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STATEMENT ON THE

REGULATION OF FOREIGN LENDING  
ACTIVITIES OF AMERICAN BANKS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS  
SUPERVISION, REGULATION AND INSURANCE OF THE *House*  
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS  
HOUSE OF REPRESENTATIVES

BY

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FEDERAL DEPOSIT INSURANCE CORPORATION

9:30 a.m.  
Thursday, April 21, 1983 ,

Room 2128, Rayburn House Office Building

Mr. Chairman, I am pleased to have an opportunity to present the FDIC's views on the regulation of foreign lending activities of American banks.

I think the Committee is well aware of the problem before us and the events leading to the request to increase the United States contribution to the International Monetary Fund, which we fully support. This morning I would like to focus attention on what we believe are necessary changes to our regulatory system if we are to keep international lending risks within acceptable bounds and maintain a sound, privately-owned banking system. Our written responses to the specific questions posed by the Committee may be found in the Appendix.

#### THE PROBLEM IN PERSPECTIVE

Before discussing remedial measures, let me try to impart our perspective on the enormously complex problem before us. Much has been said and written alleging irresponsible behavior of American banks in failing to restrain the growth of their international loan portfolios in the face of growing risk. In fact, many view the IMF proposal as a bail-out of the banks. This is simply not the case, as the banks, for better or worse, will be required to continue to lend as part of the solution to this problem.

We believe the banking industry has indeed been much too eager to provide huge amounts of credit. At the same time, I would be remiss if I did not express our belief that a large share of the blame rests with governments throughout the world, which for years and years pursued overly stimulative fiscal policies and accommodative monetary policies that produced inflation and fueled the expectation of continuing increases in prices. Those policies encouraged an ever-growing appetite for credit to the point where debt-servicing in the current worldwide economic downturn has become extraordinarily difficult for many borrowers.

As bank supervisors, we failed to effectively caution American banks to restrain foreign lending growth. Although portfolio concentrations were identified and commented upon, sufficiently firm steps were not taken to limit concentrations and the leveraging of bank capital. Without question our supervisory efforts need buttressing.

We are now faced with the difficult task of working out these problems. Cessation of all lending is not an option. It is necessary to bring fresh funding to the table to allow countries with debt-servicing difficulties the time to make adjustments in fiscal and monetary management, which, it is hoped, will lead to economic recovery.

SUPERVISORY REMEDIES

The task before us as supervisors requires us to achieve a delicate balance. We recognize that too harsh a supervisory approach could cause harm to foreign countries as well as our domestic economy by retarding growth and limiting the banking system's ability to meet legitimate credit needs.

In previous hearings on this topic, members of Congress made it clear that some changes in our practices with respect to the international lending activities of our banks were needed to avoid repetition of the current dilemma. We wholeheartedly agree. It is not our purpose -- indeed we would strenuously oppose any attempt -- to punish the banking industry. Rather, we simply believe a degree of restraint and order must be restored. This is completely consistent with our prescription for what must be done as we move forward with the process of deregulation.

As you know, Mr. Chairman, the three Federal banking agencies recently fashioned a joint memorandum that sets forth a program for improved supervision and regulation of international lending, which has since been embodied in a legislative proposal.

Disclosure

The joint memorandum provides that the agencies will adopt regulations requiring greater disclosure by banks of their foreign exposures. The agencies have agreed to collect country-exposure data quarterly rather than semi-annually and to disclose exposures that exceed a specified percentage of a bank's total assets. Requiring banks to report exposures in all countries in excess of one percent of assets will allow the marketplace to judge the extent and nature of their portfolio risk.

Fee Income

Increased international lending, together with an increased number of reschedulings, has provided banks with substantial fee income. These fees are often taken into income immediately, providing a boost to current earnings. A more appropriate treatment, particularly on rescheduled debt, would require the portion of the fee related to increasing the loan yield to be taken into income over the life of the loan. The objectives would be to better reflect the economic substance of the transactions and to discourage banks from originating or rescheduling loans as a means to boost current earnings.

### Prudential Reserves

The third major element of the proposed supervisory approach relates to prudential reserves. Full collection of certain foreign loans is in serious doubt, and provision of a prudential reserve is entirely appropriate. The reserves are to be established out of the income stream and, unlike the traditional reserve for loan losses, will not be included in our definition of capital for capital adequacy purposes.

### Improved Supervision

The joint memorandum calls for strengthened supervision of international lending activities. Examiners are to be more forceful in pointing out excessive exposures to bank managements and boards of directors, and capital adequacy standards are to be tightened for these banks.

There are some areas in the joint memorandum that still need to be worked out, after receiving public comments. These have to do primarily with the definitions used in connection with the new categories of troubled foreign debt -- e.g., "Debt Service Impaired" and "Reservable" -- in comparison with the traditional problem-asset designations, "Substandard" and "Doubtful"; the criteria for situations

in which reserves are to be required; and capital adequacy requirements for those banks that choose to concentrate their foreign lending activities. If we ultimately decide to adopt the new procedures and definitions, considerably more thought will have to be given to these issues.

We believe our ability to carry out our statutory responsibilities is dependent upon correctly identifying emerging problem credit situations. After making a reasonable determination of the seriousness of an asset problem, we are then in a position to determine whether the level of a bank's traditional valuation reserves is sufficiently large to cover potential losses in the loan portfolio and whether increased surveillance and enforcement are indicated. The determination of asset classifications and reserve adequacy is an exercise that should be undertaken based on time-honored tests. We would prefer to have the same degree of freedom to classify assets and require reserves that we have in domestic credit situations.

Let me make clear, since there was some confusion after last week's hearing before the Senate Banking Committee, that the FDIC supports the increase in IMF funding and the legislation proposed by the regulatory agencies. Our

reservations relate solely to some issues raised by the joint memorandum, which I am confident will be worked out to our satisfaction after further study, public comment, and interagency discussions.

#### DEPOSIT INSURANCE REFORMS

Before I conclude, let me emphasize a point I have made previously at other Congressional hearings. Our current system of deposit insurance is in need of fundamental changes with an emphasis on bringing marketplace discipline to bear on bank risk-taking. We are convinced 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 have just released a study to Congress, pursuant to the Garn-St Germain Act, which provides a blueprint for deposit insurance reform. While I will not dwell on the specifics of those proposals at this time, we believe the changes are essential to the continuation of a sound and stable banking system and urge their prompt and serious consideration.

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

ADDENDUM TO  
TESTIMONY OF WILLIAM M. ISAAC

APRIL 21, 1983

In view of the overlap in some of the questions in the April 7 and April 13 letters, we have chosen to cover them on a topical basis. For convenience, we have attached a copy of the April 7, 1983 Joint Memorandum, "Program for Improved Supervision and Regulation of International Lending" referred to throughout this addendum.

April 21, 1983 Hearings Before Subcommittee on  
Financial Institutions Supervision, Regulation and Insurance

STATUTORY, REGULATORY, OR SUPERVISORY REQUIREMENTS  
IN EACH OF THE GROUP OF TEN COUNTRIES AND SWITZERLAND

The most recent available study of bank supervision in the Group of Ten Countries and Switzerland is Richard Dale's Bank Supervision Around the World, published by the Group of Thirty in late 1982. This study and our own observations show that there is considerable variation in statute, regulation and supervision among the eleven nations. A major variation is the greater reliance outside the United States placed on bank management and accounting firms in the establishment of adequate reserves and the supervision of banks. Since most nations permit their banks to operate with considerable secrecy, the extent of these reserves are unknown. Dr. Dale reported that outside of the United States, no other country has established formal government requirements for disclosure, increased loan reserves, prevention of foreign loan concentrations, or rules for accounting for fee income.

Since the Dale study, we have been informed of one noteworthy change. The Japanese recently issued guidelines for banks to establish provisions for specific overseas loans. The provisions, ranging from 1% to 5%, would be established for loans to government and private borrowers in "problem" countries which are defined as countries which have (1) fallen behind by one month or more in the payment of principal or interest on private commercial bank loans; (2) concluded rescheduling, across the board refinancing or a similar arrangement involving commercial bank loans within the last five years; or (3) have at least one month prior to the end of the bank's fiscal year requested a rescheduling of private commercial bank loans.

DATA AVAILABILITY

Although there are deficiencies in data on the debt structures of borrowing countries, information was available which would have enabled banks to evaluate external debt exposures and country risks. The greater difficulty for the banks was in forecasting record interest rates, a precipitous fall in commodity prices and a prolonged world recession, and the extent to which these factors would impair the debt-servicing capabilities of particular countries.

In general, the FDIC, as part of the Interagency Country Exposure Review Committee ("ICERC"), relies on the same data available to banks when evaluating the transfer risk characteristics of individual countries. The findings of ICERC are then used to determine whether banks have excessive credit exposure in countries that pose greater risk and are able to manage their exposures properly.

The World Bank provides annual data, with recurrent supplements, on public debt of borrowing less developed countries ("LDCs"), including disbursed and undischursed debt outstanding. However, neither the maturity distribution of the public debt, nor the external debt owed specifically to banks is provided by the World Bank. The World Bank does, however, provide quarterly data, by country, on new Eurocurrency syndicated credits and bond issues which include the interest rate, the term, various fees, and the lead and co-manager banks. Private banks and some international banking publications provide similar information.

The Bank for International Settlements ("BIS") is the primary source for data on external debt owed to banks in the major industrialized countries. The amount of external debt owed, by country, is reported quarterly and the maturity distribution of the debt is reported semiannually. Information on the external debt exposure of United States banks is derived from the semiannual Country Exposure Reports submitted to the United States bank regulatory authorities. In the future, it is expected such data will be reported quarterly (see pp. 5 and 6 of the Joint Memorandum).

To place the debt burden of countries in perspective for country risk analysis, information is required on population, national income, unemployment, inflation, domestic monetary and fiscal conditions, trade balance, and capital flows. This information is available, by country, in publications of the International Monetary Fund ("IMF"), United Nations, and International Labour Office (Geneva). Reports on economic, social, and political conditions in individual countries are also available from the United States Commerce Department, some private banks and consulting services, and central banks abroad. Major United States lenders supplement the above information with periodic travel to the countries in question and with information obtained from affiliates overseas.

While the above data are useful to regulators and banks in evaluating international lending opportunities, some problems still exist. First, the data are often available with a lag of six months or longer. Second, there

is no comprehensive data on (1) all private sector debt in each country; (2) debt owed to banks in all countries; (3) net external debt of each country, after subtracting deposits and other claims on borrowers in other countries; and (4) the maturity distribution of all external debt in each country. There is also justifiable concerns over the accuracy of some of the data.

These concerns warrant being addressed. One organization intending to work in this area is the Institute of International Finance. This Institute, which is presently being organized by a group of 35 international banks, will track time-sensitive data on borrowing countries, including exports and imports and changes in loan profiles and in short-term borrowing. It will serve also as a vehicle for the flow of information between borrowers and Institute members. Access to the services of the Institute will permit smaller lenders to make more enlightened lending decisions independent of lead managers of syndicated credits. The Institute was established to help borrowers deal with with the large numbers of banks typically involved in international loans and serve as a focal point for discussions with multilateral institutions and bank supervisory authorities. We hope that this private sector initiative, coupled with the proposals in the Joint Memorandum for strengthening international cooperation, will facilitate a better and more timely international exchange of information among regulatory authorities.

In addition, as covered in the Joint Memorandum (pp. 8-9), a significant contribution could be made by the IMF. The IMF, in working with its members,

is in an unique position to monitor, analyze and publish information on the financial and economic conditions of countries. While we recognize that the IMF must operate with some degree of confidentiality with its member countries, this needed confidentiality will have to be balanced against the requirements of the markets for adequate information if they are to provide the needed funds to the IMF's borrowing members.

THE FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL AND H.R. 2378

Since the establishment of the Federal Financial Institutions Examination Council (the "Council"), the agencies have conducted their international training, the design of the examination reports and issuance of policy statements concerning international banking through the auspices of the Council. Prior to the establishment of the Council, the three federal banking agencies had established the ICERC to both improve the collection and analysis of information of United States banks' country exposure and achieve consistency in evaluations which are the same objectives of the Council. The semiannual reports of United States banks' country exposures are released under the auspices of the Council.

The banking agencies' schools for training examination staff in international banking are conducted under the auspices of the Council as well. Each year the Council, using a curriculum developed by agency staffs and instructors drawn from the same agencies, conduct some eight sessions each of basic and

intermediate level schools in international banking. Examiners from the three federal banking agencies, state banking departments, as well as examiners from other nations attend these schools. Earlier this year, the Council sponsored a two-day seminar on the topic of country exposure that was attended by some 80 examiners and senior staff from the three federal banking agencies and state banking departments. There can be no doubt that under the auspices of the Council there has been increased consistency and improvement in training the examination staffs of the three banking agencies.

Under the International Banking Act of 1978, the three federal banking agencies were given differing responsibilities for the supervision of United States based operations of foreign banks. A uniform examination report for United States based branch and agency offices of foreign banks was designed and released under Council auspices. A uniform call report for these branches and agencies was designed and released under Council auspices. Two uniform policy statements on internal controls for foreign exchange activities in commercial banks and on the supervision of United States branches and agencies of foreign banks were also written and released under Council auspices.

The responsibility for the supervision of United States banks or the United States based activities of foreign banks continues to remain in the hands of the different agencies. It was not the intention of legislation establishing the Council to consolidate the responsibilities of the agencies. Nonetheless, the agencies represented on the Council have the same primary concerns in regards to bank supervision, the safety and soundness of the United States

banking system. The agencies have some differences of opinion on supervisory techniques, but there have never been differences in implementing the examination policies or practices established by the Council.

The FDIC sees no advantages to allocating more responsibility for international regulation, examination and supervision to the Council. Consistency has already been achieved through existing arrangements. H.R. 2378 calls for the Council to establish country exposure limits. As representatives from all three federal banking agencies have testified before, we do not seek the responsibility for establishing across the board country limits. Our reasons are detailed on page 9 of the Joint Memorandum. As we have witnessed during the past two years, the dynamics of an interdependent global economy make it difficult to predict all crises. The only effective way for a bank to protect against uncertainty, in international lending or otherwise, is by diversification and ensuring an adequate cushion to absorb losses so as to maintain confidence in the institution. We have long been proponents of banks maintaining a strong equity position, particularly those larger banks with large commitments in international lending, and feel that approach to be a more appropriate direction in which to move.

The FDIC also does not believe that the Council is the proper forum for making specific judgments on bank supervisory matters, be they domestic or international issues. For one, two of the agencies represented on the Council supervise types of financial institutions with little current international activity. As to the supervision and regulation of country exposure, the three

banking agencies already work closely through the ICERC and it would be counterproductive to reorganize it to fall under the supervision of the Council. Indeed, some of the high level commitment by the banking agencies, in terms of staffing and management support, could be lessened.

As to the regulation of international banking activities, it should be noted that the Federal Reserve Board is responsible for the regulation of all overseas activities of both national and state member banks. The OCC is responsible for supervision of all foreign branches and direct investments in overseas subsidiaries of national banks. These activities could not be assumed by the Council unless a large number of personnel from OCC, the Reserve Banks and at the Board level were transferred to the Council. This would result in a further fractioning of bank supervision and regulation because H.R. 2378 does not envision the transfer of domestic supervision and regulation to the Council.

#### INTERNATIONAL ORGANIZATIONS

##### International Monetary Fund

International organizations such as the IMF have a major role in working with member countries and public and private lenders to assist in the very important task of restoring order to international lending both through lending and

recommendations. Consequently, we support the quota increases proposed as critical to the IMF's function. By working with countries to develop appropriate adjustment programs, the IMF is in a unique position to impose and maintain discipline during the adjustment process. As such the IMF's actions can not only have a positive impact on United States banks with international loans but equally important on the United States and world economies.

#### Bank for International Settlements

The Bank of International Settlements ("BIS") is an organization of central banks and its role as an international lender-of-last-resort during the past year has been an important stabilizing influence and enabled countries to "bridge" to necessary debt restructurings. While the United States is not officially a member, the Federal Reserve has been an active participant in its deliberations.

#### "Basle (Cooke) Committee"

The Basle or "Cooke" Committee was organized in 1975 under the auspices of the BIS to better coordinate bank supervision by the Group of Ten countries and Switzerland. The United States was given three seats, one of which was held by the Federal Reserve Board and two by the Federal Reserve Bank of New York. In 1978 the Comptroller of the Currency was given one of the seats held

by the Federal Reserve Bank of New York. The FDIC has access to the information discussed at the meetings but does not participate in them. This circumstance is not satisfactory from the standpoint of the FDIC, which insures and supervises both foreign and domestic banks involved in international lending, but to date efforts by the FDIC to gain direct access to the Committee have been unsuccessful. The problem appears to be that membership is limited to a maximum of three per country and the three United States seats are occupied.