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A REGULATOR'S VIEW OF THE RESCHEDULING PROBLEM

Remarks by

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

at the

1982 Euromarkets Conference

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Once more I am glad to have an opportunity to speak to the Euromarkets Conference sponsored by the Financial Times on a topic related to international bank lending, specifically, on some aspects of the rescheduling process.

The Rise of Rescheduling

Three circumstances combine to focus attention on rescheduling in the U.S. regulatory view. First, international bank lending, and especially lending to developing and until recently East Bloc countries, has been expanding at a faster rate than bank lending in general. Second, international lending, at least among U.S. banks and probably those of other countries, has tended also to be more concentrated among a relatively small number of large banks. Third, the frequency of reschedulings has increased in the last few years. Thus, international exposure of large U.S. banks, and perhaps large banks elsewhere, has tended to increase, and the fraction of

There is the rest of the financial community. It is usually well informed, has its antennas out in all directions, and is capable of throwing off perceptible signals in response to even very small impulses. But the market, in my view, is subject to trends and fashions like all the rest of us. Sometimes it puts a disproportionate weight on the views or examples of a few highly visible participants. Moreover, the market may believe that governments and central banks have knowledge, or have powers to deal with situations, that may represent an overoptimistic appraisal. In particular, the faith that financial crises can always be controlled seems to be deeply rooted in present market psychology.

As a member of a regulatory body, of course, I welcome this confidence, and I wish only that the same confidence could be transplanted to the market's view of our capabilities for sticking to our monetary policies, controlling the money supply, and bringing inflation down. But the market may overestimate the authority's powers with respect to the former as it underestimates, I believe, their power with respect to the latter range of purposes. While financial authorities will always make an effort to prevent or alleviate serious malfunctions in financial markets, they cannot forestall all difficulties. Indeed, it would be unwise to do so. If risks are to be run there must be winners and losers.

In recent weeks, I have seen newspaper reports urging the use of the threat of financial crisis as a means of achieving political objectives. These reports have focused on the terms in the Polish official 1981 debt rescheduling that was concluded some time ago. Under certain circumstances, that agreement could be declared void. This could lead to a default on private as well as official debt.

Using the international financial mechanism in that way could be extremely dangerous. A default by itself is something the market must always envisage as an ultimate possibility and should, therefore, be prepared to live with. But it makes a great difference how a default comes about. If it were to come as the result of market forces, the market can and would have to deal with it. If it were the result of a political maneuver, the implications would be quite different. Banks would then have to be concerned, especially after having lived through the Iranian precedent, that international credit had become a pawn of national political purposes. Whether one welcomes such broadened reach of the political purpose or not, the consequences are plain. Any international loan could be exposed to this new type of risk. Conventional sovereign risk analysis using economic criteria in international lending would avail little. Governments in borrowing countries may change and may run afoul of the political purpose in lending countries. Governments in lending countries also may change and may take a different view of existing governments in borrowing countries. Nobody could foresee these kinds of contingencies. But the damage to the mechanism of international credit, to all kinds of countries, might be widespread.

I view the advice contained in these press comments as all the more misplaced because demands on the private international financing mechanism may well increase. Flows from official sources of international lending do not seem to have much prospect of expanding. More adjustment and less financing seems to be the watchword in that sphere. This does not mean that the private sector should do more. That depends on what can be done without excessive risk. But the private sector should not be expected to confront types of risks other than those that it is capable, to an extent, to evaluate.

On the subject of international lending risk of the traditional kind, several things deserve to be recalled. Banks' loss record in international lending has been good, much better in fact than the domestic record in the United States. Nevertheless, there is the growing number of reschedulings underway and probably a growing volume of rescheduled loans on the books of the banks. There is a range of circumstances that differentiate today's risks from those of 10 years ago as far as international lending is concerned. The banks, in effect, had discovered the developing countries well before the first oil shock. However, that was environment of rapid growth both of the developing world and their customers among the developed countries. It was a world of low interest rates, relatively speaking, of low international debt, of often strong raw material prices. Today, most of these things have changed. Two oil shocks, together with other factors, have slowed down growth everywhere. Costly oil imports preempt a sizable portion of export proceeds. Debt service ratios for many countries have risen. So has exposure to developing countries for many banks. Prices of many raw materials are weak at least temporarily. And, above everything, real interest rates, which used to be preponderantly negative, now have become pronouncedly positive. Nobody any longer gets paid to borrow, unless he can deduct interest including an inflation premium for tax purposes. Developing countries cannot.

Beliefs That Will Be Tested

Therefore, I believe, that we may have ahead of us a time when some of the old hypotheses about international lending may be tested. One such theory, which I have already mentioned, says that losses in international lending have historically been lower than at home and will, therefore, continue that way. But one reason for this seemingly favorable experience may be that it is harder to recognize a loss on a sovereign loan than on a commercial loan. On a loan to a business firm, the loss is final when the borrower goes out of business. That kind of tap on the head with a two-by-four usually does not happen in the international field. Another theory, which relates to the last, says that while old corporate borrowers may die, sovereign borrowers at worst can fade away. But just how good might be a claim on the smile of a Cheshire cat be? We know that developing countries need credit in order to grow. But, as the man running from a barking dog said, it did not matter whether <u>he</u> knew that barking dogs don't bite but whether the dog knew. Will all developing countries act as if they knew that they must preserve their credit standing in order to grow? Will this knowledge still mean something when a country approaches the stage where its new borrowing is needed increasingly to pay interest rather than to finance a trade deficit reflecting a real resource transfer?

Another theory we have often heard is that domino effects among borrowing countries don't happen. Default of country A historically has not induced similar action by countries B-Z. The case that nobody wants to be first but many want to be second clearly has not arisen. One hopes that the banks will remember this doctrine as they look at different East Bloc countries. The credit quality of most of these countries is different. It would be a mistake to give them all the same treatment. But a careful and discriminating evaluation of East Bloc country credit is not going to be made any easier by the questions that now have to be raised about another old foreign lending hypothesis -- the Soviet umbrella theory.

Maintaining Perspective

What can one say about the present status of international lending, without falling back on any of these more or less uncertain theories? We can reject the implication of the frequently heard question "how can all those countries repay all that money?" Likewise to be rejected is the alternative view that there is nothing to worry about because these loans just will be rolled over and over ad infinitum. Whether or not a borrowing country ever "repays" in the sense of ceasing to be a net capital importer and becoming a net capital exporter depends on its own circumstances and policies as well as on those of the rest of the world. Many of the industrial countries that were structural capital exporters before OPEC to some extent pushed them out of that role once were structural capital importers, including the United States. Some of today's capital importers no doubt some day will make the same transition. One may wonder why some of the most advanced among them are not already moving closer to that role. Their great developmental opportunities, and the more ready availability of capital in more mature countries, may be the reason. I must confess that I would feel more comfortable if this secular historical transition from capital importer to capital exporter were more often visible in the developing world.

On the other hand, the eternal rollover view is equally fallacious. A country can roll over its debt, just like a corporation, if it keeps its economic base strong and growing. So long as that is the case, the strength of the country's credit will be documented, not by net repayment, but by the terms on which old debt can be refinanced and new debt incurred. It is not usual, in any case, for old loans specifically to be rolled over. They are amortized on schedule and their place taken, in the structure of the economy, by new borrowings. The market is always in a position to deny these new borrowings or allow them only at penalty rates. Some of a country's creditor banks, to be sure, may be so deeply involved that they may find it difficult to refuse to participate in new financings. There is danger in such concentration. But there will always be other potential creditors who are free to make their decision whether to participate or not. Thus, perpetual rollovers are never assured. But neither is continued refinancing of debt by itself a sign of weakness.

What one can say positively is that sovereign borrowers, like other units, have a certain debt capacity. In the normal course of events this capacity will be growing if they manage their affairs competently. To be safe, their debt should not be growing faster than this capacity, once it has been fully utilized. In recent years, the debt of most developing countries has grown faster than their economy and probably their debt capacity. Because the limits of a country's debt capacity are not easily definable, one cannot be sure to which extent debt capacity has been utilized or perhaps overutilized. For countries that have to reschedule the limits obviously have been exceeded. What one can say for certain is that a continuous rise in debt relative to debt capacity is not feasible. At some point there must be a leveling off, so that the debtor economy and its debt burden grow at the same rate. For most countries, I fear, this transition is still ahead. The need to navigate it is one of the problems of our situation.

Provision Against Rescheduled Loans

This thought leads me back to the question of rescheduled loans. Their volume on many bank balance sheets probably has been increasing. There are reasons to fear that they may continue to increase. Moreover, the quality of the rescheduled loans may in some cases diminish, particularly where the International Monetary Fund cannot, or cannot adequately, exert an influence for better policies on the part of the borrower. It seems increasingly desirable for regulators to move toward requiring the making of provision against some part of such loans.

At the present time, there is very little international uniformity as regards the treatment both of nonperforming and of rescheduled loans. As regards international loans that are nonperforming, either with respect to interest or principal, the banks are free to recognize this condition in some form as they wish or as their auditors advise them. If interest is seriously deliquent, a loan may be placed in nonaccrual status. Only if a default is called, leading to an attachment of assets and possibly the triggering of cross-default clauses, do legal requirements seem to take over in some countries. In the United States, regulatory judgment continues to prevail even in cases of apparent default. Pending an agreement and rescheduling between borrower and lenders, some American banks might, but would not be required to make reserve allocation against a nonperforming loan. Both would have the effect of reducing its loan loss reserve. To the extent that increased provisions are needed to restore the adequacy of the reserve account, the net loans are reduced. In any event, the loan remains on the books as part of gross loans.

A U.S. bank can reduce its taxable income by building up its loan loss reserve to a statutory limit. That limit may be governed by its historical loan loss experience, if the bank elects to use the experience basis. Alternatively, the bank may raise its loan loss reserve tax deductibility up to a statutory limit, given by a percentage of eligible loans. Prior to legislation passed in 1969 that percentage was 2.4 percent. It is now being reduced periodically until 1987 when all banks will go on an experience basis. At the present time, the statutory limit is 1.0 percent. It was to have been reduced to 0.6 percent in 1982 but was kept at 1.0 percent by special legislation. Most banks are at their loan loss reserve limits by one definition or the other. The limit, of course, can be exceeded for financial accounting purposes, but without tax deductibility.

When a bank wants to charge off a loan loss against its reserve account and make provisions to restore the adequacy of the reserve account, the attitude of the Internal Revenue Service becomes decisive for the tax consequences. Provisions to the loan loss reserve reduce earnings. The IRS will allow this if the charge-off reflected an unquestioned loss. This will be the case if the regulator has classified the loan as a loss, in which case, the bank is required by law or requested by the supervisory authority to write off the loan. If the regulator has not so classified the loan, the bank would probably have to convince the IRS by other evidence.

In some instances, the examiner may decide to classify a loan, whether or not it is still performing and whether or not it is in accrual status, as "substandard" or "doubtful." In instances of "doubtful" classification, the examiner will make a charge of 50 percent for the purpose of evaluating capital adequacy of the bank. If the amount is material, the examiner may encourage but does not require the bank to make a corresponding allocation of the reserve for that particular credit. If the bank makes such allocation on its own initiative, the IRS ordinarily will not accept it as an unquestioned partial loss, unless the examiner can also be convinced, upon a second examination of the facts, that a charge-off should be made. Hence provision for doubtful loans to offset corresponding charges to the loan loss reserve usually cannot be claimed as tax deductions.

Most of the experience with the classification of loans has been in the domestic field. Here it usually is possible, in cases of work-out or bankrupty, to make a reasonable guess at the ultimate loss. In the international field, this is much more difficult. The circumstances and policies of the debtor, the possible long duration of a default, the eventual consequences of a rescheduling are difficult to foresee. A full loss of the type that the regulator would certify and the IRS would recognize is not easy to envisage. A partial loss is hard to substantiate. Thus the chances of tax deductibility for sovereign loans before or after rescheduling are slight under present conditions.

Making provisions to the loan loss reserve, whether general or special, without tax deductibility, of course, is possible but without immediate tax benefit and more costly in the sense of yielding only future rather than current "tax savings." Such "extra" provisions charged to income are assigned future income tax benefits in accordance with the deferred tax concept used in financial accounting. At least that is the case for banks whose tax payments are large enough to cause a significant difference between deductible and nondeductible provisions. The reluctance of banks to make nondeductible provisions is likely further to be enhanced by the possibility that lawyers and accountants may require equal treatment to be given to domestic and international problem loans. This might increase the volume of total credit loss expense once the desirability of provisioning for international loans was accepted.

Against a requirement for provisioning against international problem loans before or after rescheduling, it has also been argued that banks could avoid the requirement by refinancing. They might, in effect, avoid rescheduling by lending the borrower the interest through a new loan. Economically, of course, the two procedures amount to the same thing. It would, therefore, be up to the regulator to observe such cases and penalize a bank for increasing its exposure to a bad risk. Reportedly the expected reaction of regulators to such a practice has already caused banks,in some cases, to prefer rescheduling to refinancing.

Finally, in opposition to provisioning against rescheduled loans, it has been argued that this would give the debtor a motive not to pay. If some of his debt has been written off, why should he make the effort? Actually, experience of past negotiations suggests that banks that are prepared to write off loan losses partially or fully are in a stronger negotiating position with a sovereign borrower than banks which, perhaps because of weak earnings, are trying to avoid a write-off.

As the foregoing observations show, potential arguments against a more rigorous balance-sheet treatment of weak loans, rescheduled or otherwise, are numerous. They cannot be completely ignored. Nevertheless, a case for recognition of such situations, whether tax deductible or not, is strong. Rescheduled loans weaken the bank in many respects. Its liquidity suffers, the proportion of weak loans tends to increase, its maneuverability suffers unless it is prepared to weaken its capital position. A more rigorous approach will make for better banks and better banking. It would help present a more nearly "true" picture of a bank. It will also help to discipline sovereign borrowers and strengthen the forces making for better balance-of-payments adjustment. In the field of sovereign lending, this is the direction in which regulators should look.

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