"LDC CREDIT RISK AND BANK REGULATION"

Remarks by

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

in the

International Conference on Latin American External Debt
and Economic Growth

Florida International University

Miami, Florida

February 25, 1982
Borrowers and Lenders

The risk in bank lending to developing countries must be seen against the background of events both as they affect the borrowing countries and the lending banks. These trends have been slow moving; nothing very dramatic has happened. Nevertheless, the overall impression conveyed by the data, which is very much a matter of averages with a wide dispersion, suggests that there has been some deterioration on the side of both borrower and lender. For the average borrower, debt has tended to increase relative to debt capacity. Whether one looks at debt or at debt service and whether one looks at exports or at GNP as a scale variable, debt and debt service ratios have been creeping up. In general debt service has advanced more than total debt, GNP has risen less than exports, and the ratios behave accordingly. But the direction remains the same. This becomes particularly apparent if one takes into account the increase in oil import bills. These bills must be deducted from resources provided by exports
before meaningful coverage ratios can be computed that are comparable to those of the days before the second, and even more, the first oil shock.

It is evident that borrowers have not yet reached a "steady state" in which debt or debt service grows parallel to GNP or exports. Yet, in the long run, a continuous rise of these ratios is not sustainable. In saying this, one must of course make allowance for wide differences among countries and for improvement in the debt-management techniques practiced by many of them. Unfortunately, allowances must also be made for much higher interest rates in recent years. While economically the inflation premium in these rates is the equivalent of debt amortization, the cash flow burdens imposed by high interest rates are severe. Moreover, real rates toward the end of the 1970's clearly began to move into positive territory after having been negative for a number of years. Again this applied to the average of countries and not in all individual cases.

On the side of the banks, there has been a tendency for individual country exposure to creep up, especially for the large money-center banks. There has been relatively little spreading of LDC lending to smaller banks. Despite this growing exposure, most banks have continued to charge remarkably low spreads over the cost of money. Such spreads as have prevailed in recent years scarcely allow for the service of the additional equity capital that a greater volume of loans requires. Nor do they allow for the establishment of a reserve cushion, in whatever form, to meet possible losses.

All this suggests that changes in the rate of lending are ahead. Borrowing countries may have to slow down the rate of growth of their indebtedness. Lending banks may have to slow the expansion of their LDC portfolios
relative to their total assets. However, there could also be new developments in sources of funds and their use. Insurance schemes, cofinancing, equity investment are among the familiar possibilities. These need to be mentioned here to avoid creating the impression that LDC borrowing is reaching some kind of upper ceiling. That need not be the case.

**Sovereign or Commercial Risks**

The purpose of this paper is to examine some of the risks inherent in bank lending to LDC's and the appropriate regulatory reaction to any perception of mounting risk. Banks have correctly diagnosed that sovereign risk, i.e., the risk of lending to foreign governments, is fundamentally different from commercial risk. But they have not always drawn the right conclusions from this insight. Three types of risk, essentially, need to be considered in international lending: commercial risk, sovereign risk, and country risk. Commercial risk refers to the possibility that an enterprise to which a loan has been made may be unable to service and repay. In the extreme case, the enterprise then goes out of business and the uncollected part of the loan must be written off. Sovereign risk refers to loans to a sovereign government that conceptually cannot go out of business. If at any time it fails to meet its obligations, these cannot be wiped out by bankruptcy. The lender can keep the loan on his books in the hope of eventually collecting. Country risk, in the sense in which these categories are here used, refers to the risk of a loan to a commercial borrower in a foreign country. It carries the risk both of failure of the borrower and of actions
by the foreign government impeding loan performance by an otherwise solvent commercial borrower, for instance by denying him access to foreign exchange.

Much the larger part of bank loans to most LDC's consists of loans to or guaranteed by the respective LDC government, i.e., sovereign-risk loans. The view taken of such loans by lenders seems to have had essentially two aspects: first, an element of safety was seen in the fact that the borrower was "immortal." Second, even if the loan should become nonperforming, there was no reason to write it off. A rescheduling was all that was needed.

An alternative, and probably more realistic evaluation of sovereign loans would be that they present a potentially deceptive appearance of ultimate collectibility. A loan that has to be rescheduled evidently is not as good a loan as the lender thought it was. Even if the interest is paid and principal only is rescheduled, repeatedly the lender may have on his books a perpetuity which is entirely unsuitable for a bank. If the interest is also rescheduled or the loan is refinanced by making a new loan to the borrower to enable him to pay the interest, any value of the loan would consist in the hope that the situation may change. On the strength of that hope would depend the percentage of the loan that should be reserved against.

Unless appropriate provision is made against nonperforming sovereign loans, the balance sheet picture they present may be excessively favorable. Thus, sovereign loans would be favored with respect to commercial and country-risk loans, where nonperformance would have to be recognized on the books. The time period within which that would have to happen usually is relatively short and is firmly embodied in accounting and regulatory practice. Consequently, loss statistics comparing domestic and international loan experience, which broadly, if not exactly, will parallel the commercial/sovereign categories can be misleading.
Treatment of Weak Sovereign Loans

Several aspects of sovereign lending that relate to the foregoing propositions may be mentioned. First, one might suppose that given the clearly distinguishing characteristics of sovereign lending, regulators around the world would have arrived at some more or less standard treatment of nonperforming sovereign loans. That, so far as I know, is not the case. Regulators, as well as banks themselves, follow a variety of approaches. Most of them do seem to have the common denominator of not penalizing substandard sovereign loans or at most doing so very mildly. In this respect, regulatory practice seems to have followed that of bank auditors and accountants, which also has been very lenient.

Second, bank response to perceived weakness of particular LDC loans has varied greatly across countries and even within particular countries. Depending on the seriousness of a case, banks often have either taken no action at all, or may have added to their general loan-loss reserves without allocating any part thereof to the particular weak loan. In some cases, a partial allocation of reserves against particular loans seems to have been made. Occasionally, a bank may reduce its commitment by putting a loan in nonaccrual status even while some interest payments are still coming through and applying receipts from whatever source to the principal of the loan.

Third, banks seem to be skeptical of a differential treatment of domestic and foreign loans or of commercial and sovereign loans. On the part of regulators likewise, legal and accounting considerations seem to create difficulties for such a distinction. There is a concern that any treatment of sovereign loans to take into account their special character might have to be applied also to domestic loans and commercial loans generally. Equality
of treatment between the various categories of loans, however, implies in effect a more favorable treatment of sovereign loans than appropriate, as has already been noted.

Fourth, the tax system interacts with the treatment of sovereign loans. This treatment moreover varies among countries. In the United States, loan loss reserves can be established and deducted from taxable income up to a percentage fixed by law, which at present is 1% of "eligible" loans. The law was changed in 1969 by downgrading the relatively favorable treatment that had been carried over from the depression of the 1930's and which allowed a cumulative loan-loss reserve of 2.4% of eligible loans to be set aside on a sliding scale over the years until in 1987 banks would be on a loss-experience basis. Most banks in fact are close to their permissible maximum. General provision against nonperforming or otherwise weak loans therefore would not be deductible to them in the absence of a demonstrable loss. In the nature of sovereign loans such a loss is hard to demonstrate to the satisfaction of the tax authorities even in the case of nonperformance, let alone prospective nonperformance. A firmer regulatory definition of appropriate accounting for weak sovereign loans might help with regard to tax deductibility.

Fifth, the differential international treatment of weak sovereign loans may put banks of different countries at odds with each other. The same could happen to banks in the same country that had voluntarily adopted different reserving practices. In rescheduling negotiations, problems may arise from such differences in banks' positions, with banks that have taken writeoffs being in a position to take a harder line with the borrower than banks that have not and may be reluctant to take writeoffs.
Sixth, there may be room for international coordination of regulatory practices with respect to the treatment of weak sovereign loans. In other countries, just as in the United States, regulators are re-examining their practices under the pressure of a mounting recognition that sovereign loans may present hitherto unexpected problems. It is to be hoped that treatment of these loans may become an occasion for greater coordinating of national banking regulation than has been the practice in the past.