

**FOR RELEASE ON DELIVERY  
TUESDAY, MARCH 11, 1980  
11:10 A.M. LONDON TIME (6:10 A.M. EST)**

**AMERICAN BANKS ABROAD IN 1985**

**Remarks by**

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

**at the**

**Banking Forum**

**sponsored by the**

**Government Research Corporation**

**London, England**

**March 11, 1980**

## SUMMARY

1. The new deficits resulting from high oil prices will be less easy to finance than their predecessors.
2. Some deficit countries may have to adjust their payments deficits sooner and more substantially than in the past.
3. This may mean that some of the deficits resulting from the OPEC surplus will shift in greater degree to the developed countries.
4. Commercial banks will continue to play a major role in the financing process.
5. Banks might act as arrangers and brokers of loans to avoid excessive risk exposure, if means can be found to make such arrangements attractive to OPEC lenders.

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I am glad to have this opportunity to address this banking forum dealing with U.S. banking in 1985 on the topic assigned to me, "American Banks Abroad in 1985." The topic presents a temptation. When the immediate outlook is obscure, it is often easy for the speaker to raise his eyes to the hills beyond and to engage in speculations and forecasts that are not likely to catch up with him for some years. But our first job is to get to 1985. I shall, therefore, devote most of my remarks to more immediate concerns.

The New Deficits

The setting of our problem is familiar. A very large new OPEC surplus and corresponding deficit for the oil-importing countries has come into existence. This surplus is not likely to shrink as quickly as did its predecessor of 1974 vintage, owing to the more limited

prospective absorption by the OPEC. The ability of many developing countries to increase their debt at the same rapid rate as in the past is in doubt, because of the mounting burden of existing debt. So is the ability of the commercial banks to expand their LDC lending as fast as in the past, because of the levels of exposure already reached.

Let me make clear immediately what these premises do not mean. They do not mean that OPEC countries cannot find investment outlets for their surpluses. They do not mean that developing countries' deficits cannot be financed. They do not mean that a massive governmental effort must be launched. They do mean that we need to take a close look at some of the parameters of the situation in order to instrument an approach.

To begin with, it is not altogether true that the OPEC surplus is in some sense immutable. It depends in good part on the action of the importing countries in conserving energy, developing substitutes for imported oil, and moderating their rate of growth. Given the prevalence of inflation around the world, the need to avoid excessive expansion for this reason coincides with the need to slow down oil imports.

Given, however, an OPEC surplus of very considerable size for several years, there remains open the question which countries are to have the corresponding deficits. This depends, of course, on the preferences among oil-importing countries as between balance-of-payments adjustment and balance-of-payments deficit financing, and on the ability to finance desired deficits. If the erstwhile heavy borrowers have to slow down their borrowing somewhat, it seems likely that a correspondingly larger part of the worldwide deficit will land with the developed countries. The

mechanism that would bring this about is the slower growth of developing countries' economies and therefore of their imports. This would slow down the exports of the developed countries and, other things equal, shift the OPEC-induced deficit in their direction. Of course, there may be other factors causing deficits to shift around including anti-inflation policies on the part of developed countries.

I am aware, of course, that slower growth of the developing countries has implications for their ability to carry past as well as prospective debt. Debt is relatively easy to carry so long as the rate of growth of the debtor's income exceeds the rate of interest he has to pay. Given that bankers tend to measure debt capacity in good part by the borrower's income, it becomes possible, under these conditions, to borrow continuously in order to pay the interest on previous borrowings. But borrowing to pay interest is not a good practice, even if it does not raise in the borrower's mind the question why he is doing this. The purpose of borrowing should be, of course, to increase investment and growth. But for that very reason borrowing, that may have as its main purpose the payment of oil bills, must be kept very firmly under control.

In this context I would like to remind you that even if a loan is made for the specific purpose of financing some particular investment project, that may not be its true economic effect. A high-priority investment project is likely to find financing from one source or another, if not from international borrowing, then from the country's own resources. What a foreign loan finances, in an economic sense, is the borrower's marginal outlay, which may be a much lower priority investment project or quite simply consumption imports.

Developed countries, with their generally stronger economies, will find it easier to borrow in order to finance deficits. For some of them, deliberate borrowing will be unnecessary because capital inflows from OPEC will meet their needs. With close to \$100 billion to be placed in 1980 and amounts perhaps not much smaller for some subsequent years, many countries will experience substantial capital inflows from OPEC through one channel or another.

#### The Role of Banks

This brings me to the role of the banks in this process. The ability of banks, especially American banks, to absorb additional country risk, relative to capital, may be diminishing. This does not mean, however, that they could not accept substantial additional OPEC deposits or make LDC loans in significant volume. The banks could afford to increase their balance sheet totals particularly if they place a part of the additional funds in a very high grade of assets, such as their home government's short-term securities. This, of course, would limit the interest rates they could pay on their liabilities. In turn, that might make OPEC less inclined to place funds with such banks. OPEC might decide instead to buy those high-grade securities directly, as indeed is happening to some extent today. It is sometimes argued that if OPEC does not get an adequate rate of return, it might simply cut back the production of oil, and I shall revert to that matter later. Here I just want to note that a reduction in the supply of oil would in all probability increase rather than reduce OPEC's total receipts, so that the investment problem would not go away while great

economic damage might result to OPEC investments. The way to reduce oil receipts, which OPEC is not likely to choose, is to increase oil production and drive down the price.

Purchase by OPEC of high-grade primary securities would in some degree solve OPEC's investment problem. It would not solve the recycling problem. The second leg -- moving the money out to where it is needed -- would remain to be solved. Frequently, it is suggested that a larger input from official financing will be needed to deal with this aspect. In this connection, it is worth noting that the International Monetary Fund today has substantial liquidity.

As far as the banks are concerned, I would like to draw your attention to the fact that, in the field of international risk taking, we seem to be going through a very significant phase in the process that governs the acceptance of risk. There can never be long-lasting stability in the evaluation of risk. So long as no major losses occur, lenders are likely to conclude that their earlier evaluation of risks has been too high. Greater risks will then be incurred and smaller risk premia will be charged, as we observed during the second half of the 1970's. Stability in the credit markets necessarily breeds instability. The process of acceptance of higher risks continues until there is a shock to lender confidence. We have now experienced such something of a shock. I agree with those many observers who see this leading back to more cautious lending policies, including shorter maturities, higher spreads, and greater differentiation among borrowers.

As banks reevaluate their lending policies, I would draw your attention also to the role that the high level of LIBOR (London Inter-Bank Offer Rate) has played in influencing spreads. The allowance for the cost of capital that the spread must cover if an additional loan is not to reduce the bank's capital ratio, diminishes as LIBOR rises. A higher part of the cost of capital is covered by the loan -- in addition to paying for the cost of the money -- when LIBOR is high relative to the cost of capital. One could regard this as a partial explanation of why spreads fell as LIBOR rose, although other factors no doubt predominated. These spreads will be increasingly inadequate, however, when and if LIBOR declines.

Given the lengthening of maturities that had occurred before the recent change in the perception of risk, many loans are outstanding that will be tested in a variety of ways during their lifetime. Movements in LIBOR are likely to be only one such dimension. Granted that even the longest syndicated bank loans are of substantially shorter maturity than the lifetime of most investment projects and in that sense therefore sub-optimal, borrowers have had to recognize that that is the nature of commercial bank loans.

Substantial changes in economic conditions, perhaps a serious depression, cannot be ruled out over a period of 10 or more years. Political changes, and changes in the quality of economic management in some of the borrowing countries, must also be reckoned with. That is why historic debt standards and ratios retain their value even if in the case of particular countries, at particular times, bankers see reasons for going beyond them. And, given the unforeseeable character even of many short-run



events, let alone those occurring over 10 years, diversification remains the cornerstone of risk management.

For that reason, I would be concerned, for instance, if recent events in the market should lead toward greater specialization by banks of different nationalities in loans to particular groups of countries. Risk diversification would suffer in consequence, and concentration would arise. This is applicable particularly to American banks, for whom supervisory analysis of country-risk concentration is one of the key features of the examination process. As I noted on a previous occasion, for loans to many developing countries, exposures in excess of 15 percent of capital even to most of the financially stronger borrowers receive special comment in the examination reports. The largest LDC borrowers would be subject to such comment in a number of U.S. banks. Comment does not necessarily imply that there is an inherent credit weakness, but it is made to alert management to exposure levels. While banks are not prevented in any way from making loans to LDCs in excess of the comment level, a decision to raise exposure significantly is properly one to be taken in full awareness of the facts by senior management. Qualitative differences in exposure, as inherent for instance in the difference between short-term, trade-related credits, and long-term, syndicated loans, are important.

### Bank Capital

Banks can put themselves in a better situation to accept additional country risk if they can increase their capital more or less proportionately. For American banks, however, new issues of stock are very difficult at this time because stocks of large banks are selling at price-earnings ratios of

4-6 and in a number of cases below book value. The market is putting this low valuation on bank stocks, in the face of rising and historically very high nominal earnings, I believe, not because it sees great risks ahead, or because of its evaluation of bank management. It does so, in my opinion, because bank capital is being eroded by inflation. Under inflation-adjusted accounting methods, this erosion must be deducted from bank's rate of return, with proper allowance for any nonmonetary assets the bank may own, to arrive at an inflation-adjusted return. The Financial Accounting Standards Board is now requiring American banks to present a supplementary statement in their annual reports showing the loss from inflation. You can find it somewhere in the back of annual reports, although, to the extent I have been able to observe, the inflation loss there shown is not integrated into earnings to the point of showing adjusted earnings after the effects of inflation. A pencil, not even a calculator, will do the job for you that the market has done all along. That will explain why banks that own little real estate or other hard assets are losers from inflation. They are compelled to invest in paper assets not only all their liabilities, but most if not all of their capital, and inflation takes its toll.

Short of issuing new stock, banks are dependent for increases in their capital on retained earnings. In the Euromarket, they must raise capital via the spread. Retentions have indeed been rising along with the rate of return on capital, which before inflation adjustment now ranges around 13-15 percent for some of the largest banks, in one or two cases higher. But since inflation also drives up bank liabilities, capital ratios, after some improvement in 1976, have tended to resume their long-term downtrend.

Banks of other countries may be in a different position. In some countries capital ratios were lower to begin with, in some countries banks are better protected against inflation by ownership of real estate, participations, or other nonmonetary assets. In the absence of consolidated balance sheets, and in the presence of hidden reserves, comparisons are difficult to make.

#### A New Approach -- Banks as Brokers

The growing concentration of country risk and the shortage of bank capital, at least in the case of American banks, suggests the possibility that on occasion banks might try to act as brokers instead of as lenders of funds, provided the suppliers of the funds can be persuaded to accept the risk. Prototypes for such techniques are numerous. In the United States, banks have created mortgage-backed pass-through securities, and in Switzerland banks employ their trustee accounts. Both techniques have the effect of economizing on bank capital. OPEC lenders generally seem to have favored low-risk investments, but they have also indicated concern that they were not getting a positive rate of return on their investments. Conceivably, a developing country might be willing to do what developed countries would hardly consent to: an indexing of liabilities. Some developing countries have had experience with indexing. The indexing presumably would have to be in terms of a price index for the currency of the loan, whether dollars, D-mark, or any other. A very moderate interest rate which would constitute a positive real return should be adequate given the indexing. A weighted index could even be constructed for an SDR loan, if such further reduction in risk were preferred by the lender. From the borrower's point of view,

the risk implied in the indexing would not be very much higher than the risk inherent in a commitment to pay LIBOR.

It seems not inconceivable, therefore, that a mutually satisfactory arrangement could be made whereby OPEC made loans directly to developing countries under conditions compensating them for the risk, arranged by banks with the use of their expertise in evaluating loans. Presumably the banks, as evidence of good faith, might want to take a share of the loan.

### 1985 and All That

Finally, let us take a look at U.S. banks in 1985. A not unimportant problem, as I said to begin with, is getting there. A look ahead over such a time span involves only one certainty -- that things will be different from what one expects. But if all goes well, I would expect, by 1985, American banks to have overcome most of the problems I have described. Inflation should have come down, bank capital ratios and the rate of return on bank capital should have adjusted in such a way that retentions of profits would largely take care of growth requirements, perhaps with some assist from an easing of the McFadden Act restrictions which at present prohibit branching and merging across state lines in the United States. I would expect banks to be implementing or at least contemplating new forms of financing, if their regulators are wise in allowing them to move with the times. I would expect the Euromarkets to be under better control than today, with some recognition that monetary authorities cannot indefinitely allow their currencies to be created outside their reach by foreign banks or foreign branches of their own banks. And some time in 1985 I would expect an enterprising arranger of conferences to be organizing a meeting on the topic of banks in 1990.