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LEGISLATIVE AND ADMINISTRATIVE OBSTACLES TO WRITEDOWNS AND SWAPPING OF LESS DEVELOPED COUNTRY DEBT

STATEMENT OF
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BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY
COMMITTEE ON BANKING, HOUSING AND
URBAN AFFAIRS
UNITED STATES SENATE

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss with you our observations on legislative and administrative obstacles to writedowns and swapping of less developed country (LDC) debt by the U.S. banks. Our work, which began in January, was undertaken for this Subcommittee in response to a request by Chairman Paul S. Sarbanes.

The objectives of our work are twofold: First, to determine what, if any, legislative and administrative provisions may deter U.S. banks from taking such steps as writing down their LDC exposures or swapping out of high concentrations of specific country loans. Our second objective is to explain the accounting standards pertinent to writedowns and swapping, as they play a decisive role in the presentation of LDC debt on bank financial statements.

A writedown, write-off, or charge-off refers to a reduction in the book value of an asset to bring it into agreement with its present or appraised value. For LDC debt, writedowns usually refer to adjusting that portion of debt principal deemed to be uncollectible. The discussion of obstacles to writedowns also includes consideration of impediments to building reserves for loan losses because realized losses on loans are written down against such reserves. It is important to note that a writedown on a financial statement does not per se involve forgiveness of a debtor's obligation to repay debt. Banks can be mandated to writedown LDC debt on their books, but they cannot be required to grant debt forgiveness.

Our analysis is based on a review of relevant documents and interviews conducted with officials of the Federal Reserve System, Office of Comptroller of the Currency, Federal Deposit Insurance Corporation, Department of the Treasury, the Internal Revenue Service, American Institute of Certified Public Accountants, Financial Accounting Standards Board, and bank executives, economists, attorneys, security analysts and trade association representatives.

BACKGROUND

When the LDC debt crisis erupted in 1982, the immediate objective of the United States was to avert widespread financial collapse. As the initial crisis passed, creditors, debtors, and the International Monetary Fund (IMF) began a process of protracted restructuring negotiations. The combination of restructuring existing loans, infusions of new funds from commercial banks and multilateral lending institutions, instituting economic reforms under IMF supervision, and world economic growth was expected to lead the LDCs out from under their burden of external debt. Today, after almost five years of painful adjustments, leaders of the major debtor nations are finding it increasingly difficult to ask their citizens to continue to comply with these economic measures. Creditors and debtors alike have been worn down by a situation that appears to have reached a breaking point for all concerned.

Brazil, which only 7 months ago was boasting large trade surpluses and appeared to be making good progress in dealing with its debt burden, recently announced an indefinite suspension of interest payments on the $67 billion owed to private foreign lenders. Ecuador has stopped making payments on its $8 billion debt. And, Peru has placed a unilateral ceiling on the amount of annual debt service payments it will make.

Total developing country debt currently stands at $950 billion, with approximately $380 billion concentrated in Latin America. Of Latin America's $200 billion owed to foreign commercial banks, one third, or approximately $67 billion, is owed to U.S. banks. This debt has become more concentrated in money center banks, that is the nine largest U.S. banks, as regional banks have reduced their LDC exposure significantly. As of the third quarter of 1986, the money center banks held $41 billion in debt from the largest Latin American debtors, while the fifteen largest regional banks held $11 billion. Another change has been a shift by all U.S. banks from holdings of LDC private commercial loans, generally considered by banks to be somewhat more risky, to sovereign or foreign government debt. Since 1983, foreign government debt rose from 38.3 to 56.5 percent of money center bank LDC holdings, while the 15 largest regionals recorded an increase of from 26 to 46 percent.

SUMMARY OF FINDINGS

1) Currently no bank legislative, regulatory, accounting or tax provisions prevent writedowns or the building of loan loss reserves. The legislative and administrative framework accommodates such actions if bank management chooses to writedown or reserve for its LDC debt. However, there are regulatory, accounting and tax provisions which are perceived as disincentives by those with whom we spoke. To the extent these perceptions influence behavior, they may serve as obstacles. Given the subjective nature of perceptions, it is not possible to substantiate the operational impact of our respondents' concerns.

2) Writedowns of debt, per se, have no bearing on the debt burden of the LDCs. Writedowns are made for financial reporting purposes and have generally little effect on the actual obligations of borrowers. Unless a restructuring involves the outright granting of principal or interest rate concessions, there is no reduction in the burden born by the LDCs. The only way that an LDC would benefit is if a loan was sold or swapped in the secondary market and eventually was purchased by the LDC borrower at the reduced price prevailing in the market.

3) According to the bank managers and others with whom we spoke, the primary obstacles to LDC debt writedowns or the building of reserves are the concerns with maintaining the strength of banks' reported earnings and the balance sheets, the possible

effect on bank stock values and the ability to raise capital, the continuing belief in the ultimate collectibility of LDC debt, and fear of sending a message to the LDCs that might weaken U.S. bank negotiating leverage during restructurings.

4) The Tax Reform Act of 1986 requires use of the "specific charge-off" method concerning tax accounting for bad debts by banks with assets of more than $500 million. Some bankers have cited this as a potential disincentive to the early write-off of LDC debt. They fear that individual charge-offs will now be the subject of much greater scrutiny by the Internal Revenue Service(IRS), and therefore, will require much more substantiation of the worthlessness of that portion of the loans written-off. Charge-offs mandated by bank regulators, such as ATRR-related charge-offs, are automatically accepted by the IRS. Voluntary charge-offs, on the other hand, are likely to be subject to close scrutiny unless the bank has a certification of worthlessness from its bank regulator. Banks supervised by the Federal Reserve are able to obtain such certifications, while banks regulated by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation are not.

5) The money center bankers we interviewed cited two impediments to diversification of LDC loan portfolios. Two accounting issues reportedly discourage them from swapping their own LDC debt to improve the overall quality of their portfolios.

Swapping can enable banks to reduce specific concentrations of LDC exposures and is one step banks can take to lower risks posed by the LDC debt problem.

The first accounting concern that allegedly holds banks back from foreign loan swapping is the requirement that assets received in foreign loan swaps be valued at current fair value (CFV). A loss will usually be recorded even when a loan swap results in no change to the real value of a portfolio, and may even represent an improvement because of a reduction in the concentration of a specific risk.

The second accounting concern is the fear that in the future banks will be required to "mark to market" the remaining comparable assets in the portfolio. It is feared that such an action could mean a severe decline in reported earnings for the money center banks as well as a significant reduction in bank equity.

6) Financial Accounting Standards Board Statement 15,"Troubled Debt Restructurings" appears to be widely misunderstood as allowing banks to avoid recognizing loan losses. This is not the case because generally accepted accounting principles (GAAP) require Statement 15 to be used in conjunction with Statement 5, which deals with assessing the collectibility of loans and other related matters. It is more difficult, however, to assess what occurs in

actual practice, since the determination of uncollectible amounts tends to be a subjective process and differs from bank to bank.

7) U.S. banks have often been criticized for setting aside far less reserves than foreign banks for LDC debt. When evaluating this criticism, it should be remembered that U.S. and foreign banks operate under very different conditions. Other countries have stiffer reserve requirements for LDC debt. However, they are often accompanied by accounting systems which permit the use of hidden reserves and the smoothing of income, less pressure from investors for short-term earnings growth, less stringent disclosure requirements, and sizeable tax deductions for loan loss provisions.

Comparative regulatory and accounting requirements also play an important role in bank LDC lending decisions. Because capitalized interest cannot be booked as current income under U.S. bank regulations, the incentive for restructuring is to provide new loans to enable the LDCs to service their outstanding loans, rather than to capitalize interest. European banks have been more willing to consider the alternative of interest capitalization as it helps to generate considerable tax savings.

ACCOUNTING FOR RESERVES AND WRITEDOWNS

A knowledge of relevant accounting procedures is key to understanding LDC debt writedowns and U.S. bank motivation to engage in such writedowns. For both domestic and international loans, bank regulators and accountants require banks to build a cushion of reserves, also known as the allowance for loan losses, sufficient to absorb both known and probable or anticipated loan losses. The allowance for loan losses includes both asset-specific reserves and a portion set-aside to cover general loan losses. The authoritative accounting standards for reserving for credit losses is found in FASB Statement 5 "Accounting for Contingencies." According to this Statement, reserves are built up by charges to income when it is probable that an asset has been impaired and the amount of loss can be reasonably estimated. This charge to income, called the provision for loan losses, builds the allowance for loan losses on the balance sheet by the same amount. Regulatory authorities do not allow banks to build up the allowance through additions from capital or undivided profits from past periods. The requirement that the charge be made directly to current income is consistent with accounting practice. When a loan is deemed to be uncollectible in whole or in part, charge-offs are made directly against the allowance, and the loan account is reduced by the same amount. Under GAAP, both charge-offs and reserves cannot be spread over a period of years but must be recognized in the period when the determination of uncollectibility is made.

It is important to note that the income statement, and hence earnings, will be affected to the extent the allowance needs to be restored to an acceptable level through charges to income. Thus, if a bank has built up its reserves prudently and was able to accurately anticipate future losses, the income statement should not be severely affected by charge-offs. Only large and unexpected writedowns therefore would tend to hurt bank earnings.

FASB Statement 15 "Troubled Debt Restructurings" provides the authoritative accounting framework for creditors and debtors involved in loan restructurings. Banks are required to use this Statement when they grant concessions to a debtor experiencing financial difficulties. Contrary to notions that Statement 15 is a little used accounting standard, banks involved in LDC restructurings are already using it and, in fact, are required to do so under GAAP.

The type of concession that has been most applicable to LDC debt restructurings is a modification of loan agreement terms, such as extending the maturity date of loans and granting interest rate concessions. According to this Statement, if the total expected cash payments, both principal and interest, over the modified term are less than the remaining balance on the bank books, the bank must writedown the loan by the amount of the difference. If, however, the total expected cash payments equal or exceed the remaining balance, no restructuring loss is deemed to have occurred. In effect, these provisions contribute to the use of longer work-out periods, as the longer the repayment period, the less likely the granting of concessions will result in a required writedown.

Because of this provision, Statement 15 is widely thought as allowing banks to avoid recognizing loan losses. However, GAAP requires Statement 15 to be used in conjunction with Statement 5, which deals with assessing the collectibility of the amounts due under restructuring. Thus, to the extent that the new restructured amounts are judged to be uncollectible, charges to income must be made to recognize the economic loss that has occurred. Actual practice is more difficult to assess, however, since determining uncollectible amounts is a largely subjective process and differs from bank to bank.

Accounting rules provide the framework for banks to accurately portray the value of their assets. However, in the view of some, banks are engaging in an accounting fiction by keeping LDC loans on their books at historical cost, in the face of serious doubts over the ultimate collectibility of debt principal. Present accounting standards allow for these impaired values to be shown in the statements through the allowance for loan losses. A decrease in the total value of loan assets is shown when the loan loss allowance is netted from loan receivables on the balance sheet. For example, if a bank believes that its $100 million exposure to country X is only 70 percent collectible, it should provide $30 million to the loan loss allowance. The aggregate loan account is then shown net of the $30 million allowance. Given the highly judgmental process involved in setting aside loss reserves, however, banks do tend to differ in the degree of prudence exercised in building these reserves.

DISCUSSION OF OBSTACLES/DISINCENTIVES TO WRITEDOWNS AND SWAPPING

Banking Legislation

Current banking legislation does not serve as an obstacle or disincentive for banks to writedown or build reserves for their LDC debt. The International Lending Supervision Act of 1983 (ILSA) requires banks to establish special reserves, called Allocated Transfer Risk Reserves (ATRR), for those international loans which in the judgement of the bank supervisory agencies have been impaired by (1) a protracted inability of the borrowers to make payment or (2) no definite prospects for the orderly restoration of debt service. These reserves are separate from the allowance for loan losses, cannot be included in the calculation of primary capital, and must be charged against income.

Bank Regulation

Our respondents unanimously agreed that current bank supervisory regulations do not, in any way, prevent banks from writing down or reserving against their LDC debt. Rather, bank regulations provide a framework for writedowns of seriously impaired LDC debt through the special reserves required under ILSA. At least annually, the bank supervisory agencies jointly determine the ATRR or special reserves through the Interagency Country Exposure Review Committee (ICERC). ICERC places bank exposures of monitored nations in one of seven risk categories, ranging from "strong" to "loss". Exposures classified as value-impaired require the use of special reserves, while those in the loss category must be completely written-off. A bank may choose to writedown the value of the loan instead of establishing a special reserve. The amount of the special reserve is generally initially set at 10 percent of the exposure, with additions of 15 percent in subsequent years if appropriate. As of July 1986, seven countries were included in the impaired category, representing only 2% of the total outstanding bank debt owed by the LDCs.

For non-mandated writedowns and reserves, banks have considerable leeway in determining amounts to be recognized. Banks are directed to follow the same standards used for domestic debt in evaluating their international loan portfolios. They must also classify as non-performing all loans for which interest payments are more than 90 days past due. After this 90 day period, interest income can no longer be recorded and income accrued during the 90 day grace period must be subtracted. Such loans are placed on a cash basis, where income may be accrued only as it is received in cash.

U.S. bank regulators and their European and Canadian counterparts have followed different strategies for dealing with the LDC debt problem. Regulators in other countries have focused primarily on requiring large loan loss reserves. Canadian banks, for example, have been required to set aside loan loss reserves of

20 percent of their exposure to a "basket" of 32 LDCs. In Spain, countries are grouped into risk categories: provisions of 15 percent are required for countries categorized as having temporary difficulties, and 20 percent to 90 percent for those categorized as "risk" and "considerable risk" nations. In Switzerland, some 100 countries have been grouped into three risk categories with reserve requirements ranging from 10 percent to 50 percent; Swiss regulators generally view 20 percent as the minimum rate for problem countries.

A majority of banks interviewed cited a provision of the joint-agency proposal on Risk-Adjusted Capital (Federal Reserve System, January 1987) as a potential disincentive to building reserves against loan losses. The Federal Reserve will be seeking specific comment on whether the allowance for loan losses should be eliminated in the future from the definition of primary capital. The bankers and security analysts we spoke with felt strongly that if such a proposal were to be adopted, it would have serious ramifications for banks' capital positions. The larger the loan loss reserve, the lower the level of primary capital when the reserve is subtracted. Banks which built up loan loss reserves therefore would, in effect, be penalized for increasing reserves to cover future losses. To meet minimum regulatory requirements, banks would have to restore capital levels after subtracting loan loss reserves.

Accounting

Our respondents unanimously agreed that current accounting standards do not prevent banks from writing down or reserving against their LDC debt. Most of the bankers we interviewed did feel, however, that two aspects of accounting standards serve as barriers to improving the quality of bank asset portfolios through swapping. The first is the requirement that foreign loan swaps be valued at current fair value (CFV). According to the American Institute of Certified Public Accountants' "Notice to Practitioners on Foreign Loan Swaps" (May 1985), a swap of different debtor loans represents a transaction or an exchange of monetary assets. As the earnings process is deemed to be complete at the date of the transaction, the debt received in the exchange must be valued at CFV. To the extent that the CFV of the debt received is greater or less than the recorded investment of the debt given up, a gain or loss must be immediately recognized. According to the Statement, the CFV of the loan received will generally be less than the book value of the loan swapped away, so that a loss will usually be recognized. If a bank seeks to swap $10 million of its country X debt for $10 million in country Y debt it must record a loss even if the debt received is equal in value to the debt swapped away. A number of banks felt strongly that the use of CFV to value the debt received results in a loss even when the swap results in no real change to the value of their portfolios.

The Statement acknowledges that the determination of CFV is a difficult and subjective process, particularly in the light of an underdeveloped secondary market for LDC debt. Therefore, this determination does not rely exclusively on secondary market indicators but also takes into consideration a basket of other factors, such as similar transactions for cash, underlying credit risk, prevailing market interest rates, and debt instruments of similar character.

The second concern expressed by bankers was the fear that if they swapped assets in their own foreign loan portfolios and wrote down the debt swapped to CFV, they might in the future be required to mark to market the remaining comparable assets in the portfolio. Marking to market refers to the writedown of debt principal to current market value. Current accounting standards provide that the remaining portion of a swapped portfolio need not be marked to market as long as recognition of a swap loss is unrelated to ultimate collectibility, and management has not demonstrated its intention to dispose of the remaining debt prior to maturity. Bankers told us they worry that as the secondary market for LDC debt becomes more standardized, accountants will be able to point to clearly identifiable values for LDC debt and marking to market will be required. The money center banks are very concerned about this, as they would have the most at stake if marking to market were to be required. Such an action could mean a severe decline in U.S. bank reported earnings. According to several officials from the accounting profession, the fear of having to mark to market is not justified, as historical cost accounting principles permit debt of various values to sit side by side on the balance sheet. They do not foresee a change being made in this fundamental accounting tenet. Other accounting representatives felt that if the secondary market for LDC debt grew sufficiently large, accountants would have little choice but to require marking to market.

Tax

Under the Tax Reform Act of 1986, banks with assets of greater than $500 million are required to switch from the "reserve" method to the"specific charge-off" method for tax deductions for bad debts. The "specific charge-off" method stipulates that banks can only receive tax deductions for loan losses actually charged-off. Previously, deductions were allowed for additions made to the tax bad debt reserve up to .6% of eligible loans. A number of bankers we interviewed cited this change in the tax law as a potential disincentive to the early write-off of LDC debt. They fear that individual charge-offs will be the subject of much greater scrutiny by the IRS than in the past, and will require much more substantiation of the worthlessness of that portion of the loans written-off.

A loan must be deemed worthless under IRS criteria in order for a charge-off to be accepted by the IRS as tax deductible. This criteria puts the onus on banks to prove beyond a reasonable doubt that loans are truly uncollectible. This approach, unwittingly, appears to work at cross-purposes with the call that is made by many for banks to charge-off their LDC debt as early as possible in a prudent attempt to reduce their developing country exposure.

For tax purposes, a debt is not worthless merely because its collection is in doubt. The loan is not considered to be worthless if there is reasonable expectation that the debt may eventually be repaid. The bankers to whom we spoke are concerned that there will be protracted disputes with the IRS given the difficulty of predicting the ultimate collectibility of LDC debt. This concern has not yet been tested as most of the LDC debt charged-off to date has been mandated by the bank regulatory agencies under ICERC's ATRR requirements. Charge-offs mandated by bank regulators, such as ATRR-related charge-offs, are accepted by the IRS. The problem arises with voluntary charge-offs. The IRS will accept voluntary charge-offs as tax deductible as long as a certification of loan worthlessness is provided by bank regulatory authorities. Depending upon which Federal agency supervises a particular bank, certification may or may not be provided. Those banks supervised by the Federal Reserve are at an advantage, as they are able to obtain certifications of their loan charge-offs, while banks under the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation are not provided with such letters.

Discussions with IRS officials confirmed the bankers' concern that voluntary LDC charge-offs would very likely be disallowed using IRS criteria for worthlessness. The criteria was developed with domestic debt in mind and therefore has limited applicability to the unique characteristics of country risk. For example, according to the criteria, a creditor must have taken all reasonable steps necessary to collect a debt, including legal action if necessary, before the debt will be held to be worthless. This requirement is not appropriate to the international lending environment. Another IRS representative stated that any bank which voluntarily charged-off portions of its LDC exposure in the absence of similar charge-offs by all banks would have to go a long way to justify such actions. According to this official,the IRS, for example, would be skeptical of a bank which charged-off portions of its Mexican debt if the other parties to the Mexican loan package did not do the same. In other words, unless banks charge-off their LDC debt collectively, individual banks will be hard-pressed to prove worthlessness and claim a valid tax deduction.

RELATED OBSERVATIONS

In considering the issues raised by the banks and integrating them with other information on the LDC debt crisis we have the following observations.

1) The balance sheets of U.S. banks appear to overstate the real value of their LDC loans. Most of this debt is carried on the books of the banks at its historical cost or par value. However, such loans in the secondary market sell at a substantial discount from par, with the actual discount varying on a country by country

basis with the market's judgement as to the relative strength of each country.

2) Banks are not providing nor are they required to provide certain information necessary to policy makers, bank regulators and investors on how the LDC debt crisis is effecting banks' financial conditions.

The extent to which the book value of a bank's LDC loan portfolio overstates the real value of these assets depends on the extent to which reserves have been built for this LDC debt. However, banks do not provide total international or total LDC reserve information in reports to regulators or in bank financial statements. In addition, on their income statements U.S. banks generally only provide a provision for total loan loss, and do not identify amounts related to LDC or other international loans. It would be useful to policy makers, regulators and investors if banks made this information available.

3) Over the past five years the cost of the LDC debt crisis has been born in large part by the real side of the economy in both the United States and the LDCs rather than the financial sector. It appears to us that U.S. commercial banks as a whole have not reserved against or written down alot of their LDC debt. As a result, their balance sheets and income statements have not been substantially affected. However, U.S. companies have lost export

sales as debt burdened LDCs restricted imports to conserve scarce hard currency. Furthermore, U.S. companies that compete with imported goods have lost sales as the LDCs expanded their exports to the United States to earn dollars with which to pay debt service obligations. We estimate that the LDC debt crisis accounts for between $12 and $24 billion of the increase in the U.S. trade deficit since 1981. In the LDCs themselves, restrictive economic policies led to recessions and a substantial decline in living standards. For example, in a recent review of U.S. participation in Mexico's Maquiladora Program we found that successive devaluations of the Peso since 1982 cut the value of the Mexican minimum wage in half - from about eight and a half dollars a day to about four and a half dollars a day.

It appears to us that more of a sharing of the cost of the debt crisis by the financial sector of the economy is appropriate.

4) A number of proposals have been advanced to provide relief to LDC borrowers by granting concessions on their current loans rather than by providing assistance in the form of new loans. These proposals have included interest rate and principal concessions, and the creation of a new intermediary facility which would buy discounted LDC debt and pass the benefits of lower principal obligations on to the LDCs. All of the proposals would require complex and difficult negotiations between a large number of interested parties.

Irrespective of what approach may be tried, they all involve an explicit recognition of the fact that the actual value of the LDC loans is less than their book value. This difference is implicitly recognized for the loans of the seven countries for which special reserves or writedowns are required by banking authorities. However, as we have said, these loans currently account for only 2 percent of bank holdings of LDC debt. By way of example, if loan loss reserves were created based on secondary market prices, the reserves against all LDC debt would be approximately 23 times those which have been required by regulators.

A prudent first step before adopting any of the new initiatives would be for the regulators to mandate required reserves for a larger number of countries than is now the case. They have this authority under ILSA. However, because of the limited use of this authority to date, further legislation may be required.

Requiring larger reserves would have several benefits. The first is that banks will be in a better position to absorb any realized losses on LDC loans. A second is that an impediment to banks diversifying their portfolios by selling LDC loans on the secondary market would be eliminated. A loan sold at a discount in the secondary market would not result in a loss on the income statement if the bank previously created sufficient reserves to absorb such a realized loss. Third, efforts to resolve the LDC debt crisis would not be driven quite as much by concerns over maintaining bank financial statements at levels that diverge from the market's assessment of their real worth. And lastly, a deeper and more efficient secondary market could provide relief to LDCs if bank loans that were sold to the secondary market found their way to debtor countries.

Mr. Chairman, this concludes my statement. We will be happy to try to answer any questions you may have.