TESTIMONY OF

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ON

IMPACT OF LDC DEBT SITUATION ON FINANCIAL CONDITION OF THE FDIC

BEFORE THE

House COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

10:00 a.m.
January 5, 1989
Room 2128, Rayburn House Office Building

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Good morning, Mr. Chairman and members of the Committee. I appreciate the opportunity to address the Committee on the impact of the Less Developed Country ("LDC") debt situation on the United States financial system and, in particular, its potential impact on the financial condition of the Federal Deposit Insurance Corporation.

My remarks will focus on three specific areas. First, I will provide some background on the LDC exposure of U.S. banks with emphasis on the nine money-center banks.[1/] Second, I will review briefly the debt-servicing capabilities of the six largest LDC borrowers, the capital adequacy of money-center and regional banks relative to their LDC exposure and the significance of the current LDC debt situation for the insurance fund. And third, I will conclude with a few remarks on the appropriateness of new initiatives to deal with the present LDC situation.

It is the FDIC's conclusion that the LDC debt situation, in and of itself, poses no immediate discernible threat to the FDIC. The FDIC fund is affected only if insured banks fail and at this time failures due to LDC debt do not appear likely.

1/ The nine money-center banks are: Bank of America, Manufacturers Hanover, Continental Illinois, Bankers Trust, J.P. Morgan, First Chicago, Chase Manhattan, Chemical, and Citicorp.

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BACKGROUND

With respect to the exposure of U.S. banks, LDC debt is concentrated in the nine money-center banks. These nine banks had over two-thirds of the total U.S. exposure to all non-G-10 countries as of June 30, 1988 (the latest quarter for which aggregate totals are available).

By way of defining Less Developed Countries for purposes of this discussion, I will use the 31 countries which refinanced their external debt during the preceding five years.[2/] These are the same countries used by Citicorp in May 1987 when announcing its decision to set up a reserve to cover 25 percent of its total LDC exposure.

Since 1982, the nine money-center banks have been successful in building their primary capital to a level which would allow them to withstand any likely event in the LDC arena. As I will illustrate later, while a worst-case scenario would greatly affect these institutions, it would not likely result, in itself, in any financial cost to the FDIC.

In December 1983, these nine banks had aggregate exposures to the 31 LDC countries of $61 billion, an amount nearly twice their aggregate primary capital of $32 billion. As of June 1988, however, these same nine banks had outstanding LDC debts of roughly $55 billion, less than 85 percent

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2/ The 31 refinancing countries are: Argentina, Bolivia, Brazil, Chile, Costa Rica, Dominican Republic, Ecuador, Honduras, Ivory Cost, Jamaica, Liberia, Malagsy, Malawi, Mexico, Morrocco, Mozambique, Nicaraqua, Nigeria, Panama, Peru, Philippines, Poland, Senagal, South Africa, Sudan, Togo, Uruguay, Venezuela, Yugoslavia, Zaire and Zambia.

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of their aggregate primary capital of $65 billion. Clearly, these banks have built up their capital positions to a point where they are much better prepared to meet foreseeable problems with LDC debt servicing. This trend of strenthening capital is expected to continue through earnings retention and other means of capital augmentation.

Over the past year and a half, the smaller regional banks have been aggressively reserving and/or writing off a significant portion of their LDC exposure. It seems fair to say that, for the most part, these banks have put the LDC situation behind them insofar as it affects their future earnings and capital.

VALUE OF THE LDC DEBT

Of the 31 refinancing countries, the six largest borrowers[3/] make up 85 percent ($47 billion) of the $55 billion exposure of the nine money-center banks. We have done studies which attempt to show the differences between the secondary market prices for these six countries and rough estimates of the debt-servicing capacities of these countries. Briefly, these computations assume that one measure of a country's debt-service capacity is a function of its gross export earnings. We derive a value based on the portion of the estimated export earnings that should be available to service its external debt burden. (We have used 25 percent.) These calculations reveal that these six countries' debt-servicing capacities exceed their current secondary market

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3/ The six largest LDC borrowers are: Argentina, Brazil, Chile, Mexico, Philippines, and Venezuela.

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prices. In fact, the weighted average of these values is "72" versus an average secondary market value of "41." This, of course, is merely an historic computation and, thus, not determinative of value; nevertheless, it is a useful calculation for evaluation purposes.

In determining an adequate reserve level, banks should determine whether they plan to dispose of their debt via the secondary market or plan to remain in the business of international lending. If the money-center banks plan to stay in this business, these calculations support the view that the reserve levels of the nine money-center banks, which average 25 percent to 30 percent, are supportable. On the other hand, regional banks which are aggressively disposing of their debt on the secondary market, should reserve at levels which more closely match the secondary market average. Determining appropriate reserve levels is not an exact science and, therefore, additional factors are and will be considered as regulators review bank policies and procedures in this area.

It should be noted that all the money-center banks would continue to be solvent even if they wrote down to current secondary-market levels all their exposures to the six major LDC countries. Moreover, even in what surely could be considered a worst-case scenario, each of the nine money-center banks could write-off 100 percent of their outstanding loans to these six countries and, on an after-tax basis, each of these banks would remain solvent.

We continue to believe that the secondary market prices, due to imperfections in the market (i.e., limited volume, disorganized markets, different transactions arranged at different prices) are not necessarily determinative

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of a country's debt-service capacity. Other factors, such as budgetary practices and economic growth, must be considered.

At this point, a few words of caution may be appropriate. While we believe that the risks posed by the LDC debt may have diminished, they have by no means vanished. Bank earnings suffer from time-to-time because of the periodic inability of LDCs (most recently Argentina, Brazil and, according to current news reports, Venezuela in the near future) to make interest payments. The exposure of the nine money-center banks to LDC debt, while no longer exceeding primary capital, is still too large relative to the banks' capital structures.

There are a number of variables which could affect a country's debt service ability, not the least of which are the changes in the political infrastructures. Other variables, which our calculations do not quantify, are: commodity prices (which make up a large segment of the countries' export earnings) and interest rates (which deplete a large portion of earnings). Any changes in either of these variables could seriously impair the ability of the LDCs to service their debt. In the end, it is the ability to service debt through improved economic performance of the debtor countries that must be achieved to resolve the LDC situation.

DEBT INITIATIVES

We believe the Baker Plan for dealing with LDC debt over the last three years has been very useful in allowing the improvements noted above. We support Vice President Bush's call for taking "a whole new look" at U.S. policy on the

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Third World debt situation and stand ready to help in any way we can. As an insurer of banks, we have a vital interest in the success of any plan adopted to deal with the LDC situation.

CONCLUSION

I will conclude by saying that most of the regional banks have put the LDC situation behind them. While large LDC debt exposure by some major banks will be with us for years to come, at this time we cannot foresee any bank failures resulting from LDC exposure alone. Thus, at this time, the LDC situation poses no discernible threat to the financial condition of the Federal Deposit Insurance Corporation. We would welcome the opportunity to assist the Committee in any way we can in its work on this very important issue.

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