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INTERNATIONAL BANKING -- FIVE YEARS AFTER HERSTATT

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

57th Annual Convention of the
Bankers' Association for Foreign Trade

Boca Raton, Florida

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I appreciate the invitation to address the Bankers' Association for Foreign Trade at your 57th Annual Convention and to have this opportunity to offer some observations on the passing scene under the broad umbrella topic, "International Banking -- Five Years After Herstatt." My title is not intended to throw out ominous hints or warnings. It just so happens that this is the fifth year since the Herstatt crisis, which occurred on June 26, 1974.

Foreign Exchange Risks Under Better Control

The Herstatt affair was brought on by high-risk foreign exchange operations. It made clear that exchange-rate speculation, which under the dying fixed-rate regime offered fairly safe bets, had become very risky under the regime of floating rates. This perception apparently required some time to take hold. The incident revealed weaknesses in international banking practices which, I believe, have since been largely corrected.

The foreign exchange side of the international business today does not seem to present major risks for the banking system provided banks remain watchful and adhere to proven principles. The exchange positions carried by an individual bank will, of course, always imply a risk. The improved climate for banks has come about not because of any improvement in the stability of the pattern of exchange rates. On the contrary, during the last year or two, fluctuations have become wider. But banks appear to have heeded the lessons of experience and to have learned to navigate safely in treacherous waters. Deviations from sound practice among American banks can be expected to be caught by U.S. bank supervisory procedures. At the same time, continued alertness and adherence to practices recognized as sound on the part of the banks themselves is an essential condition of continued public confidence.

Change in Country Risk

Another potential risk today confronts the international banking business -- that of international lending. In contrast to what has happened in the foreign exchange area, no bank of which I know has suffered the fate of Herstatt because of mistakes made in this field.

In fact, the loss experience in the international field, at least of American banks, has been substantially better than their experience domestically. Nor has any country since the events of Cuba failed to meet its obligations in a way making ultimate recovery unlikely. But none of this means that the special risks in foreign lending have somehow vanished. But great efforts have been made by banks and bank supervisors to analyze correctly the so-called country, i.e., non-commercial, risk element of foreign lending, and these seem to have borne some fruit.

For a time, following the rise in oil prices and the development of a huge OPEC surplus, there was considerable concern about the ability of countries borrowing to cover their payments deficits to meet their financial obligations. These concerns have diminished with respect to the great majority of borrowers. The financial condition of many borrowers, measured by a variety of tests, has improved. But this improvement, particularly in the light of the latest OPEC oil price increases, may not be lasting.

Highly sophisticated techniques have been employed to evaluate country risk, from an economic and political point of view. They all come up against the elementary fact that the future is hard to predict. After all is said and done, therefore, the course of wisdom still calls for strong emphasis on diversification. That has been the principle relied upon by bank supervisors and embodied in their newly instituted examination approach for international lending. At the same time it is possible to arrive at some generalizations and describe broad trends affecting borrowing countries on average by examining a few figures that broadly reflect improvement or deterioration in the ability to service debt. I have put together a few such figures in a table appended to my text and will give you here the very general impressions emerging from these data as they are indicative of country risk.

Numerous measures of country risk have been suggested singly or as part of a sophisticated system containing many indicators. None taken by itself is an infallible barometer of risk. All that can be argued is that a closer look should be taken at countries that are ranked high on the scale of risk provided by one or more of these measures.

One group of indicators that I have examined comprises measures of the current account deficit, interest payments, and debt service in relation to exports and reserves. The data cover groups of forty to seventy countries but do not yet include the year 1978. The overall impression is that from the 1974-75 recession through 1977 there was improvement in some respects and no major deterioration in any. However, the statistical dispersion among countries has tended to widen over a longer period, which seems to indicate that some countries need to be watched more closely. Moreover, there has been a clear rising trend in one indicator -- the ratio of interest payments to exports. This seemingly greater vulnerability needs to be evaluated in the light of the fact, however, that the share of interest payments in total debt service rose through 1976.

For the longer period 1970-77, all indicators show -- for the average of all countries covered -- significant deterioration. Since these years include the period antedating the oil price rise that observation should not be surprising. It nevertheless cannot be ignored altogether.

In addition to examining financial ratios, it is important also to look at certain basic economic factors, especially the rate of real growth and the proportion of income that is devoted to productive investment. For a group of ten prominent LDC borrowers that I have examined, it is reassuring to note that growth has accelerated on average during the period 1975-78, while for the years since 1970-78 it has at any rate not slowed. The share of available resources devoted to investment rather than consumption has increased fairly sharply since 1975 and has clearly trended up also since 1970. Some individual countries in the group, naturally, have had different experience.

Growth and high investment are essential, of course, if a country is to be able to meet its international obligations. High investment gives some evidence that a country is borrowing not merely to maintain a high rate of consumption. There is some question, however, whether merely to maintain a high rate of investment is enough. If that rate is no higher than it was before the country began to borrow abroad heavily, the incremental resources becoming available to it do not seem clearly to have made a contribution to investment and growth. Obviously, this way of looking at the development of an economy does not imply that all borrowing must lead to the importation of capital goods. It does presuppose, however, that investment and growth are oriented in directions that will improve the balance of payments, so that higher exports or lower imports will leave room for enlarged debt service.

The overall impression gained from the data is that many countries have made progress in consolidating their positions and that countries, on average, have not lost ground, with notable individual exceptions. In looking at countries and bank loans that have gotten into trouble, one reassuring sign is that there seem to have been no "domino effects." No country seems to have slowed its payments because some other country perhaps similarly situated did. Neither have borrowers been abandoned by their bankers because bankers had adverse experience with some other country. The absence of domino effects is important because the principle of diversification derives part of its usefulness from the expectation that there will be no such effects. Diversification would lose some of its protective power if domino effects were to become frequent.

Limitations of Country Risk Analysis

Some other aspects of recent experience, on the other hand, are more nearly on the sobering side. First, it has become evident that country analysis data such as the foregoing are far from being reliable predictors of difficulties ahead. In the case, for instance, of Iran and Nicaragua, the foregoing tests did not flash signals of trouble ahead. Test data for Iran compare very favorably with the respective medians of the test ratios; those for Nicaragua compare favorably with some and not significantly unfavorably with other test ratios. It was the political factor that brought about the financial uncertainties now prevailing.

Second, the availability of the data required for the foregoing tests is as yet incomplete. The Manual on Statistics Compiled by International Organisations on Countries' External Indebtedness, issued by the Bank for International Settlements, the so-called "Burns' Report," indicates that different groups of countries are lacking data of numerous kinds relating to foreign debt. Short-term debt is least well captured almost everywhere. Private medium- and long-term debt is available for many but not all LDC's, and only inadequately for long-term debt of developed countries. Systematic information on East Bloc countries is largely lacking. As a result, such familiar relations as the debt service ratio can be computed only for a much smaller sample of countries than some of the other ratios. It is one of the virtues of the BIS Burns' Report to make clear how far we are still removed from a comprehensive coverage of borrowing countries' statistics.

Third, a factor that could give rise to some concern is that the well-trodden path to the IMF seems to have provided somewhat less smooth going of late than in former years. For years, it has been an important factor in international debt management that countries in difficulties have not defaulted or walked away from their debts. They have made the trip to the IMF, in a rational effort to protect their long-term credit standing, and have arrived at a rescheduling or refinancing of their debts where necessary. This has conveyed a reassuring sense of a fail-safe procedure being in place.

The IMF has continued to perform its important function in this regard. But some recent cases of troubled countries have been permitted to progress to a more severe stage and have proven more resistant to the traditional financial medicine than in the past. It is not a compliment to the credit judgment of commercial banks that some countries should have been afforded the means to get into debt so deeply that they are having such great difficulty extricating themselves.

Fourth, recent experience also raises certain questions concerning some of the conventional wisdom of country analysis. It has been a truism that country credit is strengthened by the fact that a country, unlike a corporate borrower, cannot disappear, leaving behind uncollectible debts. A corporation can go out of business. But the principal cause of such an event is precisely that the firm could not pay its debts. Confronted with the choice of pay or die, a corporation will ordinarily do its utmost to pay and survive. A country does not confront that pay-or-die alternative. Accordingly, while its ability to pay may be greater than that of a corporation, its motivation is not necessarily so.

Fifth, in examining risk factors, we must consider also the floating interest rate factor, i.e., the movement of the London Interbank Borrowing Rate (LIBOR), upon which Euro-loans are based. A few years ago, six months LIBOR was in the 5-1/2 - 6-1/2 per cent range for dollar loans. It has been trending upward since early 1977. For dollar loans, it rose sharply in 1978, to a peak level of 12.5 per cent. Since then, it has come down moderately, to the 11-11.5 per cent range. Obviously, LIBOR is important for the ability of borrowers to carry their debt. Assumptions as to the future level of LIBOR are important also in country analysis and in computing various sorts of debt service ratios.

<u>The Lender's Side</u>

So far I have examined the evolution of debt relationships from the side of the debtor, i.e., the borrowing country. I now turn to the side of the banks engaged in foreign lending. Here some divergent trends deserve to be noted. Total international lending by all banks of the G-10 countries, together with Austria, Denmark and Ireland, has proceeded at a mounting pace. Outstanding loans rose by $110 billion or 20 per cent in 1977 and at an annual rate of $150 billion or 23 per cent in the first three quarters of 1978. American banks, however, slowed down their lending, noticeably increasing their overall international loans by only $32 billion (15 per cent) in 1977 and $36 billion (also 15 per cent) in 1978. The years 1977 and 1978 also saw a shift of lending away from developing countries and toward developed countries, as developing countries reduced their payments imbalances. Outstanding loans to developing countries by all banks amounted to $161 billion in September 1978, including loans to OPEC developing countries. American banks' loans to LDC's were $70 billion.

In the course of this expansion, the Euro-bank lending market has clearly become a borrower's market. Spreads have diminished, maturities have lengthened. This is a development that needs to be watched carefully. With spreads of 5/8 or even 1/2, a bank cannot earn enough to cover the cost of the additional capital that should support an incremental loan, except perhaps if the ratio of capital to total assets was very thin to begin with. Nor can such a spread make an adequate contribution to covering risk and expenses.

This inadequacy of earnings on Euro-loans is made more serious by the fact that the spread is too small to contain anything like an adequate offset to the erosion of capital that results from inflation. The equity of the average American bank is protected by hard, i.e., non-monetary, assets only to the extent of about one-quarter in terms of book value. These non-monetary assets can be thought of as providing some protection against inflation. They are, in any event, less exposed to inflation than are the bank's monetary assets which cover, after deducting liabilities, the remaining three-quarters of the average bank's equity. This concept of bank capital's exposure to inflation leads to an analysis of the impact of inflation on bank earnings which, however, tentative, has a clear bearing on spreads in the Euro-markets.

First, I note that, with only about one-quarter of bank equity matched by "hard" assets, three-quarters of the capital of the average American bank is exposed to erosion by inflation. Earnings of banks will be inadequate to protect the real value of capital unless this erosion is taken into account in the pricing of bank loans. Evidence of this can be seen in the fact that the market place does not consider the earnings of many American banks sufficient to maintain their market value at the level of book value. For banks, whose assets are almost entirely monetary, book value is more meaningful than for an industrial firm whose assets are largely non-monetary and derive their value mainly from their earning power. The market's judgment concerning the adequacy of bank earnings is reflected also in the very low price/earnings ratios, ranging from about 5 to about 7 for leading banks, at which the market evaluates those earnings. Under these conditions, it is understandable that banks feel under considerable pressure to increase their earnings by taking on additional Euro-loans. But these additional loans require additional capital to avoid raising the leverage and increasing overall risk. If the additional loans do not earn enough to support such additional capital, the banks will, in effect, have allowed capital/asset ratios to deteriorate. They will have diluted their capital and the protection it gives to depositors and to the banks' ability to raise money.

Regulatory Concerns

I would now like to turn to some regulatory concerns arising from the heavy volume of foreign lending by American banks. As you are undoubtedly aware, some actions have been taken recently to improve regulatory capability in this area. The Comptroller of the Currency and the Federal Reserve have instituted a new examination approach which focuses upon concentration of risk in particular countries measured against a bank's capital. The Comptroller has also finalized his regulation concerning the aggregation of loans to governments and their agencies under the limit that restricts loans to a single borrower to ten per cent of capital. The regulators' evaluation of banks' commitments has taken place, of course, within the context of worldwide consolidated balance sheets, as has long been the U.S. regulatory practice. Such consolidation is not necessarily practiced by the banks and regulatory authorities of all other countries. Thanks to cooperation among bank regulators, consolidation of banks with their subsidiaries and, to some extent, joint ventures is becoming increasingly a regulatory objective in other countries.

Regulators, like bankers, must bear in mind that there is a difference between ordinary credit risk and country risk. That difference is well known and recognized. It has some aspects, however, that are not always given their due weight. For instance, it should be remembered that the soundness of foreign loans may depend on business cycle conditions in foreign countries which are influenced by the local government's fiscal and monetary policies, which policies may be adopted without much concern for the welfare of foreign bank lenders. Domestically, the condition of debtors and, therefore, the condition of banks is in some degree a result of the overall economic policies followed by government. In countries where the central bank is also a bank regulator, as in the United States and in many other countries, this nexus is particularly obvious. It implies that action in the field of macro-economic policy will be taken with recognition of its possible impact on debtors and on banks. In the international sphere, this is not possible. The condition of foreign debtors depends largely on conditions in the foreign country. These are influenced by the policies of local authorities and, of course, by international conditions, but only remotely by economic conditions and policies in the home country of the lending bank. This is an aspect of country risk that is not always clearly perceived. Of course, it does not affect the general role of lenders of last resort and the understanding concerning that role put in place by the central bank governors at the BIS in September 1974.

Finally, bank regulators must take into account particularly the existence and behavior of the Euro-markets. These markets have been expanding more rapidly than home markets, in good part because they enjoy lower costs in terms of absence of reserve requirements, insurance premia, and economies of scale. They are not, of course, as is sometimes believed, "out of control." In a prudential sense, they are under the responsibility of both local authorities and the supervisors of the head office. In a sense of monetary control, the volume of credit creation in the Euro-market tends to be limited by the level of interest rates given the demand for loans. That level of interest rates depends, broadly speaking, on the level of interest rates in the home country of each currency, making allowance for differences in costs such as reserve requirements. Nevertheless, the tendency of the Euro-markets to grow faster than domestic markets, owing principally to the difference in costs, poses a problem for central banks concerned with limiting the overall volume of money and credit in their currencies. This concern remains whether the creation of money and credit occurs in branches and subsidiaries of U.S. banks or in foreign banks.

In closing, let me express my view that progress has been made in many phases of the international banking business and its prudential regulation. More remains to be done. I believe also that American banks have been wise to slow their international lending. This type of lending has been beneficial to the world economy, and the world's banks can look with satisfaction on their contribution in this area and on the creativeness in new forms of financing which has been displayed. But it is an area of potentially high risks that banks and supervisors will have to observe with caution.

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Quartile Values for Country Risk Indicators 1/

	1970	1971	1972	1973	1974	1975	1976	1977
I. Current Account Deficit/Exports:								
1st Quartile	-18.0	-24.6	-14.4	-16.9	-27.7	-35.7	-26.9	-22.9
Median	-6.7	-11.1	-4.5	-4.3	-13.7	-19.5	-9.4	-11.8
3rd Quartile	2.2	1.8	3.5	5.2	-2.7	-4.4	3.2	1.9
II. Cumulative Deficit/ Exports: 2/								
1st Quartile	-61.2	-55.8	-50.8	-54.2	-53.6	-76.7	-86.0	-83.7
Median	-19.4	-22.8	-22.2	-16.7	-20.3	-36.6	-29.5	-34.8
3rd Quartile	7.8	8.4	5.3	6.0	-.7	-12.9	-10.7	4.9
III. Interest/Exports:								
1st Quartile	-4.9	-5.1	-5.3	-5.6	-6.0	-5.9	-6.3	-7.0
Median	-2.3	-2.0	-2.8	-3.3	-2.5	-2.9	-3.2	-3.5
3rd Quartile	.6	-.1	-.3	0	.8	-.5	-.7	-.7
IV. Interest/Reserves:								
1st Quartile	-20.2	-16.9	-18.4	-23.0	-22.6	-34.9	-29.1	-33.4
Median	-7.9	-8.2	-7.7	-5.5	-4.7	-14.0	-12.4	-12.6
3rd Quartile	2.1	-.1	-.9	-.1	1.7	-2.6	-1.8	-1.5
V. Debt Service/Exports:								
1st Quartile	14.3	16.2	17.9	16.5	14.8	16.3	12.3	15.0
Median	9.0	10.2	10.3	10.3	9.7	9.3	9.1	10.3 e/
3rd Quartile	4.7	5.8	6.3	5.6	4.8	5.6	5.0	6.5 e/

e/ Estimated.

1/ Quartile values mark the boundaries between the intervals containing one quarter of the countries ranked in order by the value of the indicator. These values were calculated for a list of up to 70 developed, developing, and Eastern Bloc countries, depending on data availability.

2/ Cumulative deficits of three years ending in year indicated.