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Testimony by

Manuel H. Johnson

Vice Chairman, Board of Governors of the Federal Reserve System

before the

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I am pleased to have the opportunity to appear before this Committee to discuss how the debt servicing difficulties of some of the developing countries have effected the U.S. banking system.

The subject you have asked me to address today has received ongoing attention in recent years by bank regulators. That attention has been against the background of the basic framework that has evolved. That framework involves the continuing cooperative efforts of the borrowing countries, the multilateral financial institutions, the commercial banks, and the industrial countries.

The potential effect on the U.S. banking system of the debt problems of the developing countries has been managed with some degree of success. First, bank exposure to developing countries has declined since the emergence of the first signs of the debt problem in 1982. Second, the condition of U.S. banks is stronger now in terms of capital and earnings which provide a base to deal with any problems. Third, supervision over foreign lending by the regulatory authorities has been strengthened. Finally, regulation over foreign lending has been amended to accommodate emerging solutions while still being consistent with standards of safety and soundness. I will address each of these topics separately.

Bank Exposure

Loans to all foreign borrowers by U.S. banks have declined significantly since the beginning of the debt crisis. As of June 1982 U.S. banks had \$344 billion outstanding to borrowers located outside the United States. Of this total, \$197 billion, or 57 percent, represented exposure to borrowers in developed countries. On the other hand, in 1982 U.S. bank exposure to the 15 countries associated with the Baker initiative¹ totalled \$90 billion. Mexico, the largest borrower among the developing countries, owed \$25 billion which at the time represented an average of 38 percent of combined gross capital funds.² Exposure to Mexico by the nine money center banks totalled \$14 billion and represented almost 50 percent of their combined gross capital funds. In 1982 banks had little or no loan loss reserves against these loans.

As of June 1988, the exposure of U.S. banks to all foreign borrowers amounted to \$280 billion. These borrowers are still primarily located in major developed countries where such borrowings constitute \$176 billion or 63 percent of the total.

¹The Baker-15 countries are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

²Gross capital funds include equity, subordinated debt and Loan Loss Reserves. Exposure is cross-border claims on a foreign country which includes deposits with banks, securities, loans, acceptances, and investments in unconsolidated subsidiaries.

Exposure to the Baker-15 countries has declined to \$76 billion which represents 58 percent of gross capital funds of all U.S. commercial bank lenders. This compares with 136 percent of capital in June 1982.

The impact of the debt problems of the developing countries has been felt most severely by the nine large banks. Their combined exposure to the Baker-15 countries as of June 1988 was \$53 billion, representing approximately 100 percent of their combined capital. But this exposure relating to capital was half of that of 1982 and the lowest it had been at any time since such data were first collected in 1977.

The large banks have continued to support additional lending to those heavily indebted countries where efforts are being made toward structural economic reform and where the country is endeavoring to maintain normal creditor/debtor relationships. As a consequence, the large banks have continued to shoulder a greater share of new lending to the heavily indebted countries.

Many smaller and regional banks, have on the other hand, largely abandoned strategies that would further involve them in continued international lending in the developing countries. These banks traditionally have been less involved in international lending and have reduced their exposures to heavily indebted countries by various means including loan swaps and sales.

New types of transactions involving bank loans to developing countries have emerged and are being used by all banks to adjust their portfolios. These include debt conversions where non-bank investors purchase loans to a particular debtor country and then exchange the loans for investments. They also include debt settlements where individual borrowers from developing countries reach an agreement with their external bank creditors to prepay their debts on favorable terms.

The volume of debt conversions and settlements has increased significantly since mid-1987. These transactions still account for only a small proportion of all bank claims on heavily indebted countries. Nonetheless, the availability of such techniques -- and more generally the development of the secondary market for loans to major borrowing countries -- has given U.S. banks, particularly those banks that are not otherwise extensively involved in international banking, added flexibility in managing their international loan portfolios.

In part by taking advantage of these opportunities, total U.S. bank exposure to the 15 countries associated with the Baker initiative dropped \$8.6 billion over the year ending June 1988. A disproportionate share of this reduction was accounted for by large regional banks, as distinct from the largest multinational banks. Nonetheless, the top nine banks did reduce their total exposure over the year by \$2.6 billion, but their share of total bank exposure rose. The largest banks typically have reported smaller discounts in such transactions than did the

regional banks. This outcome is associated with the capacity of the former group of banks to employ a wider range of debt-reduction techniques, including sales, exchanges for other credits, and debt-for-equity swaps.

U.S. banks' reductions in exposures to the Baker-15 countries over the year ending June 1988 involved essentially a handful of countries. Reductions in banks' exposures to Mexico of \$3.7 billion accounted for slightly more than 40 percent of the total, and were largely associated with negotiated debt retirements by Mexican private sector borrowers. Declines in U.S. banks' exposures to Brazil and Chile were roughly proportionate to the decline in total exposure, while a smaller than proportionate decline was reported for claims on Venezuela. Small increases were reported in the total of U.S. banks' exposures to Argentina and Colombia.

Condition of the Banking System

U.S. banks today are in a better position to absorb the impact of any suspension of debt servicing by borrowers, domestic or foreign. A number of reasons justify this assessment.

First, primary capital ratios of the large multinational banks, the major lenders to developing countries' borrowers, have increased significantly. In 1982, the average primary capital-to-asset ratio for multinational banks was 4.82 percent. Today it stands at 8.19 percent.

Second, earnings of the large multinational banks are at high levels. There was some slowing of the growth of earnings in the third quarter but, nevertheless, bank earnings in 1988 were healthy. Diversified earnings help to act as a cushion if a major borrower suspends debt service.

Finally, banks have increased their loan loss reserves against claims on developing countries. For the nine largest banks these reserves now total almost \$14 billion. These reserves represent approximately 26 percent of exposure to those heavily indebted developing countries that have incurred external financial difficulties.

Supervision and Regulation over International Lending

Supervision over lending practices of banks is a matter of continuing attention by U.S. bank regulatory authorities. This has been especially true in the past decade in the area of international lending. Loans to private sector foreign borrowers are evaluated in the same manner as domestic loans. Regulatory classification procedures are the same for all loans regardless of whether the loan is domestic or foreign. Regulators continually review bank managements' policies and procedures on lending to ensure that the risk in the loan portfolios is being properly evaluated and adequate reserves against future loan losses are being provided.

Lending to foreign borrowers involves an added risk which is commonly referred to as transfer risk. This risk

involves the possibility that a country's economic and financial policies may not be compatible with producing an environment that provides sufficient foreign exchange earnings to meet debt service requirements. The bank regulatory agencies review and evaluate transfer risk uniformly. This is accomplished through the Interagency Country Exposure Review Committee (ICERC). ICERC meets three times a year to make judgements on the degree of transfer risk inherent in lending to 80 countries. The resulting categorizations are applied uniformly to all borrowers in a country whether public or private although some differentiations are made at times for trade credits.

The committee also recommends the level of charge-off or Allocated Transfer Risk Reserve (ATRR) in those countries where debt service has been interrupted for a protracted period of time. Banks have the option of writing off the loans to the level established by the regulatory authorities or of establishing an ATRR for that amount. The ATRR is not counted as capital.

This system of evaluating transfer risk was established in 1979 and modified in 1983 in line with the provisions of the International Lending Supervision Act passed by Congress.

Lending to foreign borrowers is monitored by the regulatory authorities through quarterly reporting. Banks that lend to foreign borrowers are required to report the aggregate claims on borrowers for each country. The results are aggregated into a Country Exposure Lending Survey which is issued publicly.

The latest report is attached as an appendix. Country exposure reports of individual banks are also reviewed to determine any sizeable new lending by a particular bank or to an individual country.

Regulatory Actions

Since mid-year 1987 the Federal Reserve Board has taken several actions to grant U.S. banking organizations additional flexibility in managing their exposure through debt-for-equity swaps. Before these amendments in August 1987 and February 1988, the Board's Regulation K, which governs the international activities of U.S. banking organizations, allowed U.S. banking organizations to invest in up to 20 percent of the voting shares of any company, regardless of the nature of its activities. A number of U.S. banking organizations sought additional flexibility from the Board to invest, through a debt-for-equity swap, in a larger percentage of the shares of a foreign company engaged in non-financial activities. The banking organizations felt that being able to purchase a larger percentage of shares would enhance their ability to bid on, supervise and ultimately divest themselves of such investments. In considering such amendments to its regulations, the Board balanced its longstanding safety and soundness concerns over the mixing of banking and commerce against a desire to allow banking organizations flexibility in managing their claims on developing countries.

The effect of the two amendments to Regulation K was to permit U.S. bank holding companies to invest in up to 100 percent of the voting shares of a non-financial company that was being privatized by the government of the eligible country and up to 40 percent of the equity (including voting shares) of any company located in an eligible country, subject to certain conditions that prevent the U.S. banking organization from having actual control of that company. These investments are not to be permanent in nature; they must be divested within the lesser of 15 years or 2 years of the date on which the bank holding company is permitted to repatriate in full the investment in the foreign company. The Board also expanded the general consent provisions for such investments. These are the limits within which an investment may be made without first seeking the Board's approval. They have been expanded to the greater of \$15 million or one percent of the equity of the investor.

It would appear, based on the reactions of the U.S. banking organizations that had sought the more liberalized treatment, that the 1987 and 1988 amendments were responsive to their concerns. It should be noted, however, that a significant number of debt-for-equity investments are being made under the original portfolio investment provisions of Regulation K. It should also be noted that most debt-for-equity transactions have involved the exchange of bank claims for equity holdings by non-banking organizations. Moreover, several of the developing countries have at least temporarily placed restrictions on or

suspended their debt-for-equity swap programs because of concern about the effect of such transactions on their money supply.

Conclusion

The international financial system should be able to deal with the international debt problem. One major reason is that many developing countries acting in their own interest have adopted strong adjustment programs and have continued to service their debts. While significant progress has been made in managing the external debt problems of developing countries, we are far from being able to declare that these problems and their consequences in the banking system are behind us.