For release on delivery
Expected at 10:00 a.m. (E.S.T.)
April 1, 1980

Statement by

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before the

Subcommittee on International Trade, Investment and Monetary Policy

Committee on Banking, Finance and Urban Affairs

House of Representatives

April 1, 1980

It is my pleasure to appear before this Subcommittee to discuss the important issue of recycling the OPEC surplus, its relationship to bank lending to developing countries, and the need for an increase in IMF quotas.

The letter from the Chairman of the Subcommittee inviting the Board to testify has accurately pointed to the dilemma facing the international financial system: a high level of lending by banks to developing countries could lead to excessive risk concentrations at banks, while on the other hand a low level of lending by banks may make it difficult for these countries to finance their anticipated current-account deficits. The latter situation would jeopardize the development objectives of many developing countries since these countries on balance need to import capital to supplement their domestic savings. Moreover, a lack of adequate financing flows would lead to excessively restrictive policies by developing countries to deal with external imbalances, with potential adverse effects on the United States and on other industrial economies.

The Federal Reserve has been conscious of the need to avoid excessive lending as well as the need to avoid a sharp curtailment of lending by U.S. banks. In cooperation with the other supervisory agencies we have designed our examination procedures in a manner that would allow bank participation in the recycling process, while guarding against excessive exposure by individual banks to individual countries. The new examination procedures are being implemented by the three federal regulatory agencies.

The Federal Reserve Board also strongly supports increasing the U.S. quota in the IMF, as I stated in my testimony of March 17 before the Senate Foreign Relations Committee on this legislation. With your permission, I would like to submit that testimony for the record.

In connection with today's testimony, I would like to provide the Subcommittee with some statistical material on the general problem of bank lending and recycling which was included in Chairman Volcker's speech of March 1.

The Subcommittee's letter of invitation requested comment on the factors that might constrain the role of banks in lending to developing countries in the future, relative to the role these institutions played in the past several years. Between the end of 1974 and the end of 1979, outstanding claims of banks from all countries on non-oil developing countries increased on average about $20 billion per year. During this same five-year period, the average annual current-account deficit of the developing countries was about $26 billion, and these countries on balance added $8-10 billion per year to their international reserves. Subtracting bank borrowings used to finance reserve increases from total net borrowing from banks, it appears that over the last five years net borrowings from banks have financed on the order of about one-half of the aggregate current-account deficit of the non-oil developing countries.

The extent of new bank lending to developing countries or any other borrower is determined by the interaction of three variables: yield, risks, and concentration of credits to a borrower in the banks' portfolios. A higher yield, within limits, can compensate for a slightly higher risk. In my view, the risk premia implicit in country lending have in recent years, not been adequate. Additionally, however, as the concentration of credits to individual borrowers or borrowing countries increases in relation to a bank's total portfolio or capital, a prudent well-managed bank will demand a greater spread for a given level of risk, before it adds more of such credits to its portfolio.

With respect to U.S. banks, in the 1974-76 period the returns on lending to developing countries were quite high relative to the risks, and U.S. banks expanded their outstanding claims on developing countries as a proportion of their total assets. In the past two years, however, U.S. bank lending to these countries appears to have been effectively constrained by the very low yields on new credits that barely compensated banks for the costs of making and servicing the loans, much less for any risks of adding new credits to their portfolios. Thus, between 1976 and 1979, U.S. banks were less active in lending to these countries and the ratio of their claims on developing countries to their total assets actually declined slightly.

The experience of foreign banks have been somewhat different. Foreign banks, in general, have lower levels of concentration in lending to developing countries, and, in many cases, lower capital-to-asset ratios. These banks have been willing to continue to expand their lending to developing countries relative to their assets despite the seemingly low returns because of their lower concentrations and because their lower capital-to-asset ratios allowed them to earn a higher return on capital for any given margin between their funding costs and the yield on the loans.

The rapid expansion in lending by foreign banks has caused some concern among foreign regulatory authorities. The German and British authorities have begun to require their banks to maintain detailed records on a consolidated basis including, as a minimum, lending by their head offices and foreign branches. Since last fall Japanese banks have been constrained by a request from the Ministry of Finance to limit their international lending.

Looking to the future, lending by U.S. and foreign banks will depend primarily on the extent to which spreads and fees on these loans increase relative to the increased risks and, to some extent, on the actions of bank regulatory authorities of industrial nations. The level of risks will depend in large part upon the policies pursued by the borrowing countries. If spreads and fees rise somewhat relative to the risks, then U.S. and foreign banks would be expected to increase the pace of their net new lending to developing countries relative to their assets and capital. As shown in the attached chart and tables, changes in concentrations relative to assets occur relatively slowly over time in the aggregate despite large increase in outstanding claims, because the banks' assets and capital also increase over time. Changes in concentrations relative to assets do, however, occur much more rapidly at individual banks.

The willingness of banks to expand their international lending is, as I noted, highly dependent on their evaluations of the risks on these loans. Evaluating country risk is an extremely difficult task that involves complex interactions of political as well as economic factors. Compared with 1973, the developing countries' debt burdens, whether measured in real (inflation-adjusted) terms, or relative to their exports and GNPs, have increased. Moreover, in 1980 the developing countries will have a significantly higher oil-import bill than in 1979 which will absorb a substantially higher proportion of their export earnings. In addition, they will bear the indirect effects of the higher price of oil on the economies of the developed countries through reduced growth in their exports, and through higher prices for capital equipment and other imports from OECD countries. Events in Iran, Nicaragua and elsewhere have highlighted the political risks associated with international lending. Finally, there is no assurance that the OPEC surplus, and the counterpart deficit of the oil-importing countries, is likely to decline as rapidly in the early 1980s as it did several years after the 1973-74 oil price increases.

Balanced against these negative factors are the greater international reserves of the developing countries, the increased resources of the IMF, the lesser likelihood that the OECD countries will experience a widespread and severe recession as they did in 1975, and the lesser likelihood that primary commodity prices will fall as much in 1980 and 1981 as they did following the 1973-74 OPEC oil price increases.

Weighing all these factors is indeed complex, but, on balance, I would conclude that the general risks are somewhat greater in 1980 and 1981 than in 1974 and 1975. The situation clearly varies greatly from country to country. Recent history has taught us that the positions of some countries can improve dramatically in a very short period of time. Unfortunately, there are other cases where the external situation has deteriorated rapidly over time, either as a consequence of financial mismanagement or because of external (and sometimes internal) events over which the country has little control.

While this general background suggests it would be reasonable for banks in general to continue to increase their lending to developing countries, it would seem appropriate under current circumstances for banks to demand higher spreads to compensate them for greater risks. In the past, the risks on loans to these countries has appeared quite low, as shown by the loan-loss record on lending to developing countries by U.S. banks since 1975. However, arrearages and collection problems may be emerging for a few countries -- such problems could foreshadow some deterioration of that excellent record in the future. In such case lending spreads would be expected to increase accordingly.

Some increase in spreads seems appropriate in any event, given the downward trend in bank capital ratios.

The Subcommittee has raised the question of the relationship between bank capital and recycling. The Federal Reserve believes that in view of the decline in banks' capital ratios in the last few years, increases in banks' capital would be highly desirable. Bank capital adequacy, however, must be judged against the entire spectrum of bank assets and not on loans to any particular group of borrowers. Capital ratios can improve even when lending to one group of borrowers grows faster than bank capital if lending to other types of borrowers on average grows more slowly. For any given ratio of capital to assets, an important determinant of bank soundness is portfolio diversification.

With these observations in mind, it is instructive to examine the recent record of bank lending to developing countries relative to the banks' capital. As shown in Table 4, the ratio of lending to developing countries to capital for all U.S. banks active in international lending in the aggregate has actually declined slightly between the end of 1977 and June 1979, although for the larger banks it has increased slightly.

If the capital funds of the U.S. banks involved in international lending were to increase on the order of 8-11 percent in 1980, the share of U.S. banks in the projected total new bank financing of the non-oil developing countries in 1980 could be about equal to their share of outstanding claims (about 40 percent), only with some fairly moderate increase in the aggregate ratio of loans to these countries relative to the banks' capital and assets. If existing capital-to asset ratios were to be maintained, the additional lending would be only, very approximately, one-half as large. It would be desirable, of course, that this new lending be spread more toward those individual U.S. banks that are less exposed to individual borrowing countries.

In view of the active role of U.S. banks in the whole area of international lending, the federal bank regulatory agencies have devoted substantial effort to evaluating and modifying the international examination procedures. For the Subcommittee's information I would like to discuss the new procedures. The three federal bank regulatory agencies now have a common approach for evaluating country risk in bank examinations. The system focuses on concentrations of exposure relative to capital. Foreign loans are not classified for country risk <u>per se</u> except in the few cases where there has been an interruption of payments or such an interruption is deemed imminent.

Data collected on the semi-annual Country Exposure Report are used by the examiners to compute exposure to individual countries by individual banks. Comments on large exposures are given in the examination report under a section entitled "Concentrations of Transfer Risk Warranting Special Comment." These comments on exposures are not a directive telling banks to refrain from further lending to a country nor are they included in the bank's asset quality rating. Rather they are designed to call to the attention of senior management exposures that are worthy of review.

In reviewing an individual bank's foreign activities, an examiner may conclude that certain exposures appear excessive in light of the position of the bank. This judgment would be based on a number of factors in addition to the level of existing exposure and the strength of the borrowers. It would take into account the bank's historical lending patterns, its management capabilities, its system for managing risk, and the size of the bank's exposure relative to other banks. In cases where the examiner judges an exposure to be excessive, a specific criticism would be noted in the front of the examination report or cited in a letter to the bank's Board of Directors. These cases are expected to be relatively few in number, and usually result from some deficiency at a particular bank, rather than a general regulatory constraint on lending to an individual country.

U.S. bank regulatory authorities evaluate the foreign activities of U.S. banks on a fully consolidated basis that includes their foreign branches and majority-owned subsidiaries, drawing upon the Country Exposure Report which is prepared on a fully consolidated basis. The reason for this approach is that loan losses at foreign branches of U.S. banks, and in most cases foreign subsidiaries, are not different from loan losses at the banks' domestic offices, since they are charged off against the earnings and capital of the parent institution.

The Federal Reserve and other regulators conduct separate examinations of foreign branches and some foreign subsidiaries. These examinations are conducted mainly to determine that the foreign offices are in conformance with U.S. regulatory policy and that their activities are being controlled and coordinated properly by their head offices.

Bank lending to developing countries or other categories of borrowers in general is not directly constrained by regulatory policy. In participating in the design of the new international examination policy, U.S. banks supervisors were well aware that a policy which focused on classifying countries as unacceptable risks might cause unnecessary problems for individual borrowing countries. The system that was developed avoids country classifications except in cases in which a country is not performing on its obligations, and focuses on individual bank exposure. In view of the deliberate flexibility in the examination system, there does not appear any need to modify it to deal with recycling the large OPEC surplus. However, the examination system I have described is relatively new. Based on operating experience, some adjustments and revisions may be necessary.

The Subcommittee has asked for comment on whether it is reasonable to expect banks in general to continue to provide new credits to the developing countries. As shown in the attached Charts and Tables, in recent years foreign banks have rapidly expanded their lending to developing countries and Eastern Europe. Measured as a percent of assets, their exposure is still below that of U.S. banks so there is potential for increased foreign bank participation.

There are also a considerable number of cases of large U.S. banks that have relatively small exposures to individual countries. These banks could increase their exposure on a selective basis without bringing their risk exposure to unacceptably high levels. Moreover, participation by smaller U.S. banks in lending has been rather limited in recent years, and there is scope for increased participation by these institutions if spreads were to widen. My conclusion from the available information is that there appears to be considerable room for further U.S. and foreign bank participation in lending to developing countries.

Whether it is realistic or desirable to expect banks to participate in further lending is a separate issue. The Federal Reserve and other regulatory agencies do not want to substitute their judgment for the business judgment of individual banks. Rather, the supervisor's role is to caution banks about the risks of excessive concentration, and, to make certain that banks have appropriate procedures for monitoring and reviewing large exposures. In order to help ensure adequate information to the banking system, the Federal

Reserve participates in efforts, such as the BIS semi-annual survey, to increase the flow of financial information to banks.

The prospects for continued bank lending to developing countries will in the final analysis depend in large part on the soundness of the international financial system and the soundness of the financial policies of the borrowing countries. Increasing the resources of the IMF, through an increase in the quotas of the United States and other member countries, would improve the ability of the Fund to meet the financing needs of its members. Increased resources for the Fund would place it in a better position to influence the policies of borrowing countries, a role that is much more appropriate for a public institution than for private commercial banks. Better coordination between the IMF and commercial banks would be desirable to prevent instances where bank credits are used by countries to avoid coming to the Fund when difficulties arise.

In view of the Subcommittee's interest, I would like to summarize recent developments in our concerns relating to the Euro-currency market. In the face of increased OPEC surpluses and corresponding deficits of oil-importing countries, it may well be that the scale of international financial flows will increase relative to purely domestic flows. Many of these flows will originate in domestic financial markets, but a significant proportion will involve the Euro-currency market. These flows, through the Euro-currency market and international bank lending, have been of increasing concern to many central banks and bank regulatory authorities. The central bank governors of the G-10 countries and Switzerland recently agreed to improve informational flows on such lending, including a general agreement that major banks of these countries should report their activities on a consolidated basis; they also agreed to increase their monitoring of developments in these markets from the standpoints of prudential considerations, as well as macro-economic and monetary policy concerns. These measures will put supervisory authorities in a stronger position to keep abreast of market developments.

In summary, Mr. Chairman, I believe that the banking system will continue to play an important role in the recycling process. Commercial banks, however, cannot be expected to assume complete responsibility for recycling the OPEC surplus. Countries in very large deficit will have to recognize that the need to adjust rather than to finance their external imbalances is greater now then it was after the 1973-74 oil price increases. The OPEC nations should be expected to provide more aid and direct financing, particularly since the size of their accumulated surpluses will allow them to hold a diversified portfolio of assets. Finally the IMF can play an important role in the recycling process, but to be effective the IMF needs to be sure of having adequate resources. The Board urges the Congress to act expeditiously to increase the U.S. quota in the Fund.

Table 1

Regional Current Account Balances
(Balances on Goods, Services, Private and Official Transfers; billions of dollars)

	1973	1974	1975	1976	1977	1978	1979e
OECD	10.1	-27.1	-0.4	-18.2	-24.8	10.9	-32
OPEC	8.0	70.0	31.0	37.0	30.0	7.0	65
Non-oil Developing Countries 1/	-7.1	-24.4	-31.9	-20.2	-14.3	-25.7	-39
Other 2/	-3.5	-9.5	-18.0	-13.0	-8.5	-9.5	-11
Statistical Discrepancy 3/	-7.5	-9.0	19.3	14.4	17.6	17.3	17

1/ Principally IMF members not included in OECD or OPEC.
2/ Principally Sino-Soviet area and East European countries.
3/ The sign of the discrepancy is such that when added to the sum of the individual regional current accounts the total is zero; e.g., a positive discrepancy offsets a global current account deficit.

e = estimate.

Table 2

Total Bank Claims on Non-Oil Developing Countries and Eastern Europe
(billions of dollars)

	December 1974e	December 1975	December 1976	December 1977 1/	December 1978 2/	September 1979
Claims on Non-Oil Developing Countries						
U.S. Banks	23.8	33.4	41.7	47.7	49.4	55.4
Non-U.S. Banks	20.0	29.6	39.2	51.1	72.3	91.8
Subtotal	43.8	63.0	80.9	98.8	121.7	147.2
Claims on E. European Countries						
U.S. Banks	3.0	3.7	5.2	6.5	6.9	7.3
Non-U.S. Banks	11.9	19.7	25.8	35.6	46.2	52.3
Subtotal	14.9	23.4	31.0	42.1	53.1	59.6
Total Claims						
U.S. Banks	26.8	37.1	46.9	54.2	56.3	62.7
Non-U.S. Banks	31.9	49.3	65.0	86.7	118.5	144.1
Total	58.7	86.4	111.9	140.9	174.8	206.8

Sources: BIS Quarterly data on banks claims and Federal Reserve and Treasury Banking data.
1/ Beginning December 1977, banks in Austria, Denmark, and Ireland began reporting to BIS.
2/ Beginning December 1978, excludes customers claims of domestic offices of U.S. banks.
e Partly estimated.

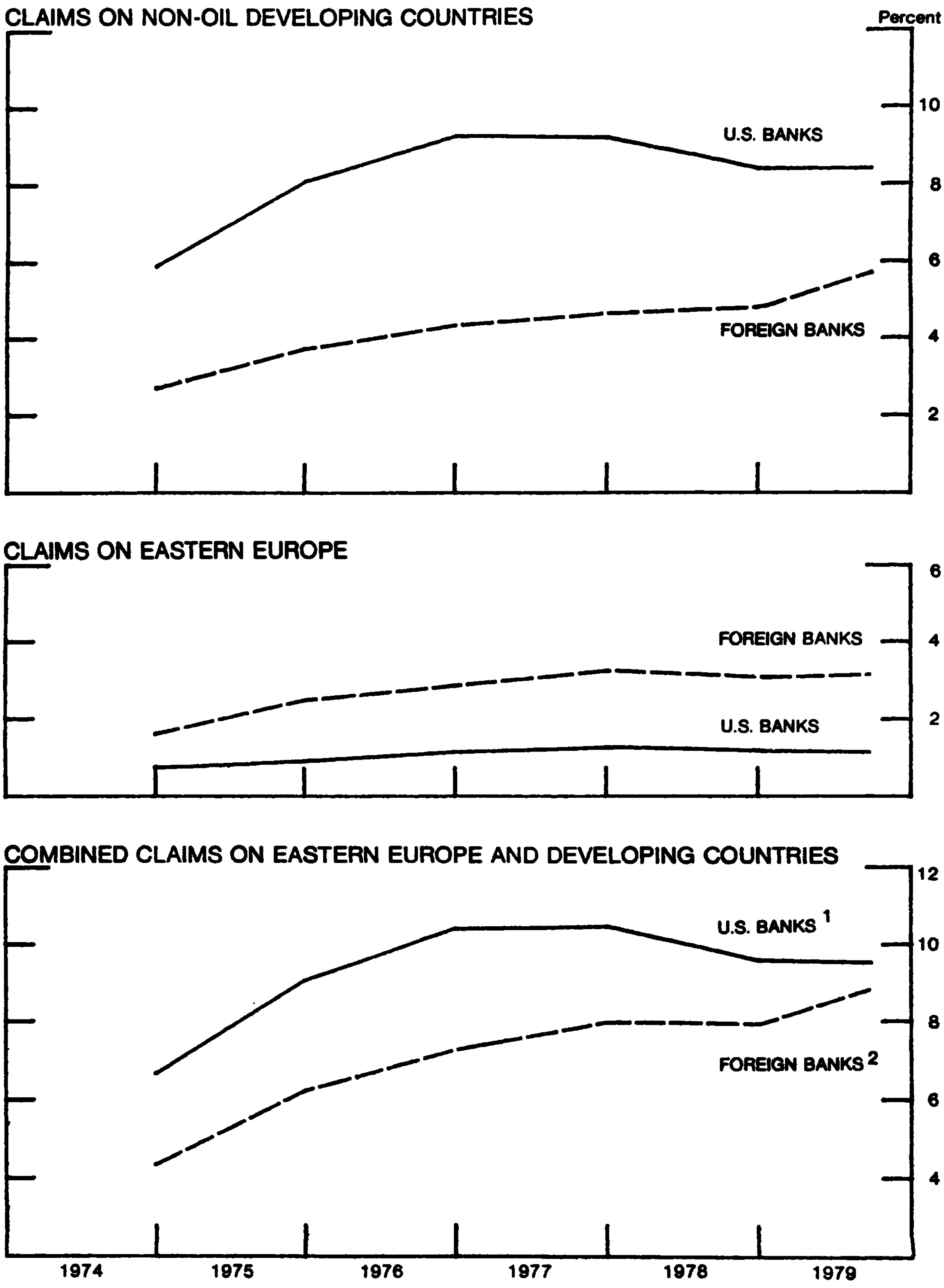
Table 3

Financing of the Deficits of Non-Oil Developing Countries
(billions of dollars)

	1973	1974	1975	1976	1977	1978	1979[e]
Current Account Deficit	-6	-24	-32	-20	-14	-26	-39
Net Long-Term Borrowing from Official Sources	5	7	11	9	11	12	14
Net Borrowing from Banks	9	16	19	18	18	23	32
Other Net Capital Inflows	1	4	3	4	-3	3	1
Equals: Reserve Increase	8	3	1	11	12	13	8

e Partly estimated.

Bank Claims as Percent of Assets



1. Computed for the 24 largest U.S. banks that account for five-sixths of lending to developing countries.
2. Computed for 34 large foreign banks

Table 4

Exposure Relative to Capital for Groups of U.S. Banks[1/]
(Percent)

Country	December 1977				June 1979			
	All U.S.[2/] Banks (1)	Nine Largest Banks (2)	Next Fifteen (3)	All[3/] Others (4)	All U.S.[2/] Banks (5)	Nine Largest Banks (6)	Next Fifteen (7)	All[3/] Others (8)
Non-oil Developing	115	156	105	61	112	161	109	53
Argentina	6	9	5	3	7	10	7	4
Brazil	30	40	28	16	28	39	28	14
Mexico	28	32	29	21	21	27	23	14
Philippines	5	7	6	2	6	10	7	2
South Korea	8	12	6	4	11	17	10	4
Taiwan	7	10	6	3	7	10	7	3
Subtotal (6 countries)	84	110	80	49	80	113	82	41
Eastern Europe	18	25	16	9	15	21	15	7
Combined Total	133	181	121	70	117	182	124	60

1/ Exposure after reallocating claims from country of obligor to country of guarantor. Capital defined as equity, subordinated debt, and loan-loss reserves.
2/ All 128 U.S. banks completing the Country Exposure Report.
3/ Remaining 104 U.S. banks completing Country Exposure Report.

Table 5

Estimated Disposition of OPEC Surpluses
(Billions of dollars)

	1974	1975	1976	1977	1978	1979[e]
Estimated Current Account Surplus	70	31	37	30	7	65
Investments						
In the United States	12	10	12	9	1	7
In the United Kingdom	8	*/	-1	1	*/	2
In the Eurocurrency Market 1/	22	8	13	12	3	38
In international financial institutions	4	4	2	*/	*/	-1
Subtotal	46	22	26	22	4	46
Unidentified investments (net)	24	9	11	8	3	19

e Estimate
*/ Less than $0.5 billion.
1/ Including minor amounts of domestic currency banks deposits outside the United States and United Kingdom.

Table 6

Debt Service Obligations of Non-Oil Developing Countries
on Medium and Long-Term Public Debt
(billions of dollars)

	1974	1975	1976	1977	1978	1979
Debt Service 1/	8.7	10.6	12.9	17.2	27.0	33.0
Interest payments	3.1	4.2	5.1	6.3	8.9	12.5
Amortization	5.5	6.3	7.8	10.9	18.1	20.4
Merchandise Exports	96.3	92.0	113.1	134.9	152.4	189.0
Ratios:						
Debt Service/Exports	9.0	11.5	11.4	12.7	17.7	17.5
Interest payments/Exports	3.2	4.6	4.5	4.7	5.9	6.6

e Estimate.
1/ IBRD reports

Table 7

Spreads and Maturities on Syndicated Bank Loans to Non-Oil Developing Countries and Eastern Europe

Date		Average Spread 1/		Average Maturity 2/	
		Non-oil Developing	Eastern Europe	Non-oil Developing	Eastern Europe
1973:	Q_4	1.17	.59	10.8	8.8
1974:	Q_4	1.46	3/	7.5	3/
1975:	Q_4	1.82	1.49	5.4	5.5
1976:	Q_4	1.90	1.33	5.1	5.5
1977:	Q_4	1.76	1.16	7.3	6.0
1978:	Q_4	1.04	.75	9.8	6.7
1979:	Q_1	.94	.89	9.9	7.3
	Q_2	.79	.78	9.0	6.8
	Q_3	.80	.78	10.1	7.2
	Q_4P	.91	.63	8.4	8.8

1/ Unweighted data on spreads in basis points on syndicated bank loans to nine developing and four Eastern European Countries.
2/ Average maturity from date of credit agreement to date of final repayment.
3/ No credits granted.

Source: International Bank for Reconstruction and Development.