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INTERNATIONAL COMMERCIAL BANKING FROM A CENTRAL BANK VIEWPOINT

Remarks by

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

at the Annual Meetings of the

Allied Social Science Associations

San Francisco, California

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The international debt situation is moving from the crisis phase to the adjustment phase. A number of major borrowers have IMF programs in place; some new bank money has been made available; some reschedulings completed. The International Monetary Fund is receiving additional resources. Obviously, the dangers of the situation have not been fully overcome. We are not yet out of the woods. But discernible progress has been made.

In these circumstances, the dimensions of the problem are coming into better view, both in their general outlines and in some particular aspects. The general outlines have been discussed many times both as regards the problems of the borrowing countries and the lending banks.[1/] This paper will be concerned mainly with selected particular aspects and recent developments. It will deal first with matters pertaining to the banks, thereafter others pertaining to borrowing countries.

1/ The present paper deals with a topic on which I have had to write and speak repeatedly, e.g., "Rescheduling as Seen by the Supervisor and the Lender of Last Resort," in Crises in the Economic and Financial Structure, edited by

[footnote continued on page 2]

The Recent IMF Legislation

The IMF legislation, recently passed, carries a number of regulatory provisions of importance for American banks engaged in international lending, of which some 190 are engaged on a scale sufficient to require filing the Country Exposure Report. The federal banking agencies are now in the process of implementing provisions of the legislation that require them to evaluate foreign-country exposure and transfer risk and to establish procedures to assure that these factors are taken into account in evaluating banks' capital adequacy. In combination with a further provision requiring the banking agencies to set minimum levels of capital and giving them detailed powers to enforce capital adequacy guidelines, the legislation offers an opportunity to make more effective the foreign country exposure supervisory system that has been in existence for some time.

The underlying principle of this system has been a good one -- to reduce as far as possible the need to rate the credit quality of particular countries and to focus instead on risk diversification. Concentration of

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1/ [footnote continued from page 1] Paul Wachtel, Lexington Books, 1982; "Financing Developing Countries," The Examiner, Vol. 8, No. 2, Fall 1983; "The World Financial System: Outlook and Prospects -- A Central Banker's Perspective," proceedings of the 1983 meeting of the Western Economic Association, to be published in 1984; "Financing Developing Countries," in proceedings of a conference of the Yale Concilium on International and Area Studies, 1984; "New Approaches to LDC Financing," Harvard International Review, January/February 1984; and "Why Is Net International Investment So Small?" contribution to a festschrift in honor of Wilfried Guth, 1984. To avoid duplication, the present paper at most touches on material covered in these earlier papers and does not deal with some major elements in the international lending picture including the lender-of-last-resort function in an international context, the role of the International Monetary Fund, the evolution and present magnitude of the debt burden, future sources of LDC financing, and others. The paper is, therefore, in the nature of a progress report.

lending to a particular country implies a risk quite aside from the credit standing of the country. But while examiner comments have made management and boards of directors more conscious of country concentrations, the system has had no further explicit supervisory penalty. Therefore, it has not necessarily affected bank lending policy. A stronger measure is one calling for banks to add to capital in amounts bearing some relation to their very large country exposures, as required by the new legislation. Requiring larger capital ratios of banks with high concentrations has the same effect as establishing a reserve. Unlike some forms of provisioning, however, it does not affect earnings, nor does it generate a tax deduction.

Capital ratios are, to be sure, a very blunt supervisory instrument. Based on total assets, they fail to differentiate among degrees of risk. However, to the extent that the structure of bank assets and liabilities is roughly comparable across banks, uniformity of capital ratios need not be a matter of great concern. Furthermore, differentiating these capital requirements with respect to foreign lending risk, in which banks do differ greatly, provides a possibility of appropriate adjustment. The capital-asset ratios that the bank regulators recently put in place made no provision for differentiation, except by asset-size categories. The new law provides for some flexibility in light of the particular circumstances of each institution.

A second provision in the IMF legislation does call for the establishment of special reserves. These are required whenever the quality of an institution's assets has been impaired by "a protracted inability of public or private borrowers in a foreign country to make payments on their external indebtedness" or when "no definite prospects exist for the orderly restoration of debt service." These reserves would not become part of a bank's capital for capital-adequacy purposes, unlike traditional loan-loss reserves. Earnings, of course, would be reduced by the new reserves. The bank supervisory agencies this month published a joint policy statement that describes changes being made to examination categories for banks adversely affected by transfer risk problems. The statement also gives banks notice of the agencies' plans for implementing the special reserves provision. Final regulations are expected to be adopted in January 1984.

The House version of the legislation would have subjected to special reserves all loans rescheduled or likely to be rescheduled. That provision not only would have affected a very wide range of loans but also would have been at odds with the intent of rescheduling, which is to make the loan a better asset. By contrast, the final legislation's reference to "orderly restoration of debt service" suggests that the country's decision to institute an IMF program when its debt is not being serviced punctually may play a role in determining the need to establish special reserves. Accordingly, the supervisory agencies intend to take account of such a decision and of subsequent compliance with an IMF program in classifying loans and requiring special reserves.

The accounting treatment of fees on international loans is to be modified. Fees are to be amortized over the life of the loan (unless the fee is limited to the administrative costs of the rescheduling). Economically speaking, fees in excess of specific expenses that must be reimbursed are the equivalent of interest. Charging a high fee makes it possible to hold down the spread over LIBOR or prime, giving a better appearance to the borrower's credit standing. Banks until now were able to bolster their current year's earnings by taking fees into current-year income. A suspicion has existed that such use of fees, and the rewards to loan officers associated therewith, have encouraged an undesirable eagerness to lend. The requirement for fee spreading contrasts with a provision in the House bill that would have prohibited the charging of any restructuring fees exceeding the administrative cost of restructuring.

Disclosure requirements are tightened up by the legislation. Disclosure requirements are already in place for publicly owned bank holding companies coming under the jurisdiction of the SEC, which comprise a large part of international lending activity. Such bank holding companies must disclose detailed information on all exposures exceeding one percent of total assets and the names of countries where exposure is .75 percent to 1 percent of assets, regardless of the status of debt service. The new legislation requires the banking agencies also to disclose to the public "material foreign-country exposure," this information to be collected quarterly instead of semi-annually as to date.

Finally, the banking agencies are directed to consult with supervisory authorities of other countries to coordinate and improve international lending supervision. International coordination of bank supervision is increasingly important, of course, in a period when banks of many countries make loans to the same borrower. The quality of each bank's loans is affected by debt incurred subsequently from other sources. At a minimum, therefore, full information is required, with assurance that all banks are subject to prudential supervision and regulation. The purpose of the Basel Concordat of 1975 is to ensure this coverage. The fact of supervision, to be sure, does not guarantee the quality of it. Nor does it ensure the success of national supervisors in preventing practices that are illegal or, if legal, nevertheless not prudent.

Bank legislation differs all over the world. It is far from uniform even in our own country. Bank legislation is difficult to change because the fact of regulation tends to generate special interests that resist change. Furthermore, many of the differences that distinguish national banking systems go far beyond the area of banking. Banks operate in a framework of national laws and conventions unique to their particular countries. These could not be changed readily even if the powers dealing with banking, public and private, were so minded. International bank regulation also bears on the competitive position of banks. High capital requirements, for instance, can adversely affect the position of banks of a particular country. Lower requirements reduce the return on assets needed to support capital.

Comparison of the capital positions of banks in different countries is extremely difficult. In some countries, banks are allowed to establish hidden reserves, by writing down particular assets or carrying others below market value. In the United States, hidden reserves are not permitted. On the other hand, no writing down of assets to market or implicit market value is required in the United States. American banks, therefore, can have hidden losses, although depreciation of the bond portfolio must be disclosed. Unrealized appreciation and hence hidden reserves on real estate used for bank operations are possible. In many countries, banks long have been able to avoid consolidating foreign and certain domestic subsidiaries, although this practice is beginning to change. While this does not lead to misstatement of capital, it leads to failure to disclose full exposure and to an understatement of potential liabilities. In the United States, consolidation has long been mandatory. One of the main areas of progress in harmonizing international bank regulation has been and probably will continue to be consolidation.

In evaluating the provisions of the new legislation in the aggregate, it seems fair to say that a reasonable balance has been struck between tightening up on bank and supervisory practices and facilitating the needed continuance of international lending. Both the micro and the macro functions of the system thus receive consideration. Individual banks are strengthened, and the opportunity for continued international flows is preserved.

On the other hand, the history of the passage of this legislation through the Congress is bound to create deep concern for those interested in the international financial role of the United States. It is difficult to read this episode in any sense other than indicating a reduced willingness of the American public to take an internationalist position in financial and economic affairs. The legislation passed only with great efforts, many compromises, and quite narrowly. It was loaded down with a large number of provisions reflecting both domestic and international political concerns. Provisions that might have affected the smooth functioning of the international financial institutions were barely avoided. Why, one must ask, is this happening at a time when the United States economy is becoming increasingly open and interdependent with the rest of the world? We were more internationally oriented when our foreign sector was of the order of two to three percent of

GNP, as in the period following the creation of the Bretton Woods institutions, than we are now when it has passed 10 percent.

Perhaps these difficulties could have been reduced had the legislation been presented in a different context and argued on less dramatic grounds. This eighth IMF quota increase occurred at a time of difficulties for developing countries and potentially for their creditors. Perhaps inevitably this made crisis management the primary argument for the U.S. contribution. But, at the same time, this was a routine updating of the resources of the International Monetary Fund, such as had occurred at regular five-year intervals, with a couple of exceptions, since the founding of the institution. For the United States to remain a member in good standing in an institution which it had itself created and in which it still plays a leading role would seem to be a persuasive argument. That the legislation preserved this U.S. role transcends in importance any other aspects. But what the legislation does to keep U.S. banks playing their international role while putting the banks on a stronger footing is also important.

The Banks and Their Stockholders

The view that continued international lending is important may not be shared by all the banks that so far have participated. In the course of the efforts to put together the Mexican and Brazilian loan packages, it became apparent that many of the participants in earlier loans wanted to get out of the game. Many of these banks may have considered it in the interest of their stockholders to do so. They may have felt that it was contrary to the principle of profit maximization to take on the risk of additional LDC loans.

The attitude is understandable, but, in a very real sense, this specific episode raises a question about what is to be maximized. Most bank stockholders, after all, are holders not just of a particular bank stock but rather of a diversified portfolio. It is in the maximization of the value of that portfolio, and of the profits underlying it, that they are interested. What does that say about the appropriate behavior of the component parts of that portfolio? That question arises pointedly in the case of a bank contemplating withdrawal from international lending. With the knowledge that this is likely to weaken in some degree banks and other internationally oriented businesses, would not the diversified stockholder prefer the bank, which represents only a small part of his holdings, to incur a greater risk if that benefits the rest of the portfolio? Would the investor not want to instruct management to that effect, even though management probably is more concerned with the success of the single institution?

I doubt that such speculations, however interesting to an economic theorist, would make much of an impression on the banker. They may, however, have some validity with respect to the concerns of legislators and bank supervisors concerned about the appropriateness of continued bank participation in LDC lending. This concern has often been expressed in terms of "the broader picture," and "the national interest." That leaves the implication that these broader objectives may be at odds with the interest of the stockholder of a bank, for whose benefit presumably maximization occurs. The argument here presented suggests that continued participation may also be in the stockholder's interest.

Insurance of LDC Loans

If acceptance of a somewhat higher risk seems appropriate for individual banks in the broader interest of the economy and of its own stockholders, consideration of risk also raises the question whether risk to individual banks could not be reduced by insurance. Various proposals have been made for the insurance of LDC loans. The techniques have rarely been spelled out.

Upon closer examination, it becomes readily apparent that, in an economic sense, most credit is "insured." There are formal insurance arrangements, each appropriate to the particular circumstances of the credit, for mortgages, for bank deposits, for municipal bonds, for export credits, for installment loans to individuals in the event that they die or suffer disabling accidents, and so on. There is implicit self-insurance undertaken by lenders who charge a risk premium as part of the interest rate and set aside reserves. Such lenders are aware that their receipts from lending must cover more or less predictable losses in addition to covering their profits and the cost of money.

There is a difference, of course, between pooled insurance and self-insurance. Pooled insurance, where it is possible, clearly is cheaper because it allows for better spreading of risks. Thus, the applicability of the insurance concept is very wide. The only question is whether it can be made to apply also to the risk of LDC lending and, if so, why the market has not already generated some kind of insurance scheme.

Transfer risk, and especially sovereign transfer risk, is hard to evaluate. The initial attitude of the lenders was that risk of loss was very small, since the borrower could not go out of existence. A credit nevertheless could diminish in value, as indicated by market quotations for various LDC bonds whose issuers had transfer problems. For a bank, moreover, what matters primarily, at least in the short run, is not the danger of ultimate nonrepayment, but the reduction in income while a loan is in nonaccrual status. Typically, this occurs when interest is 90 days past due.

For a not untypical bank with capital equal to, say, five percent of assets, pre-tax profits of 15 percent of capital, and a gross interest return on (performing) assets of 12 percent, nonreceipt of income on 6-1/4 percent of the assets wipes out profits, in the absence of a tax cushion or other mitigating factors such as substantial noninterest income. With non-oil LDC loans plus loans to Eastern Europe and troubled OPEC countries exceeding 10 percent of assets for the nine largest U.S. banks, income clearly is a very important consideration. But, to calculate an appropriate insurance premium for this type of risk, let alone gather together the resources that would make the insurance credible, would not be an easy task. In addition, there is, of course, no strong reason to believe that banks would necessarily prefer a collective insurance scheme to their present method of self-insurance via spreads that, over the life of a loan, provide a degree of protection. What can be said is that the protection derived from spreads well below one percent, such as used to prevail in the late 1970's and the beginning of the 1980's, did not provide much insurance. Efforts to put in place a credible insurance scheme, if successful, would, therefore, be well worthwhile.

The Borrowers' Side

After this review of a range of current developments affecting banks, as seen by a central banker, the focus of this paper now shifts to the borrowing countries. A central banker's perspective should embrace a macro framework, and an extended period of time. In this perspective, many developing countries now seem to be entering or to have already entered upon a new phase in their international borrowing. There is every reason to believe that developing countries' debt will continue to increase, with occasional interruptions. The question "How are all those countries going to pay back all that money?" will not be a realistic one for many years, if ever. If debt service is punctual, continued growth of debt is highly likely. But, in the present new phase, the novel element may well be that net new borrowing falls short of interest payments. That means that the countries in this situation will have to generate a trade surplus to cover the remainder of the interest together with the net balance, normally adverse, of other invisibles. Many countries indeed have already had such trade surpluses, sometimes admittedly as a result of a drastic shrinkage of imports.

Assuming that this trend were to continue, it could reflect one of two underlying conditions. One possibility is that the interest rate exceeds the growth rate of GNP or exports. If that situation were to prevail continuously, and if the country were to borrow at least as much as its interest payments, the debt eventually would rise without limit relative to GNP or exports. Since markets are not likely to permit this, the country would have to limit its borrowing to less than the interest it pays. To pay the remainder of the interest, it would have to generate an export surplus. An interest rate exceeding the growth rate, therefore, could be one explanation of emerging trade surpluses.

The other possible though probably less likely explanation is that the country has been moving forward in the life cycle through which have passed many international borrowers that eventually became creditors. In order to end up as a creditor country, the borrowing country first must develop a trade surplus, which leaves its debt still growing, although at a diminishing rate. Later, the country develops a current-account surplus, i.e., becomes a net exporter of capital, at which point its international liabilities (including equity and direct investment) of course still exceed its assets but by a diminishing margin. Eventually, with the current account always in surplus, foreign assets begin to exceed liabilities and the country becomes a net creditor.

We need not pursue the further stages by which a net creditor, always exporting capital, can develop a trade deficit as its investment income becomes large enough to cover both capital exports and a trade deficit. It may seem fanciful to contemplate the possibility that today's newly industrializing countries, which have been heavy borrowers, should already be embarked on this road. Nevertheless, a trade surplus is, of course, the first milestone on that road. Accumulation of foreign assets might be another piece of evidence. There has indeed been a substantial accumulation of foreign assets, as indicated by the fact that for many countries net borrowings until recently exceeded the current-account deficit plus reserve accumulation. Evidently, there must have been capital outflows but these outflows for the most part took the form of capital flight. They are, therefore, not easily traceable, and they do the home country little good in the way of returning income, foreign exchange, and tax revenues even though they constitute a form of foreign investment. Thus, conceivably a gradual movement of some LDCs along the road to eventual net capital exporter status may be on its way. That would be consistent with the appearance of trade surpluses. The further evolution of the country's international position would, of course, be quite uncertain.

Given such a pattern, a country's gross international liabilities nevertheless need not diminish. Indeed, they would almost certainly continue to rise. It is normal and appropriate for a growing organization, whether a corporation or a country, to increase its debt. As the firm or economy grows, so does debt capacity. What is important is that debt remain in appropriate relationship to ability to service. But, as the debt grows, a country may also find itself accumulating foreign assets.

Trade surpluses do not imply that the country has ceased to receive net resource transfers from abroad, or indeed is making net transfers to the rest of the world. Shipments of merchandise are not the only resources being transferred. Services, including the services of foreign capital, also imply a real resource transfer. To treat only the net movements of goods, or of goods and services excluding interest and dividends, as resource transfers would imply, for instance, that a creditor country with a current-account surplus and a trade deficit, which is the normal condition of a mature creditor, would have to be regarded as receiving net resource transfers instead of making them. In treating interest as a payment for services, of course, care must be taken to separate the real interest component from the inflation premium inherent in most nominal interest payments. The latter is a repayment of principal, not a payment for a service, even though the capital account does not treat it that way.

Trade surpluses on the part of developing countries are only one of several reasons why today there is much comment to the effect that LDC debt is unmanageable. The seeming magnitude of the debts, and the difficulties of the adjustment process, are cited even more frequently. I believe that the debts of the major borrowing countries are manageable, in the sense that recent debt-service difficulties represent liquidity rather than solvency problems. For that reason, I do not regard as appropriate the various schemes for debt relief, buy-out of bank-held debt at a discount by some public agency, and similar devices. Certainly, central banks could not take over any part of these assets from banks, which would mean substituting LDC credit for domestic resources as backing for their currencies.

Reschedulings of debt are a different matter. They occur in both the domestic and the international field, and are a familiar fact of financial life. In some recent reschedulings, high spreads have been applied, representing a new burden that surely is not helpful to the future undisturbed service of the debt. In any event, LIBOR and prime themselves contain a large inflation premium which really represents repayment of principal. This is recognized in an approach that seems to have intrigued some analysts, although personally I do not recommend it, which places the loan, in effect, on a real-interest basis. This would be analogous to real-interest-rate mortgages, with which some lenders have been experimenting. The borrower would pay an interest rate reflecting the real rate. The difference between that real rate and the nominal interest rate on the debt would be capitalized and added to the principal of the debt. These add-ups would bear interest immediately and would thus not have to be discounted to maturity.

One may wonder about the accounting treatment of such loans. However, I am told that if there is good prospect that the loan will ultimately be repaid, taking rolled-up interest into income may be acceptable. The procedure may provide an economically meaningful form of rescheduling in times of inflation. I cannot say more for it than that. There are no universally applicable plans for rescheduling.

In conclusion, I would like to remind you of a historical record of international transfers. During the 1920's, when German reparations and inter-Allied war debts, together with new German short-term indebtedness, were laboriously kept afloat, an argument went on about the viability of these debts. Keynes argued that they were not sustainable. Ohlin took the opposite view. The collapse of the 1930's seemed to prove Keynes right.

From this experience, the post-World-War-II planners concluded that international debt ought to be minimized. They did not burden Germany with heavy obligations. But, in the expansive climate of the post-World-War-II period, Germany recorded a string of surpluses for almost 30 uninterrupted years. Very sizable transfers would have been possible had they been demanded. Ohlin proved right in the end.

The same opportunities exist today. Large international payments need not be unmanageable, in a world environment of expansion, free payments, and diminishing protectionism. These elements were lacking during much of the 1920's and during all of the 1930's. Given their presence, the debts of developing countries should prove quite manageable.

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