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Statement by

J. Charles Partee

Member, Board of Governors of the Federal Reserve System

before the

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Committee on Banking, Finance, and Urban Affairs

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I am pleased to appear before this Subcommittee to discuss various issues of supervision and regulation of international lending. These issues and the proposed increase in the IMF's financial resources have been discussed by Chairman Volcker in his February 2 testimony before the House Committee on Banking, Finance and Urban Affairs, in testimony by Governor Wallich before the House Subcommittee on International Trade, Investment, and Monetary Policy, and by Chairman Volcker in testimony before the Senate Committee on Banking, Housing and Urban Affairs -- this last, just ten days ago.

I want to reiterate the Federal Reserve Board's support for prompt Congressional action on the IMF legislation. Increased financial resources for the IMF will add to its capacity to assist member countries in pursuing orderly adjustments in their balance-of-payments problems and will buttress the role of the IMF in the international monetary system at a time when that system is being subjected to extraordinary pressures. A strengthened IMF should also be helpful in encouraging countries to avoid adopting restrictive trade policies that would be to the detriment of all trading countries, including the United States.

Increasing the IMF's financial resources, however, will not provide a complete solution to the external financing problems of some major international borrowers. Countries that borrowed excessively in the recent past are now faced with the necessity of adopting to more stringent circumstances. In this adjustment process, some assistance should come from

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the economic recovery in the major industrial nations, which will improve export markets on a world-wide basis. Some help will also flow from the decline in interest rates from their previous high levels.

In addition a resolution to the external financial problems of some major borrowers requires a marked slowing in the pace of borrowings from the international markets from that prevailing up to a year ago; in the case of banks, we would expect that lending to such countries generally will be below the growth of capital and of other earning assets, so that relative exposure to such countries will decline. In the late 1970's bank loans to many countries were increasing on the order of 20-25 percent per year, a rate that clearly was unsustainable. While a slowdown in new bank lending to the heavily indebted countries is now in process, attempts by banks to reduce their aggregate outstanding credit to these countries would be self-defeating and potentially dangerous. Indeed, as with other large borrowers, some further increase in loans, to make possible an orderly adjustment process, can help preserve the value of the existing loans.

While fully recognizing the need for an orderly adjustment process, Congress and the public have raised legitimate concerns about the pace and prudence of international lending by banks in recent years, and these lead directly to issues of bank regulation. After reviewing the recent experience, the federal bank regulators have developed a program for strengthening the supervision and regulation of international lending and, in response to a request from the Senate Banking Committee, have prepared draft legislation to embody the major features of this program.

Before reviewing the proposals of the bank regulators, I think it

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would be useful to discuss briefly the examination and reporting procedures that have been in place over the last few years. This provides a background against which the Committee can consider the regulators' proposals now before them.

As noted by your Chairman, prior to 1977 there were significant differences among the agencies in their approaches toward supervising country exposure. However, beginning in 1977 the banking agencies implemented a number of measures to improve supervisory procedures and to insure basic uniformity of treatment.

In 1977, the three Federal banking agencies began collecting the Country Exposure Lending Survey on a semi-annual basis. This common report allowed the agencies to monitor the exposure of individual banks on a systematic basis. It also insured that the banks themselves had a mechanism for evaluating their own exposure levels. The aggregate information on the amount of lending by U.S. banks to individual countries is published. The information is also provided to the BIS which aggregates similar data from other major countries on the overall indebtedness of various countries to banks in the major developed countries.

In late 1978 the three banking agencies agreed to new uniform procedures for supervising country risk for banks significantly involved in international lending. In this regard I might note that a GAO study last year found that "the system stresses uniformity among examiners and agencies, and there is also much uniformity in practice." The GAO Report did note some areas where greater uniformity might be needed, and our current proposals are in part responsive to these suggestions.

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The examination procedures adopted in 1978 were designed to encourage diversification of loan portfolios, to identify problem credits subjected to transfer risk, to bring to the attention of management comments on country concentrations of loans, and to evaluate the extent to which the banks had satisfactory systems for monitoring country exposure and assessing country conditions.

The new procedures involved the creation of the Interagency Country Exposure Review Committee (ICERC), comprised largely of senior field examiners, to insure the uniform treatment of transfer risk with respect to comments on concentrations of country exposure. ICERC determines when credits warrant classification due to country risk. It also places countries in one of three broad groups in order to determine the level at which a bank's exposure to a particular country is high enough to warrant mandatory comment. ICERC's determinations are followed jointly by all three agencies. In general, the federal bank regulators are satisfied with the mechanisms, including ICERC, that have been established in recent years to provide uniform treatment of banks' international lending. For this reason we are not recommending any change in those arrangements in the new program.

In making determinations about the level of transfer risk in lending to various countries, ICERC has available a considerable amount of information. To provide a starting point for ICERC's analysis of country conditions, comparable quantitative information was developed for about seventy countries. In addition to compiling this information, economists at the Federal Reserve Bank of New York and the Board provide ICERC with current studies covering specific countries --studies that include available

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information from the IMF. ICERC also receives oral briefings from U.S. Treasury staff on conditions in the countries under review. Finally, prior to each meeting examiners visit a number of banks to obtain their views on the countries and the banks' current and future lending plans.

Although the new procedures adopted in 1978, together with the introduction of the Country Exposure Lending Survey, represented improvements in the supervision of country risk, it is clear in retrospect that the system did not have sufficient force or impact on banker attitudes. Indeed, international lending by a growing number of U.S. banks accelerated in the wake of the increased demand for credit following the second round of oil price increases in 1979.

Against this background, we have submitted a proposal designed to address the problems that have emerged in international lending. This package should enhance and strengthen the regulatory structure developed in recent years.

The proposal submitted by the regulators includes five specific elements:

(1) a strengthening of the existing country risk examination and evaluation system,

(2) the establishment of a system of special reserves against exposures to countries which have been unable to service their debts over a protracted of time,

(3) mandating guidelines for spreading fee income over the life of an international credit,

(4) increasing reporting frequency and disclosure of information on banks' country exposures, and

(5) improving international cooperation with foreign banking regulators and through the IMF.

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The changes in the examination system are designed to improve both the way in which the regulatory agencies take transfer risk into account in assessing the condition of a bank, especially in relation to the evaluation of capital adequacy, and the manner in which transfer risk is brought to the attention of the bank's senior management and board of directors.

While present country risk procedures call on examiners to comment on concentrations of transfer risk in the examination report, these comments have not always been adequately impressed on senior bank management or directors. The agencies intend now to highlight large concentrations and to ensure that a bank's board of directors considers fully the risks associated with such exposures, including in-house monitoring of the bank's lending to individual countries.

At the same time procedures will be developed to incorporate the level and concentration of a bank's transfer risk and country exposure into the agencies' own analysis of the condition of a bank. In particular, banks with relatively large concentrations of credit in individual countries will be expected to maintain higher capital ratios than those institutions that are well diversified.

The program will also require that banks establish special reserves against credits to borrowers in countries that have demonstrated protracted debt service problems. This proposal is based on the belief that when a borrower has been unable to service its debts over an extended period of time, whether or not that borrower is a sovereign, it is appropriate to recognize the diminished value of these assets. Such reserves would be

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established through provisions deducted from current earnings and would not be included in capital for regulatory and accounting purposes.

The program would also impose specific standards in accounting for the fee income associated with international lending. To the extent that so-called front-end fees have been taken into income in the quarter or year in which they are charged, rather than spread over the life of the loan, there may have been an incentive to promote international loans in order to boost earnings. The regulators' proposal would reduce this incentive by requiring fees that are not identifiable as reimbursement of direct costs to be taken into income over the expected life of a loan.

The program also requires that country exposure information be reported by banks and published by the agencies in aggregate form quarterly, instead of semi-annually, and that full information on concentrations of country exposure at individual banks be made public. This increased reporting will allow the regulators to monitor exposure levels more closely and provide more information to lenders on the aggregate bank indebtedness of individual countries. The increased disclosures will improve information to investors and depositors and should enhance the prospects of market discipline.

The final point in the program prepared by the agencies concerns coordination and cooperation with foreign bank regulators and through the International Monetary Fund. Problems in international lending affect all participants in the world banking system and their resolution requires a common effort. It is for this reason, and also to help avoid competitive inequities, that the agencies propose to make every effort to strengthen

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relations with foreign bank regulators.

Those relationships have materially improved in recent years, notably through participation in the work of the Committee on Banking Regulations and Supervisory Practices at the Bank for International Settlements. Indeed, the Federal Reserve Board was instrumental in founding that Committee in 1975 and has been active in its work ever since. The Office of the Comptroller of the Currency now also is a participant.

The Committee, which is sometimes known as the Basle Committee because it meets in Basle or as the Cooke Committee, after its present chairman, has as its objectives the establishment and maintenance of close working relationships among national bank regulators to facilitate resolution of common problems and the achievement of greater coordination of approaches to bank supervision. The Cooke Committee is concerned with bank supervisory matters; it is not concerned with lender-of-last-resort responsibilities. It is a consultative body; it is not empowered to enter into agreements among its members. However, it does seek to establish general principles to which bank supervisors around the globe may subscribe.

International cooperative efforts are by their very nature difficult and time consuming. While the Cooke Committee has been successful in reaching agreement in principle on a number of matters dealing with good practices in international banking, implementation is effected at the national level. Thus, while the U.S. banking agencies are determined to strengthen cooperation with foreign bank regulators, that process will necessarily be a continuing effort, with results becoming apparent only over time.

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National bank regulatory systems differ substantially from one country to another, and what is sought is not international uniformity but rather a convergence of supervisory approaches. For instance, very few countries in the world have bank examinations at the center of the supervisory process as we do. Thus, the part of our program dealing with improved examination techniques in relation to international lending has few parallels abroad. In these circumstances, we will be consulting with foreign regulatory agencies, through the Cooke Committee and otherwise, on ways of achieving a common goal of limiting excessive exposures. Similarly, we have a formal rating system in this country for assessing capital adequacy and appraising asset quality. Other countries have quite different sytems. As part of our program, we intend to develop procedures through which country exposures can be factored systematically into our evaluation of capital. Internationally, there is agreement in principle that capital standards should not be allowed to erode further. And some countries, for example, the Netherlands, have already begun to include elements of country risk in their capital assessment systems.

The subject of reserves or loan loss provisions on country lending has been discussed within the Cooke Committee over an extended period. From a strictly technical point of view, the subject is a difficult one. Provisioning policies in most of the countries represented on the Committee are still largely determined by, and are the responsibility of, the banks themselves. As a consequence, there is a good deal of variation in the country credits against which provisions have been made and in the proportions of credits reserved. At the same time, there is a growing

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practice for the banking authorities of the various countries to hold consultations with the banks about appropriate provisioning. In this connection, I hope that the reserve proposal we have made will provide impetus to achieving greater progress in this area of supervision.

On disclosure, which is an important element of our program, I do not expect much near-term progress on the international front. Other countries do not have the same approach to disclosure about the affairs of individual banks that we do as a matter of national policy. Again, the U.S. example will certainly help in efforts to hasten the day when other countries also call for fuller disclosures.

One can be more optimistic about improved reporting requirements on aggregate international lending by national banking systems. An important function of the BIS in recent years has been to collect and publish data on international banking activity. (The Appendix to my statement describes the role of the BIS in gathering and disseminating international lending data.) These data are accompanied by a fairly detailed commentary (copies of which have been provided for the Committee's records), and are made available to all commercial banks from whom data are collected.

Because of the complexity of the system, the BIS semi-annual series often has not been available until about 6 months after the report date, though efforts are now underway to accelerate that process. Various efforts are also underway to improve the coverage of the BIS data, including converting the semi-annual series to a consolidated basis, and expanding the coverage of banks in the quarterly series. In addition, the IMF, in

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consultation with the BIS, is preparing to collect international banking data from countries not currently covered by the BIS data, which should help to improve the overall banking data.

Questions have been raised concerning the lag in availability of international banking statistics. While reporting has not been as timely or complete as might have been desirable, I want to emphasize that data were readily available from existing sources pointing up the growing external bank debt of major countries. For example, BIS data available in mid-1981 indicated that in the 18 months to December 1980 total bank claims on Mexico had increased about two-thirds, and short-term bank claims had more than doubled. Therefore, while statistical reporting systems can and should be improved, it seems equally clear that there is room for lenders and regulators to make better use of existing information.

The IMF, of course, plays a central role in the international financial system, and strengthening the role of the IMF is an important aspect of the regulators' proposal. In particular, we believe that the IMF's surveillance process can be improved by encouraging it to monitor more closely the external indebtedness of member countries, and to report to its Executive Board when such indebtedness appears to be growing excessively relative to debt service capacity. In developing stabilization programs the IMF should be encouraged to place limits on short-term external public sector borrowing when appropriate. The IMF also needs to consider whether it can provide more data and analysis to the international banking community without jeopardizing its access to confidential information from its members.

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A stronger surveillance role for the IMF, as well as the proposed increase in Fund resources to provide credit to countries adopting appropriate adjustment programs, will help contribute to the safety and soundness of the international financial system. It is in this context that the regulators have included the IMF provision in their program and why we all support the IMF legislation before you.

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APPENDIX

The Role of the BIS in Gathering and Disseminating International Lending Data

The Bank for International Settlements (BIS) in Basle, Switzerland has collected various kinds of international banking data from the G-10 countries[1/] and Switzerland for 20 years. Since end-1975 the BIS has collected, and disseminated publicly, comprehensive data showing the external claims and liabilities of banks in the reporting countries vis-a-vis all countries of the world. Since 1977 the list of reporting countries has been expanded to include Austria, Denmark, and Ireland as well as the G-10 countries and Switzerland. The reporting banks also include branches of U.S. banks in major offshore banking centers.[2/] Branches of non-U.S. banks in offshore banking centers are included as reporters in some BIS international banking series but not in others. (The submissions to the BIS of the individual countries are not published.)

There are two principal BIS series on international bank lending, one of which is of quarterly frequency and the other semiannual. There are a number of important differences between them regarding both the institutions covered and the type of information collected. Descriptions of the two series, and of the data supplied by the United States, are found below.

I. Quarterly series

A. Beginning date: December 1975

B. Reporting banks: banks in G-10 countries, Switzerland, Austria, Denmark, and Ireland, and U.S. bank branches in the Bahamas, Cayman Islands, Panama, Hong Kong, and Singapore.

1/ Belgium-Luxembourg, France, Germany, Italy, Netherlands, Sweden, the United Kingdom, Canada, Japan, and the United States.
2/ Bahamas, Cayman Islands, Panama, Hong Kong, and Singapore.

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C. Detail collected: external assets (and liabilities) vis-a-vis each country of the world. The aggregate data are also grouped, by the BIS, into various categories of countries of customer.[3/]

D. Currency: all data are expressed in U.S. dollars at current exchange rates. (Thus, the levels are affected by changes in dollar exchange rates.) The BIS also publishes supplementary data showing some breakdowns of the banks' assets and liabilities by currency and type of customer, but these data are shown only for the banks' worldwide operations and not for their positions with the individual countries.

E. Lag in data: the report appears about 3-1/2 months after the end of the quarter.

F. U.S. input: based on Treasury data for banks in the United States (with data for U.S. agencies and branches of foreign banks included) and on Federal Reserve data for U.S. bank branches in offshore centers. Data for U.S. bank branches in other reporting countries are supplied to the BIS directly by the host central banks.

II. Semiannual series

A. Beginning date: December 1977.

B. Reporting banks: banks reporting on the quarterly report plus (1) branches and subsidiaries of U.S. banks outside the usual BIS reporting area,[4/] since U.S. banks report on a consolidated basis, and (2) most branches and subsidiaries of non-U.S. banks in offshore banking centers.

3/ Reporting countries; developed countries outside the reporting area; non-OPEC developing countries; OPEC countries, Eastern Europe; offshore banking centers.

4/ The more important branches in this category are in Argentina, Brazil, Chile, Greece, Spain, Bahrain, Egypt, United Arab Emirates, Korea, the Philippines, and Taiwan.

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C. Detail collected: total assets and liabilities vis-a-vis each country of the world (other than the reporting countries themselves), plus (for the assets) a breakdown into three categories of remaining maturities (up to one year, one to two years, over two years) and a breakdown by type of customer (bank, nonbank public borrower, nonbank private borrower). In addition, the report also shows undisbursed credit commitments.

D. Currency: all data are in U.S. dollars at current exchange rates.

E. Lag in data: about six months after the end of the half year.

F. U.S. input: the asset data are based on the Country Exposure Lending Survey, with some adjustments to fit into the BIS format, for U.S.-chartered banks, and a special Federal Reserve report for U.S. agencies and branches of foreign banks. Since U.S. banks file the Country Exposure Lending Survey on a worldwide consolidated basis, steps must be taken to prevent doublecounting of assets of U.S. bank branches and majority-owned subsidiaries in other reporting countries. The U.S. banks' liabilities data are the same as those supplied for the BIS quarterly report.

G. Shift to consolidated reporting by other countries: The BIS has requested that all the reporting countries submit data for the semiannual report on a worldwide consolidated basis. Countries other than the United States (which already reports on this basis) will shift over to the consolidated basis for the report as of December 1983 or as soon thereafter as possible. Steps will be taken to avoid doublecounting or omissions during the transition period from a geographical to a consolidated basis.

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