

FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 83-155
December 30, 1983

REGULATION K

INTERNATIONAL BANKING OPERATIONS

(Proposed Amendments)

TO ALL STATE MEMBER BANKS,
EDGE AND AGREEMENT CORPORATIONS,
BANK HOLDING COMPANIES,
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

The Board of Governors of the Federal Reserve System is proposing to amend its Regulation K in order to implement a section of the International Lending Supervision Act of 1983 requiring banking organizations to maintain special reserves against certain foreign loans or other foreign assets. The Board welcomes comments on this proposal; written comments should be directed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C., 20551. Comments should refer to Docket No. R-0498 and must be received by January 11, 1984.

Attached is a copy of the Board's press release and the material as submitted to the Federal Register. Questions regarding the material contained in this circular should be directed to Nancy P. Jacklin, (202) 452-3428, Kathleen O'Day, (202) 452-3786, or Michael G. Martinson, (202) 452-3621, at the Board of Governors, or to the Legal Department, Extension 6171.

Additional copies of this circular will be furnished upon request to the Public Affairs Department, Extension 6289.

Sincerely yours,



William H. Wallace
First Vice President

FEDERAL RESERVE press release



For immediate release

December 23, 1983

The Federal Reserve Board today requested public comment on rules proposed to implement a section of the International Lending Supervision Act of 1983 requiring banking organizations to maintain special reserves against certain foreign loans or other foreign assets.

The Board requested comment by January 11, 1984, and intends to issue final regulations by January 31, 1984.

The reserves would be required for those assets the quality of which has been impaired, in the judgment of the federal banking agencies, by a protracted inability of public or private borrowers in a foreign country to make payments on their external indebtedness or where no definite prospects exist for orderly restoration of debt service.

The proposal is one facet of a joint program by the federal bank regulators to strengthen, under the new law, the supervision and regulation of foreign lending by U.S. banking organizations.

The Board's proposal is the same as proposals being made by the other federal bank supervisors (the Office of the Comptroller of the Currency, with respect to national banks and the Federal Deposit Insurance Corporation, with respect to state-chartered banks that are not members of the Federal Reserve System). The Board's proposals would apply to state-chartered member banks, Edge and Agreement Corporations, bank holding companies and their nonbank subsidiaries. The federal banking agencies are considering, as directed by the Act, the extent and manner in which to apply provisions of the Act to the United States banking offices of foreign banks, and the agencies request comment on this issue.

Further rules as necessary to implement provisions of the Act other than Section 905(a), dealt with in the present proposals, will be issued separately.

As detailed in the attached notice, the draft regulations address four aspects of implementation of Section 905(a) of the Act.

1. The establishment of special reserves and the amounts of such reserves.
2. Procedures the federal bank regulators will follow in determining: the assets that will be subject to reserves, initial amounts of the special reserves, and the subsequent increases in or reductions of the reserves.
3. The criteria the agencies will use in making these determinations.
4. Accounting procedures applicable to the special reserves, including a requirement that the reserves be established as a charge against current income and not be counted as capital and surplus. The proposals, which track the Act closely, also give banking institutions the option of writing off amounts of their assets equivalent to the required reserves.

The agencies particularly requested comment on:

- The proposed percentage norms of special reserves.
- Factors to be used in determining the amount of the reserves.
- What international assets will be subject to the special reserves, including the treatment of new loans to borrowers in countries where comparable outstanding loans are subject to the special reserves.
- Technical comment on the accounting provisions of the proposed regulations.

FEDERAL RESERVE SYSTEM

REGULATION K

[12 CFR PART 211]

[Docket No. R-0498]

INTERNATIONAL BANKING OPERATIONS

International Lending Supervision

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of proposed rulemaking.

SUMMARY: This proposal would require banking institutions to establish special reserves against the risks presented in certain international assets. In particular, it is intended to require banking institutions to recognize uniformly the risk and diminished value of international assets which have not been serviced over a protracted period of time. This proposal would implement one aspect of the joint program of the Federal banking agencies (Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation) to strengthen the supervisory and regulatory framework relating to foreign lending by U.S. banks, incorporated in section 905(a) of the International Lending Supervision Act of 1983.

It is important that this provision of law be implemented expeditiously so that banking institutions, in the

process of preparing financial statements, will have timely information on the reserves to be required by the agencies pursuant to section 905(a). Accordingly, it is the intention of the agencies that final regulations be adopted no later than January 31, 1984.

Further regulations implementing other provisions of the International Lending Supervision Act of 1983 will be issued separately.

DATE: Written comments must be submitted on or before January 11, 1984.

ADDRESS: All comments, which should refer to Docket No. R-0498, should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, or delivered to Room B-2223, 20th and Constitution Ave., N.W., Washington, D.C. between the hours of 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m. weekdays.

FOR FURTHER INFORMATION CONTACT: Nancy P. Jacklin, Assistant General Counsel (202/452-3428); Kathleen O'Day, Senior Counsel, Legal Division (202/452-3786); or Michael G. Martinson, Projects Manager, International Activities, Division of Banking Supervision and Regulation (202/452-3621).

SUPPLEMENTARY INFORMATION:

Purpose

The purpose of this proposal is to establish uniform requirements for banking institutions to provide against the

risks presented in certain international assets by establishing a special reserve for such assets out of current income.

Background

As part of the review of their procedures for supervising "transfer risk" in U.S. banking institutions (the possibility that an asset cannot be serviced in the currency of payment because of a lack of foreign exchange needed for payment in the country of the obligor), the Federal banking agencies have examined the methods used by banking institutions to account for credits to governments or others in countries with severe and protracted external payments problems. In the opinion of the agencies, present bank procedures do not always reflect the reduced quality of these credits and do not account for them uniformly.

Under current procedures, banks are required to review their assets, domestic and foreign, to determine whether they should be written down or whether additional provisions should be made to the allowance for possible loan losses. This traditional commercial credit process has not worked well for assets that have been adversely affected due to transfer risk. For example, private sector borrowers may be capable of honoring debt service obligations, but may be prevented from doing so by governmental restrictions on the availability and uses of foreign exchange.

Transfer risk problems can seriously impair the liquidity and earning power of an asset. Indeed, to the extent interest has not been paid, that, by itself diminishes the value of the underlying asset. The Federal banking agencies believe that when assets have not performed according to their terms over a protracted period of time due to a country's inability to generate or unwillingness to provide the necessary foreign exchange, the net carrying value of the affected assets should be reduced in a banking institution's financial statement through charges to earnings and balance sheet provisions.

Section 905(a) of the International Lending Supervision Act of 1983 (Title IX, Pub. L. 98-181)("the Act") provides that the appropriate Federal banking agency -- the Board of Governors of the Federal Reserve System in the case of State member banks, bank holding companies, nonbank subsidiaries of a bank holding company, Edge Corporations, and Agreement Corporations -- shall require banking institutions to establish and maintain a special reserve whenever, in the agency's judgment, (1) the quality of the banking 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, as indicated by such factors, among others, as:

- (i) a failure by such public or private borrowers to make full interest payments on external indebtedness;

- (ii) a failure to comply with the terms of any restructured indebtedness; or
 - (iii) a failure by the foreign country to comply with any International Monetary Fund or other suitable adjustment program; or
- (2) no definite prospect exists for the orderly restoration of debt service.

The Act requires that such reserves be charged against current income and not be considered as part of capital and surplus or allowances for possible loan losses. The Federal banking agencies are required to promulgate regulations necessary to implement this section on or before March 29, 1984.

Proposal

The agencies propose to require banking institutions to establish "Allocated Transfer Risk Reserves" (ATRR) against assets that are found to be impaired by the transfer risk problems described above. In the alternative, a banking institution would have the option to write down all or part of the assets that are subject to the special reserves and, consequently, reduce the amount of ATRR balances that would otherwise be required. If that option is selected, the allowance for possible loan losses must be replenished out of current earnings by the amount written down.

International assets subject to the reserve may include loans or other extensions of credit, debt securities,

deposit arrangements, or similar claims. A representative listing of the types of assets which may be reservable is contained in the agencies' joint "Instructions for Preparing Country Exposure Report" (Form FFIEC No. 009, provided to banking institutions and available to the public upon request to any of the Federal banking agencies). International assets are those included in banking institutions' Country Exposure Reports and may be liabilities of foreign governments or their agencies and instrumentalities of foreign corporations, banks or individuals.

A determination that severe transfer risk problems exist would be based on the Federal banking agencies' application of the general criteria contained in section 905(a) of the International Lending Supervision Act. Applying such criteria, the Federal banking agencies will jointly determine which international assets will be subject to the reserve and the amount and timing of the reserve for specified assets. As prescribed by section 905, each agency will implement these determinations with respect to the banking institutions for which it is the appropriate Federal banking agency.

Banking institutions will be notified of the percentage amount of reserve required for specified assets. The first year's required reserve normally will be 10 percent of the principal amount of the asset but it may be lower or higher. In view of the fact that some countries already have

exhibited debt service problems over a number of years, the initial reserves established upon implementation may be substantially higher than 10 percent. Additional reserves may be required in subsequent years, generally in increments of 15 percent of the principal amount of the asset. The specific amount and timing of the reserve would vary by country and may also vary by the type of asset. The percentage reserve for specified assets would be uniform for all banking institutions.

Banking institutions must establish the reserve out of current income. The ATRR cannot be considered part of capital and surplus or allowances for possible loan losses. If the agencies determine that the transfer risk problems affecting an asset have decreased to the extent that the reserve is no longer necessary, banking institutions will be notified that the reserve may be reduced.

As required by section 905, the rules for the establishment and maintenance of the ATRR by banking institutions would apply for all federal regulatory, supervisory, and disclosure purposes, including disclosure under the federal banking and securities laws.

Comments are specifically requested on: (1) the percentage norms for the reserve; (2) the factors to be used in determining the amount of reserves; and (3) the appropriate treatment of new loans where comparable outstanding loans are subject to reserves required by this regulation. The Federal

banking agencies also are considering the extent to and manner in which to apply this and other provisions of the Act to U.S. branches and agencies, and commercial lending company subsidiaries, of foreign banks. Comments are invited on these questions.

Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 96-354, 5 U.S.C. 601 et seq.) the Board of Governors of the Federal Reserve System has certified that the proposed regulation, if adopted, will not have a significant economic impact on a substantial number of small entities since small banks generally do not hold international assets which would be affected by this regulation.

Executive Order 12291

The Board of Governors of the Federal Reserve System has determined that the proposed regulation does not constitute a "major rule" and therefore does not require a regulatory impact analysis.

List of Subjects in 12 CFR Part 211

Banks, banking; Federal Reserve System; Foreign banking; Investments; Reporting requirements; Export trading companies; Allocated transfer risk reserve.

Pursuant to its authority under sections 9, 25 and 25(a) of the Federal Reserve Act (12 U.S.C. 221 et seq., 601-604a, and 611 et seq.), section 5 of the Bank Holding

Company Act (12 U.S.C. section 1844), and sections 905 and 910 of the International Lending Supervision Act of 1983 (Pub. L. 98-181, Title IX), the Board proposes to amend 12 CFR Part 211 as follows:

1. By adding a new Subpart D as follows:

PART 211

INTERNATIONAL BANKING OPERATIONS

Subpart A * * *

Subpart B * * *

Subpart C * * *

Subpart D - International Lending Supervision

Sec.

211.41 - Authority, purpose and scope

211.42 - Definitions

211.43 - Requirements

211.44 - Procedures

211.45 - Standards for Requiring an Allocated Transfer Risk Reserve

211.46 - Accounting treatment of Allocated Transfer Risk Reserve

AUTHORITY: Federal Reserve Act (12 U.S.C. 221 et seq.); Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 et seq.); the International Banking Act of 1978 (Pub. L. 95-369; 92 Stat. 607; 12 U.S.C. 3101 et seq.); the Bank Export Services Act (Title II, Pub. L. 97-290, 96 Stat. 1235); and the International Lending Supervision Act of 1983 (Title IX, Pub. L. 98-181, 97 Stat. 1153).

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SUBPART D - INTERNATIONAL LENDING SUPERVISION

SECTION 211.41 - AUTHORITY, PURPOSE AND SCOPE

(a) Authority. This part is issued by the Board of Governors of the Federal Reserve System under the authority of the International Lending Supervision Act of 1983 (Pub. L. 98-181, Title IX 97 Stat. 1153) ("International Lending Supervision Act"); the Federal Reserve Act (12 U.S.C. 221 et seq.) ("FRA"), and the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 et seq.) ("BHC Act").

(b) Purpose and scope. This part is issued in furtherance of the purposes of the International Lending Supervision Act, the FRA, and the BHC Act. It applies to State banks that are members of the Federal Reserve System ("State member banks"); corporations organized under section 25(a) of the FRA (12 U.S.C. 611-631) ("Edge Corporations"); corporations operating subject to an agreement with the Board under section 25 of the FRA (12 U.S.C. 601-604a) ("Agreement Corporations"); and bank holding companies (as defined in section 2 of the BHC Act 12 U.S.C. § 1841(a)) and their subsidiaries other than bank subsidiaries, but not including a bank holding company that is a foreign banking organization as that term is defined in 12 C.F.R. 211.23(a)(2).

SECTION 211.42 - DEFINITIONS

For purposes of this subpart the following definitions shall apply:

(a) "Banking institution" means State member bank; bank holding company; subsidiary of a bank holding company other than a bank and its subsidiaries; Edge Corporation; and Agreement Corporation.

(b) "Federal banking agencies" means the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

(c) "International assets" means those assets included in banking institutions' "Country Exposure Report Forms" (FFIEC No. 009) as such forms may be revised from time to time.

(d) "Subsidiary" means any organization 25 percent or more of whose voting shares is directly or indirectly owned, controlled or held with power to vote by a banking institution, or which is otherwise controlled or capable of being controlled by a banking institution.

SECTION 211.43 - REQUIREMENTS

(a) Establishment of reserve. A banking institution shall establish an Allocated Transfer Risk Reserve (ATRR) for specified international assets when required by the Board after the Federal banking agencies determine that such a reserve is necessary.

(b) Amount of reserves.

(1) Initial provisions. The initial year's provision for the ATRR shall be ten percent of the principal amount of the specified international assets, or such greater

or lesser percentage, required by the Board after determination by the Federal banking agencies.

(2) Subsequent provisions. Additional provision for the ATRR in subsequent years shall be 15 percent of the principal amount of the specified international assets, or such greater or lesser percentage, required by the Board after determination by the Federal banking agencies.

SECTION 211.44 - PROCEDURES

(a) At least annually, the federal banking agencies shall jointly determine which international assets should be subject to the ATRR and the amount and timing of the ATRR for specified assets based on the standards in section 211.45. Applying the same standards, they shall also determine whether an ATRR no longer is required for specified assets and may be reduced under section 211.46.

(b) Banking institutions holding assets subject to the ATRR will be notified by the Board of the amount and timing of the ATRR to be established for each such asset and whether the ATRR for a specified asset may be reduced.

SECTION 211.45 - STANDARDS FOR REQUIRING AN

ALLOCATED TRANSFER RISK RESERVE

(a) Assets requiring an ATRR. In determining whether an ATRR is warranted for particular international assets the following criteria shall be applied:

(1) whether the quality of a banking institution's assets has been impaired by a

protracted inability of public or private obligors in a foreign country to make payments on external indebtedness as indicated by such factors, among others, as:

- (i) whether an obligor has failed to make full interest payments on external indebtedness;
 - (ii) whether an obligor has failed to comply with the terms of any restructured indebtedness; or
 - (iii) whether a foreign country has failed to comply with any International Monetary Fund or other suitable adjustment program; or
- (2) whether no definite prospects exist for the orderly restoration of debt service.

(b) Amount of ATRR. The amount of ATRR shall be determined based upon the length of time the asset quality has been impaired, recent actions taken to restore debt service capability, future prospects for restored asset quality, or such other factors as the Federal banking agencies may consider relevant to the quality of the asset.

SECTION 211.46 - ACCOUNTING TREATMENT OF ALLOCATED
TRANSFER RISK RESERVE

(a) The ATRR shall be established by a charge to current income.

(b) The ATRR is to be accounted for separately from the General Allowance for Possible Loan Losses, and is to be deducted from "gross loans" to arrive at "net loans."

(c) The ATRR shall not be included in the banking institution's capital or surplus.

(d) No ATRR provisions are required if the banking institution writes down the assets in the requisite amount but, in that event, the General Allowance for Possible Loan Losses must be replenished out of current earnings by the amount written down.

(e) The ATRR may be reduced by a banking institution when notified by the Board.

2. By transferring 211.601 and 211.602 which are currently located at the end of Subpart B, to the end of new Subpart D.

Board of Governors of the Federal Reserve System,
December 22, 1983.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board