



FOR RELEASE ON DELIVERY  
THURSDAY, SEPTEMBER 24, 1981  
5 A.M. EDT

**INTERNATIONAL LENDING AND  
THE ROLE OF BANK SUPERVISORY COOPERATION**

**Remarks by**

**Henry C. Wallich**

**Member, Board of Governors of the Federal Reserve System**

**at the**

**International Conference of Banking Supervisors**

**sponsored by**

**Comptroller of the Currency, Federal Deposit  
Insurance Corporation, and Federal Reserve Board**

**Washington, D.C.**

**September 24, 1981**

**INTERNATIONAL LENDING AND  
THE ROLE OF BANK SUPERVISORY COOPERATION**

**Remarks by**

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

**at the**

**International Conference of Banking Supervisors**

**sponsored by**

**Comptroller of the Currency, Federal Deposit  
Insurance Corporation, and Federal Reserve Board**

**Washington, D.C.**

**September 24, 1981**

-----

Two years have gone by since the first International Conference of Banking Supervisors in London. This is not a long time in banking, where long experience and established relationships matter. However, the pace of change in today's world of banking leaves us, as banking supervisors and regulators, no scope to relax our vigilance. We have had to contend with no major international banking problem since the events of 1974; in part this can be attributed to the post-Herstatt prudence of the banking community itself. Nevertheless this should not lead us to expect smooth sailing ahead. Instead we must peer beyond the surrounding calm to see whether there are signs of turbulence building up on the horizon. One good way of doing that is to stop for a moment and gather together our collective thoughts about where we are and where we are going.

As bank regulators, we have many problems in common, even though each in his home country often faces very different sets of circumstances. Today the world's financial system is highly integrated. Bank credit and deposit-taking reaches out all over the world. The smooth functioning of the major banking markets is important to borrower and lender alike, in economies near and far. Any major damage that might be suffered by one part of the system will be felt by all. If the boat should spring a leak, it will not help to say that while the damage looks nasty, fortunately it is at the other end of the boat. We are all in the same vessel.

Growing integration across national boundaries makes it important for us to attain a better insight into banking laws and practices elsewhere. These laws and practices, which increasingly affect the condition and competitiveness of the banks we supervise, differ enormously across nations. Probably most of us believe that there are good reasons for doing things the way we do. We are not proposing to change each other's ways. But there is a need to individually adapt our national laws and practices into an international framework so that they will accommodate and support each other instead of creating gaps or even conflicts that could pose a threat to the worldwide system. That must be one of the principal aims of a conference like ours. The purpose of this conference, therefore, is to understand different approaches to similar problems, and to develop ways of working together to make supervision more effective in an international context.

For my part, I shall discuss some aspects of international lending risk and how the banks might respond if some of these risks were to materialize. In particular, I intend to address the questions of anticipating international

lending problems, banks' rescheduling of country debt, and the degree to which banks are preparing themselves to meet such risks by charging appropriate spreads and by building up adequate capital positions.

Analysts of lending risk in the international sphere have focused, in recent years, on the assessment of country risk -- especially the risk of lending to developing countries. The past few years' experience suggests that our ability to anticipate future problems in this sphere is modest. First, problems have sometimes cut across country lines, involving particular industries such as shipping, steel and real estate. Second, some country problems do not involve developing countries, as the present debt situation of a certain Eastern European country exemplifies. Third, among developing countries themselves, difficulties have been experienced with countries of very good credit standing, as was the case of Iran. From a regulatory point of view, I believe, these experiences suggest that analysis of country risk cannot be relied upon to the point of ignoring the elementary precaution of wide diversification. However carefully lenders try to anticipate events in particular countries or industries, the main threat still comes from the unexpected. That threat can be met only by a prudent spreading of risks.

I am taking the time to remind ourselves of this fundamental principle of risk management because it is sometimes thought that the usual rules of lending risk do not apply to sovereign borrowers. It has been said that lending to countries is less risky than lending to businesses or individuals because a country, unlike a business or individual, will always be around. Country lending, it is sometimes said, is free of final bankruptcy and definitive loss. All that is needed is occasional rescheduling that gives

the lender a breathing space and does not significantly affect the earnings or capital of the lending banks. In my judgment, this is too complacent an attitude.

Rescheduling clearly poses problems -- both for the lending bank and for the borrower. At a minimum it reduces the lending bank's liquidity by effectively extending the maturity of the loan. This may not be a vital matter, and it can be offset by increasing liquidity elsewhere, although at some cost. If short-term credit is included in the rescheduling, as has happened in some recent cases, the change in banks' liquidity positions may be more serious. If short-term credits are regularly rescheduled, banks may be less willing to extend such credits generally -- a development that could eventually be very damaging to the borrowing countries. Moreover, from the standpoint of the borrower, it needs to be noted that rescheduling may increase debt in a nonproductive way, either absolutely or relative to what the debt would have been had the original repayment schedule been maintained. Properly used, the deferred debt service averts the imposition of an excessively severe adjustment on the country, giving it time to channel domestic resources into productive uses. Improperly used, rescheduling allows resources to continue to be devoted to low priority tasks at a time when there is need for adjustment and only postpones the day of reckoning, increasing the severity of the eventual real balance-of-payments adjustment.

One common way in which the international financial community seeks to ensure appropriate use of the rescheduling mechanism is to make debt restructuring contingent upon a standby agreement with the IMF. Disbursements from these standby agreements are contingent upon an economic stabilization

program and the meeting by the borrowing country of various performance criteria. The Fund's conditionality then serves the purpose of altering the policies of the borrower. Since national economic policies are the crucial element of creditworthiness, the IMF plays a key role in the rescheduling process. For this reason, our own governments should insist that the IMF adhere to a strict line on conditionality. Should it bow to pressures to greatly expand its lending on relaxed conditions, the long-term viability of borrowing countries may be threatened, and the integrity of the rescheduling process could be undermined. These developments would jeopardize the availability of private credit to the developing world.

Situations where a country might begin to rely on rescheduling for the indefinite future should be guarded against. Rescheduling then could become a Ponzi game in which the banks would be lending the borrower the interest so as not to have to treat the ever-mounting loan as nonperforming. When the unpaid interest on a loan is capitalized, i.e., treated as part of the principal whose repayment is deferred, a first step is being taken in that direction.

There can be no assurance that debt service problems will always take the relatively mild form of a rescheduling. The extreme case of a country altogether repudiating its obligations may be unlikely in a world in which countries realize that their economic development depends on access to credit. But an intermediate case -- suspension of payments or whatever the term might be -- surely cannot be ruled out as a possibility by lending institutions. If the terms of a rescheduling cannot be agreed upon, if a debtor country is unwilling or politically unable to do what it takes to sustain even the

interest service, such a case might occur. Regulators must also consider the implications of such a situation.

To play our own roles in averting this possibility, we should pause to ask ourselves whether the present rate of growth of international bank lending is warranted by real needs and economic capacity on the part of the borrowers. We have become accustomed to a very rapid rate of increase in the aggregate debt of developing countries. This was not objectionable so long as it simply implied that the debt capacity of foreign borrowers, for largely historical reasons, had remained underutilized, and likewise that the lending banks had not significantly committed their ability to take on these risks. But debt capacity and risk capacity are now being more fully committed.

A country with a small volume of outstanding debt in relation to debt service capacity can afford to increase its debt at a rate exceeding its nominal economic growth, for a time; eventually, however, the growth of debt must level off to a rate that matches the growth in the nation's productive assets. For two reasons it may be argued that the world has reached the point where a slowing down in the rate of growth of debt is necessary. First, the higher proportion of rescheduled debt should make us uneasy, especially in cases if, as has recently happened, the interest itself is capitalized. While the various debt ratios are not deteriorating drastically on average, in many countries they are creeping up. Moreover, a given ratio of debt service to exports today does not mean what it meant before the recent great increase in oil prices. Today a much larger share of exports is preempted by oil-import bills. Second, the high level of interest rates unfortunately

also adds to the risk inherent in any given level of debt. As a recent IMF study on the subject of LDC indebtedness points out, inflation-induced higher interest rates cause the real value of a loan to be amortized at a faster rate.

My conclusion from all this is that we, as supervisors, should begin looking seriously at the treatment of rescheduled loans. In particular, the question arises at what point the banks should begin to set up reserves against such loans. A recent multi-country review of country practices by the Bank for International Settlements found that in no major country are delays in payment or interest on sovereign loans automatically classified as doubtful assets. In most countries the banks themselves have considerable leeway with regard to the accounting treatment of loans to sovereign borrowers that are in arrears. In the United States, only loans that are explicitly delinquent must be placed in a non-accrual status by the banks. Rescheduled loans seldom reach this state: as an illustration, loans to Poland and Turkey are not now considered in a non-accrual status by U.S. banks.

Some U.S. banks have set aside reserves, at their own discretion, against potential losses from such rescheduled loans. Moreover, examiners in some cases may classify rescheduled loans as substandard. This would affect the bank's asset quality rating. It may also affect the examiner's view of the adequacy of a bank's overall loan loss provision. While U.S. examiners go further than those of most countries, U.S. banks or their auditors are still not required to set aside reserves specifically against such loans, although the overall levels of classified loans must be considered in arriving at "adequate" reserves.



The tax treatment of reserves against loans that are rescheduled could lead to different attitudes among banks toward a rescheduling negotiation. Consider two banks, one with strong earnings and the other with losses. The strong bank may be willing to reduce taxable earnings by an allocation to reserves. Hence, that bank may take a firmer negotiating stance toward the borrower than will the bank with losses. The latter may wish to avoid showing any write-off of loans. International differences in tax and regulatory treatment can also lead to differences in behavior among banks. U.S. banks, for example, are not permitted to set aside general reserves for future losses. In contrast, I have heard it said that for some non-U.S. banks a "serious" loss is one too large to be taken care of out of hidden reserves that would therefore appear on the balance sheet.

For all these reasons, it seems advisable to me that regulators begin to formulate ideas about the balance-sheet and income-statement treatment of rescheduled loans. This would contribute to a wholesome discipline on banks to avoid getting into rescheduling situations, and on borrowers to maintain policies that would make rescheduling unnecessary. Developing policies on reserves against rescheduled loans will not be simple. We will first have to address a number of questions such as: should reserves apply only to country loans or should they be maintained on rescheduled commercial loans as well? How do regulators discern the difference between a refinancing and a rescheduling? Should all rescheduled loans be accorded the same treatment, or should supervisors have discretion? If reserves are to be set aside, how big should they be in relation to the loan, and how long should they be maintained?

Whatever the outcome of the reconsideration that I am proposing, it is evident that an explicit set of policies will not be developed in the near future. Meanwhile it is up to us to make sure that banks have or are on their way to achieving adequate means to protect themselves against sovereign risks. We should ask such questions as: are they pricing this risk properly, building earnings that will offset any eventual losses? Are they adjusting their capital to serve as a buffer against potential international lending losses?

As to pricing of risk, while it is difficult to determine the proper level for country-loan spreads, it seems to me that the evidence of reduced spreads in recent years implies that earnings from sovereign loans are contributing little to the accumulation of such a buffer. As I have pointed out in the past, an analysis of the spreads charged to most borrowers in the Euromarkets makes clear that only banks whose capital ratios are very thin to begin with can hope to avoid diluting their capital by participating in such loans. According to our staff analysis, loans to non-OPEC developing countries have carried a weighted-average spread of less than one percent for about the last year, except for a recent quarter distorted by weighting effects, compared with almost two percent in 1976.

To be sure, it is up to the market to price risk correctly, and it may be trying to do so. For example, it is often pointed out that the spread is only part of the total return. In particular, fees of various kinds contribute to the loans' profitability. However, informal evidence gathered here at the Federal Reserve Board suggests that fees, when expressed as an annualized percentage return, generally add little to the total return, and that fees

have tended to decline, not rise, as spreads have fallen. In addition, one suspects that at present high levels of interest rates, particularly of high real rates, risks are greater and lending banks should be better compensated for bearing these risks. Higher real rates may increase default risk because the loan becomes more expensive to service, without any offsetting increase in revenues. All things considered, I find good reason to believe that spreads should have risen under conditions such as the present: high inflation-adjusted interest rates, more heavily burdened debtors, and more frequent rescheduling.

If international lending risks are indeed on the rise, and earnings on sovereign loans are doing little to offset these risks, then the adequacy of our large banks' capital becomes of special concern. Moreover, there are factors other than country risk that point to the need for stronger capital. In the United States, bank capital ratios have trended downwards over the past few years even though during the last year or so they have improved slightly on average for large banks.

It is my impression that a similar downward trend in bank capital exists in other countries -- perhaps I can learn more about this from some of you -- although international comparisons of bank capital are very difficult to make. It is apparent that reported capital of banks is very much a function of accounting conventions. Major international differences seem to exist in the ability of some countries' banks to establish hidden reserves, in the treatment of deferred taxes and foreign exchange translation, and in the writing up or down to market of assets. A bank may show a conservative statement if it has a large stock of appreciated assets, which are carried on

its books at acquisition cost. The same conservatism is implied in a statement in which depreciated assets are written down to market. The same cannot necessarily be said of a statement on which appreciated assets are marked up, or depreciated assets not marked down. In an environment of mounting inflation, a bank that has on its books long-term assets at fixed interest rates is very likely to have a significant amount of depreciated assets. Rising interest rates will reduce even the soundest fixed-rate assets to a discount. If the credit quality of the assets is unimpaired, the bank will be fully repaid at maturity. Meanwhile, however, it is in an adverse earnings position, and in a competitive financial world it may have a hard time during this interval.

Regulators obviously must follow a compromise position with respect to the evaluation of appreciated and particularly depreciated assets. It would be counterproductive and unrealistic to require assets depressed by increases in interest rates to be uniformly written down to their market or implicit market value. To do so might produce insolvency when the business is in fact an ongoing enterprise. But there is danger also in the opposite direction, if solvency is treated merely as a problem of demonstrating a positive cash flow and if true loss of substance is ignored so long as a bank's inflows exceed its outflows.

Bank capital adequacy is affected by inflation in other ways as well, and generally in a negative direction. Banks as net creditors are predestined to lose from inflation. Their capital is likely to be invested, in good part, in paper assets that depreciate with the value of money. Bank liabilities expand rapidly during inflation as the money supply grows. A bank needs high earnings to maintain its capital position under these circumstances, be it by accumulating capital from retained profits or by showing

profits and paying a dividend sufficient to make capital issues attractive. In the United States, bank earnings appear high when stated as a percent of capital. But the stock of many large banks is selling well below book value, perhaps because inflation causes an overstatement of true earnings, or because large banks are seen to be exposed to high risk.

I have raised these problems in what I believe to be the spirit of this conference and in order to give a focus to our mutual task. We need to look ahead and try to anticipate problems before they become serious. As long as one keeps an eye on it, the kettle is less likely to boil over. I have stressed the areas of loan rescheduling treatment and of capital adequacy and, of course, raised far more questions than I have suggested answers. My principal conclusions have been the desirability of fuller balance sheet recognition of rescheduling and the need for a strengthening of capital, together with greater comparability of capital internationally. I hope that some of my observations may encourage similar reexaminations at the level of individual national banking supervisors, and I am gratified that the first issue on your agenda is bank capital. In this area as in the others we need to learn about our differences and to discover issues of common concern.

#