exist in this system. First, the data are not reported in a timely enough manner. We are working on a proposal to increase the reporting of these data to quarterly in an effort to eliminate this problem.

The second, and perhaps more important, drawback of the system is that none of the information we collect is available to the public on an individual bank basis. If the market is to assist us in imposing discipline, it must have timely information. We, therefore, are working on a proposal to make certain of the information in the Country Lending Survey publicly available. In general, we are thinking along the lines of making available information on bank exposures to countries where those exposures exceed a specified percentage of a bank's total assets. This is not too dissimilar from the SEC's reporting requirements, except that we would not limit the disclosure to those countries experiencing "liquidity problems." By requiring banks to report exposures in all countries where the exposures exceed one percent of total assets, we would allow the marketplace to judge the extent and nature of the risk in a bank's international loan portfolio.

FEE INCOME

The level of international lending and increased incidence of reschedulings over the past two years has provided many banks with substantial income in the form of front-end fees. Those fees are often taken into income in the period a loan is made, providing a boost to current earnings. A more realistic approach, particularly for rescheduled debt, would have that portion of the fee used to increase the yield on the loan taken into income over the life of the loan. We propose that all such fees not identifiable as reimbursement for out-of-pocket administrative costs be amortized over the life of the loan. This would discourage banks from originating or rescheduling loans merely to boost current earnings or sustain past earnings levels.

PRUDENTIAL RESERVES

The third area of concern relates to how problem foreign loans are carried on the bank's books. There has been much criticism of the regulators' failure to force banks to write down international loans which appear marginal to many observers. A very valid question arises as to whether their failure to do so results in a misrepresentation of the banks' true condition. It seems obvious that the full collection of certain foreign loans is in serious doubt, and we believe prudential reserves for those loans should be established. Our proposal is that such reserves be established out of the income stream, and we intend to require them. Moreover, these reserves will not be included in our definition of capital for purposes of capital adequacy calculations, as is the traditional reserve for bad debts.

LENDING LIMITS

We have given a great deal of thought to the notion of country lending limits and have concluded they would be highly inappropriate. Lending limits based on objective criteria are likely to be too rigid. Such limits would fail to distinguish between countries capable of carrying substantial debt without significant risk and countries where smaller amounts of debt pose great risk. Limits based on subjective criteria that change over time are likely to have abrupt effects on credit flows, imply a degree of foresight on the part of regulators that may be unrealistic, and be difficult to administer while avoiding political complications. Finally, in view of the already substantial exposures in many banks, a program of lending limits would need a very long transition period that would tend to vitiate its credibility.

DIVERSIFICATION RESERVES

An additional area we at the FDIC are exploring is that of diversification reserves -- that is, requiring banks to in effect maintain higher equity capital positions when those banks choose to concentrate their foreign lending activities. We understand a bill has been drafted that would require a minimum capital base for all banks. Although we would have several suggestions for improvements in the bill, we would strongly object to banks being singled out from other very similar, insured financial institutions -- in particular, savings and loan associations -- we are interested in the concept of a minimum capital standard. Such a requirement would add significance to mandated diversification reserves, since amounts taken from capital to establish our reserve presumably would have to be replaced if the statutory minimum were violated.

Thank you Mr. Chairman and members of the Committee. I will be pleased to respond to any questions you may have.

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

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. Special Reserves

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.

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.

APPENDIX B

REPORTING AND PROPOSED DISCLOSURE OF COUNTRY EXPOSURE

Reporting

The federal banking agencies have required U.S. banks since 1977 to file a Country Exposure Report semi-annually for federal supervisory purposes. This report, which is published in aggregate, has proved to be very useful both for the bank supervisors and the banks themselves. Other countries have used it as a model for their own consolidated reporting systems for the country exposure of their banks. The growth of international lending and the increased number of short-term international liquidity problems suggests the desirability of more frequent reporting for supervisory purposes. Therefore, the federal banking agencies propose to require U.S. banks to file the Country Exposure Report quarterly rather than semi-annually, and on a tighter time schedule than is now required. The aggregate data would continue to be published by the supervisors.

Disclosure

Disclosures of concentration of country exposure in U.S. banks need to be more uniform, complete and timely. To this end, the Country Exposure Report (FFIEC Form 009) would be amended to include a disclosure section which the agencies would make available on request. The disclosure section would indicate concentrations of country risk. A sample form is attached. Country exposures exceeding one percent of bank's total assets would be profiled to detail risk. The profile would show exposure on a gross basis and adjusted for third-country guarantees and would show the exposure by sector and maturities. Country exposures between three quarters and one percent of a bank's total assets would also be indicated, but not profiled.

Attachment

REPORT OF CONCENTRATIONS OF TRANSFER RISK

(This report is being collected for public disclosure purposes and will be made available to the public upon request)

A. Exposures Exceeding One Percent of Total Assets

Country	Credit outstanding after mandated adjustments for transfers of exposure (1)	Credit outstanding before adjustments (2)	Distribution of outstandings reported in col. 2: To banks (3)	To public sector (4)	To others (5)	Maturing in less than one year (6)	Maturing in more than one year (7)	Total commitments to provide credit, after adjustments for guarantees (8)

B. Exposure Between Three-quarters of One Percent and One Percent of Total Assets

Total number of countries	Credit outstanding after mandated adjustments for transfers of exposure	List Individual Countries

GENERAL INSTRUCTIONS FOR REPORT OF CONCENTRATIONS OF TRANSFER RISK

A. Exposures Exceeding One Percent of Total Assets

The data required for this section must be submitted for each country where "credit outstanding after mandated adjustments for transfers of exposure," exceed 1 percent of a bank's total assets as of the reporting date.

Col 1 -	Credit outstanding after mandated adjustments for transfer of exposure. Report the sum of the following columns from the Country Exposure Report ("CER")--Cols. 4-9 + 10-11 + 12 + (18-19 provided greater than 0).
Col 2 -	Col 4 of CER
Col 3 -	Col 1 of CER
Col 4 -	Col 2 of CER
Col 5 -	Col 3 of CER
Col 6 -	Col 5 of CER
Col 7 -	Sum of Cols. 6, 7, & 8 of CER
Col 8 -	Cols. 14 + 15-16 + 17 of CER

B. Exposures Between Three-Quarters of One Percent and One Percent of Total Assets

Show in this section the total number of countries in which the bank's "credit outstanding in each country after mandated adjustments for transfers of exposure", as computed above, range between three-quarters of one percent and one percent of total assets as of the reporting date. Also show the aggregate amount of all credit to those countries. Finally, list the names of each country.

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.

ATTACHMENT A CDF 2

Domestic and Foreign Consolidated Report of Condition of ____________________
Legal Title of Bank

at close of business on ______________ 19__

Dollar Amount in Thousands | Bil | Mil | Thou

1. Cash and due from depository institutions (From Schedule C, item 8, Column A) 1.
2. U.S. Treasury securities 2.
3. Obligations of other U.S. Government agencies and corporations 3.
4. Obligations of States and political subdivisions in the United States 4.
5. Other bonds, notes, and debentures 5.
6. Federal Reserve stock and corporate stock 6.
7. Trading account securities 7.
8. Federal funds sold and securities purchased under agreements to resell in domestic offices of bank and of its Edge and Agreement subsidiaries 8.
9. a. Loans, Total (excluding unearned income) (From Schedule A, item 10, Column A) 9.a.
b. Less: allowance for possible loan losses 9.b.
Less: Allocated Transfer Risk Provision
c. Loans, Net 9.c.
10. Lease financing receivables 10.
11. Bank premises, furniture and fixtures, and other assets representing bank premises 11.
12. Real estate owned other than bank premises 12.
13. Investments in unconsolidated subsidiaries and associated companies 13.
14. Customers' liability to this bank on acceptances outstanding 14.
15. Other assets (From Schedule G, item 3) 15.
16. TOTAL ASSETS (sum of items 1 thru 15) 16.

ITEMS 17 THROUGH 24.a(2). REFER ONLY TO DEPOSITS IN DOMESTIC OFFICES OF THE BANK

17. Demand deposits of individuals, partnerships, and corporations (From Schedule F, item 1e, Column A) 17.
18. Time and savings deposits of individuals, partnerships, and corporations (From Schedule F, item 1e, Columns B and C) 18.
19. Deposits of United States Government (From Schedule F, item 2, Columns ~~A &~~ B & C) 19.
20. Deposits of States and political subdivisions in the United States (From Schedule F, item 3, Columns A & B & C) 20.
21. Deposits of foreign governments and official institutions (From Schedule F, item 4, Columns A & B & C) 21.
22. Deposits of commercial banks (From Schedule F, items 5 & 6, Columns A & B & C) 22.
23. Certified and officers' checks (From Schedule F, item 7, Column A) 23.
24. a. TOTAL DEPOSITS IN DOMESTIC OFFICES (sum of items 17 thru 23) 24.a.
(1). Total demand deposits (From Schedule F, item 8, Column A) 24.a(1)
(2). Total time and savings deposits (From Schedule F, item 8, Columns B & C) 24.a(2)
b. TOTAL DEPOSITS IN FOREIGN OFFICES AND EDGE AND AGREEMENT SUBSIDIARIES (Schedule F/F, item 8) 24.b.
c. TOTAL DEPOSITS (sum of items 24a and 24b) 24.c.
25. Federal funds purchased and securities sold under agreements to repurchase in domestic offices of bank and of its Edge and Agreement subsidiaries 25.
26. a. Interest-bearing demand notes (note balances) issued to the U.S. Treasury 26.a.
b. Other liabilities for borrowed money 26.b.
27. Mortgage indebtedness and liability for capitalized leases 27.
28. Bank's liability on acceptances executed and outstanding 28.
29. Other liabilities (From Schedule H, item 4) 29.
30. TOTAL LIABILITIES (excluding subordinated notes and debentures) (sum of items 24c thru 29) 30.
31. Subordinated notes and debentures 31.
32. Preferred stock a. No. shares outstanding ________ (par value) 32.
33. Common stock a. No. shares authorized ________
b. No. shares outstanding ________ (par value) 33.
34. Surplus 34.
35. Undivided profits 35.
36. Reserve for contingencies and other capital reserves 36.
37. TOTAL EQUITY CAPITAL (sum of items 32 thru 36) 37.
38. TOTAL LIABILITIES AND EQUITY CAPITAL (sum of items 30, 31 and 37) 38.

Amounts outstanding as of report date: Memo
a(1). Standby letters of credit, total 1.a(1
(a). To U.S. addressees (domicile) 1.a(1
(b). To non-U.S. addressees (domicile) 1.a(1
a(2). Amount of standby letters of credit in Memo item 1a(1) conveyed to others through participations 1.a(2
b. Time certificates of deposit in denominations of $100,000 or more in domestic offices (included in

Legal title of bank

...od ending on .... 19___.

Section A - Sources and Disposition of Income

Dollar Amount in Thousands

	Year-to-date Mil	Year-to-date Thou	
1. OPERATING INCOME:			
a. Interest and fees on loans			1.a.
b. Interest on balances with depository institutions			1.b
c. Income on Federal funds sold and securities purchased under agreements to resell in domestic offices of the bank and of its Edge and Agreement subsidiaries			1.c
d. Interest on U.S. Treasury securities			1.d
e. Interest on obligations of other U.S. Government agencies and corporations			1.e
f. Interest on obligations of States and political subdivisions in the U.S.			1.f
g. Interest on other bonds, notes, and debentures			1.g.
h. Dividends on stock			1.h
i. Income from lease financing			1.i.
j. Income from fiduciary activities			1.j.
k. Service charges on deposit accounts in domestic offices			1.k
l. Other service charges, commissions, and fees			1.l.
m. Other operating income (from Section D, item 4)			1.m
n. TOTAL OPERATING INCOME (sum of items 1a thru 1m)			1.n
2. OPERATING EXPENSES.			
a. Salaries and employee benefits			2.a
b. Interest on time certificates of deposit of $100,000 or more issued by domestic offices			2.b
c. Interest on deposits in foreign offices			2.c
d. Interest on other deposits			2.d
e. Expense of Federal funds purchased and securities sold under agreements to repurchase in domestic offices of the bank and of its Edge and Agreement subsidiaries			2.e
f. (1) Interest on demand notes (note balances) issued to the U.S. Treasury			2.f
(2) Interest on other borrowed money			2.f
g. Interest on subordinated notes and debentures			2.g
h. (1) Occupancy expense of bank premises, Gross			2.h
(2) Less: Rental income			2.h
(3) Occupancy expense of bank premises, Net			2.h
i. Furniture and equipment expense			2.i
j. Provision for possible loan losses (from Section C, item 4)			2.j
Provision for Allocated Transfer Risk			
k. Other operating expenses (from Section E, item 3)			2.k
l. TOTAL OPERATING EXPENSES (sum of items 2a thru 2k)			2.l
3. INCOME BEFORE INCOME TAXES AND SECURITIES GAINS OR LOSSES (item 1n minus 2l)			3.
4. APPLICABLE INCOME TAXES			4.
5. INCOME BEFORE SECURITIES GAINS OR LOSSES (item 3 minus 4)			5.
6. a. SECURITIES GAINS (losses), GROSS			6.a
b. APPLICABLE INCOME TAXES			6.b
c. SECURITIES GAINS (losses), NET			6.c
7. NET INCOME (item 5 plus or minus 6c)			7.
OR			
7. INCOME BEFORE EXTRAORDINARY ITEMS			7.
8. EXTRAORDINARY ITEMS, NET OF TAX EFFECT (From Section F, item 2c)			8.
9. NET INCOME (item 7 plus or minus 8)			9.

APPENDIX D

PROPOSED SUPERVISORY GUIDELINES FOR ACCOUNTING FOR FEES ON SYNDICATED INTERNATIONAL CREDITS

A. Description of types of fees and recent practices

In addition to the stated interest on international syndicated[1/] loans (including stated interest adjustments for late payments), banks often require payment of certain fees in connection with these credits. These fees are identified by a variety of terms, and are intended for a variety of purposes: for example, a flat fee added specifically to increase the yield of the loan; a fee designed to cover costs associated with syndicating a loan (e.g., for structuring and negotiating a loan package, underwriting a syndicated loan, advising the borrower); a fee to cover the costs of committing funds on the prescribed terms for a fixed period of time; or a fee for serving as agent in administering a syndicated credit. In addition, banks frequently provide in the loan agreement that the managing bank(s) is to be reimbursed for all out-of-pocket expenses incidental to the arrangement of a credit facility, as well as collection or enforcement costs. (A glossary of terminology and description of the principal fees associated with the extension of international credits by commercial banks is attached.)

A survey of a sample of international syndicated loan agreements, concluded between 1978 and 1983, for borrowers in those countries recently experiencing balance of payments difficulties indicates the following:

1/ "Syndication" is the process of arranging a Multi-bank Credit Facility and is characterized by the formation of a Management Group, assumption of "Underwriting Commitments" and participation of various Lending Banks.

-- Over this period, commitment fees have ranged generally between 1/4 to 1/2 percent on the undrawn amounts of the loan during the availability period. Agency fees have varied for example from $7,500 per year to $300,000, with the variations perhaps related to the size and complexity of the loans. Practically all the agreements surveyed had detailed provisions relating to reimbursement of expenses.

-- The stated interest rates on the loans surveyed by-and-large ranged around 1% to 1-5/8% above LIBOR, with only a few notable exceptions.

-- Management and other front-end fees were unstated in the loan documents in the majority of cases, with the fees established by a side agreement. It is not clear the extent to which these fees are disclosed to other participants in the syndicate. Where the front-end fees were stated, they ranged from 3/4% to 1-1/2%.

B. Current accounting rules and practices applicable to nonrefundable fees

We understand that there are differences in the manner in which banks account for the nonrefundable fees associated with international loans. The major difference is the extent to which the fees are amortized over the life of the loan, as an adjustment to the interest yield on the loan, or instead are taken into income at the time the fees are received. Currently, neither generally accepted accounting principles nor regulatory policy definitively specify the manner in which fee income to the bank should be recognized.

Existing guidance on the timing of recognition of revenues is provided in Accounting Principles Board (APB) Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises that states the following realization principle:

> Revenue from services rendered is recognized under this principle when services have been performed and are billable. Revenue from permitting others to use enterprise resources, such as interest, rent, and royalties is also governed by the realization principle. Revenue of this type is recognized as time passes or as the resources are used.

Thus, under these accounting principles, each activity for which nonrefundable fees are received must be analyzed to consider whether the activity provides services and constitutes a separate earning process or is an integral part of the entity's central operations.

The American Institute of Certified Public Accountants (AICPA) Industry Audit Guide, Audits of Banks ("Bank Audit Guide") (1983) at pages 52-55, provides very general guidance as to accounting recognition of fees. As to commitment fees, the Bank Audit Guide in part states:

> "Banks have recorded income from commitment fees in a variety of ways including recognition:
>
> (a) in full when received.
> (b) when the commitment period has expired or the loan has been drawn down.
> (c) ratably over the commitment period.
> (d) ratably over the combined commitment and loan period.
>
> "The accounting for recognition of income from commitment fees should be based on the nature and substance of the transactions. However, a bank's method of accounting should ensure that any income that represents an adjustment to the interest yield is deferred until the loan is drawn down and then amortized over the expected life of the loan in relation to the outstanding balance.
>
> "Fees representing compensation for a binding commitment or for rendering a service in issuing the commitment should be deferred and amortized over the commitment period using the straight-line method."

The Guide does not directly address questions of front-end fees in syndicated international credits, but discusses "origination fees" as follows:

> "Banks also receive fees for originating loans in-house. The normal origination fee (generally referred to as points) is essentially a reimbursement for the expenses of the underwriting process, that is, processing the loan application, reviewing legal title to the collateral, obtaining appraisals, and other procedures. Origination fees, to the extent they are a reimbursement for such costs, should be recognized as income at the time of loan closing. Loan origination fees that are not reimbursements of such costs should be amortized to income over the expected loan period by application of the interest method."

Thus, existing accounting principles allow for a substantial exercise of discretion and so disparity in practice for accounting for front-end and other fees associated with syndicated international credits. Indeed, the accounting profession has recognized that clearer guidance is needed with respect to accounting for nonrefundable fees by financial institutions on all forms of credits. The AICPA has, for this reason,- formed a task force to prepare an issues paper addressing the diversity in accounting practice. The study has been underway for several months and no recommendations have as yet been made.

C. <u>Proposed supervisory guidelines for accounting for fees on syndicated international credits</u>

There has developed an increased use of fees to cover a number of different purposes including additions to the yield of international syndicated credits. In view of the present diversity in accounting practice as to those fees among banks, and paucity of definitive guidance as to the appropriate accounting for the wide range of fees that has developed, the federal bank regulatory agencies consider that to achieve conformity and uniformity in accounting for fees the following guidelines should be established.

PROPOSED GUIDELINES

1. Front-end fees in most instances represent an adjustment to the interest yield and shall be deferred until the loan is issued, and then amortized over the expected life of the loan in relation to the outstanding loan balance using the interest method. Front-end fees, or the portion thereof, that are identifiable as reimbursement of direct costs shall be recognized as income at the time of the loan closing or restructuring.

2. Fees for guaranteeing the funding of a loan (i.e., commitment fees) shall be recognized as revenue over the combined commitment and loan period. Reimbursement of any direct loan processing costs will be recognized as income at closing. Then the straight line method, based on the combined life of the commitment and loan period, shall be applied to the remaining fee to recognize income during the commitment period. When the loan is disbursed, the interest method shall be applied to the balance of the fee to recognize income over the life of the loan. If the loan in fact is not funded, unamortized commitment fees will be recognized as income at the end of the commitment period.

3. Agency fees and advisory fees should be recorded as income when received to the extent they represent reimbursements for identifiable, direct costs, otherwise they should be amortized over the expected period of the loan.

COMMENTARY

A. In a syndicated credit, it is often difficult to determine what share of the front-end fees represent a reimbursement of direct costs of the Managing Bank(s) and what share represents an adjustment to the interest yield. A reasonable presumption is that a Managing Bank should recognize a portion of the fee as an adjustment to interest yield based upon the other Participating Banks' share of the fee. Hence, it may be appropriate to consider the portion equal to the largest of any Participating Bank's*/ share of the front-end fee as an interest yield adjustment. The balance of a Managing Bank's share of a front-end fee, or some portion thereof, may be considered as reimbursement of direct costs if such costs are identifiable.

B. Proposed Guideline #2 reflects a presumption that commitment fees often embody three elements -- reimbursement of direct processing costs, remuneration from services in making commitments (such as assumption of risk of adverse changes in market interest rates over the commitment period), and a component that represents a yield adjustment. Determining the amount of each component may be difficult. When the separate components of the fees cannot reasonably be identified, the foregoing guideline provides a reasonable solution for recognizing the total fees over the combined commitment and expected loan period, and is the approach currently recommended in the Bank Audit Guide. The guideline also presumes that it is difficult to determine at the outset of a loan whether the loan in fact will need to be funded. Accordingly, a commitment fee should be accounted for over the combined life unless the loan is not actually funded.

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*/ A "Participating Bank" is not included in the Management Group for the credit nor does it assume any underwriting risk, i.e., the bank does not commit to lending obligations in excess of the amount it intends to lend in the transaction.

Glossary of Fees

1. Front End Fee: A flat fee paid by the Borrower to the Lending Bank(s). The fee is generally expressed as a percentage of the amount of the Credit Facility and is paid on the signing or disbursement dates of the Credit Facility. This fee is also sometimes referred to as a commission, financing fee, or flat fee.

   a. Management Fee: The portion of the Front End Fee which is distributed to Lending Banks (in a Multi-bank Credit Facility) in differing amounts depending on their roles in the transaction (i.e. Managing Bank, "Underwriting Bank," Participant, etc.) and participation amount. Managing Banks normally receive a larger share of the Front End Fee than do Participants. There are numerous alternatives for payment of the Management Fee to accomplish different structure and pricing objectives. The Management Fee normally represents an interest yield paid in fee form and, in the case of Multi-bank Credit facilities, frequently includes an element of compensation for additional service provided or "underwriting risk" assumed.

   b. Praecipuum: The portion of the Front End Fee which is distributed to one or more of the Lending Banks (generally Managing Banks) in a Multi-bank Credit Facility. This allocation of the Front End Fee serves as compensation for handling a disproportioniate share of the responsibility for arranging a Credit Facility or assuming an underwriting risk.

c. Pool: The residual amount resulting from the payment of Participating Banks in Multi-bank Credit Facilities of a less than full share of the Front End Fee. The Pool amount, which may or may not exceed the Praecipuum, is normally apportioned among Managing Banks on some preagreed upon formula and represents a form of compensation for the additional service provided by the Managing Bank(s) during the arrangement of the transaction.

2. Agency Fee: An annual fee paid to the Agent Bank by the Borrower and is normally intended to reimburse the Agent Bank for out-of-pocket expenses incurred in the performance of its administrative duties. Such expenses normally include telex, telephone, postage, printing, and travel. The amount of Agency Fee is generally fixed at the time of the signing of the Credit Agreement and varies in amount depending upon the number of Lending Banks participating in the Credit Facility, the complexity of the transaction and the frequency of communication with the Lending Banks.

3. Commitment Fee: This fee is paid by the Borrower and compensates Lending Banks for legally committing to lend to a Borrower at agreed upon terms and conditions at some future time. This fee is sometimes referred to as a Reservation Fee. This annual fee is customarily expressed as a percentage of the unused commitment from the Lending Bank and is normally paid quarterly in arrears.

4. Advisory Fee: A fee paid by a Borrower to compensate a bank(s) for a specific advisory service provided in relation to a transaction, such as a complex project loan. The advice may relate to the structure of the transaction or its arrangement and execution. This fee often is not listed in the loan agreement.

5. Expense Reimbursement: It is customary for a Borrower to reimburse banks active in arranging multi-bank or direct (i.e. one-bank) Credit Facilities for out-of-pocket expenses incidental to the arrangement of such facility. Normally these expenses include legal, telecommunications, travel and other expenses incurred during the arrangement of the Credit Facility and collection or enforcement costs.