United States General Accounting Office 138974

GAO

Testimony

138974

For Release
on Delivery
Expected at
9:30a.m. EST
Tuesday
June 27, 1989

Federal Supervision of Overseas Lending by U.S. Banks

Statement of
Allan I. Mendelowitz, Director
Trade, Energy, and Finance Issues
National Security and International Affairs Division

Before the Subcommittee on International Development, Finance, Trade and Monetary Policy
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

045821/138974

GAO Form 160 (12/87)

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to summarize and update our major findings on federal supervision of overseas lending by U.S. banks. Our statement is based on our May 1988 report[1], follow up conversations with regulators concerning our recommendations, and updated information on the secondary market for less developed country (LDC) debt.

It is now more than 6 years since many developing countries began to experience debt service difficulties. Initially, the problem was viewed as a temporary liquidity crisis, but has since been recognized as a crisis stemming from more fundamental causes.

Since the start of the debt crisis, growth in the LDCs has been slow. Many loans were not put to economically rational uses. Further, many heavily indebted countries did not generate sufficient growth in their export earnings to service their debt. Their export sectors have been hurt by large declines in primary product prices, slow economic growth in some countries that import their goods, and increased protectionism of these importing countries. Inappropriate and inadequate economic incentives, mismanagement, and corruption have also been problems.

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[1] International Banking: Supervision of Overseas Lending is Inadequate, (NSIAD-88-87, May 1988).

Additionally, a portion of the loans were reinvested in the developed countries through "flight capital."

From 1981 to 1989 total external debt owed by the 15 Heavily Indebted Countries[2] increased from $335 billion to almost $500 billion. An $8.9-billion net inflow of resources at the beginning of this period quickly became a substantial net outflow. The value of their imports fell from $133 billion in 1981 to an estimated $101 billion for 1989, while the value of their exports has remained relatively unchanged. By 1986, these countries' imports from the United States had declined approximately $12 billion.

From 1981 to 1989, real per capita output for the 15 Heavily Indebted Countries fell at an average rate of about 0.1 percent per year while their consumer prices increased at an average rate of about 107 percent per year. In addition, investment in these countries declined substantially after 1982.

The debt crisis has forced many LDC governments to undertake painful adjustment and austerity programs, often at the risk of losing domestic political support. At a time when real per capita incomes have fallen on average for these nations, it has been difficult to politically justify these programs, particularly when they are seen by the public to have been imposed by outsiders and

[2]The 15 Heavily Indebted Countries are: Argentina, Bolivia, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

for the benefits of creditors. While the economic condition of some LDCs has improved over the past 6 years, the economic condition of many others has not.

At the beginning of the LDC debt crisis in 1982, U.S. bank regulators viewed it as a liquidity crisis for U.S. banks. Their principal objective was to ensure that the banking system did not crash. Just before the debt crisis began, the book value of loans owed by LDCs to U.S. banks equaled $139.7 billion -- 211 percent of their regulatory capital; the book value of LDC debt owed to the largest nine U.S. banks was proportionally even greater--323 percent of their regulatory capital. At the same time, many banks had problem loans to the domestic energy, agricultural, and real estate sectors of the U.S. economy.

RESPONSE TO THE DEBT CRISIS BY BANKS AND REGULATORS

The International Lending Supervisory Act of 1983 (ILSA) imposes requirements on banks and regulators to ensure that "imprudent lending or inadequate supervision" does not endanger the "economic health and stability of the United States" or other nations. The Interagency Country Exposure Review Committee (ICERC), established in 1979 to bring a uniform approach to the supervision of bank loans to foreign countries, is the central decisionmaking body for implementing ILSA.

ICERC has seven rating categories for rating the riskiness of international debt. These categories, from least risky to most risky, are "strong," "moderately strong," "weak," "other transfer risk problems," "substandard," "value-impaired," and "loss." These categories are defined in table 1.

U.S. banks have reacted to the debt crisis by curtailing new loans to the LDCs, by substantially increasing regulatory capital, and by slowly increasing equity capital. The major component of the increase in regulatory capital during the period was the increase in general loan loss reserves.[3] Although similar improvements occurred for the largest nine money center banks as occurred for the banking system as a whole, the large money center banks still have larger book value of LDC exposure compared with their capital than the banking system as a whole. Many regional banks have sold or written down their LDC debt, thus lessening the book value of their LDC exposure.

Reserves

U.S. banks have increased reserves by over $20 billion. While much of this reserve increase is not formally "earmarked" for LDC exposure, industry analysts generally believe the increase responds to a recognition of the diminished value of LDC loans.

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[3]The other major component of the increase in regulatory capital was subordinated debentures.

In our testimony before the Senate Committee on Banking, Housing, and Urban Affairs on April 2, 1987 and in our May 1988 report, we concluded that the federal bank regulators had not required adequate levels of loan loss reserves given the large risk in these LDC loans. Although cumulative required reserves have grown from $1.7 billion as of February 1987 to $4.9 billion today, required reserves are still inadequate.

We estimate that at least $49 billion is currently needed, based on our analysis of the secondary market in which this debt is traded. We therefore believe that the regulators should use secondary market prices as the principal consideration in setting reserve requirements.

The regulators have not accepted this recommendation because they believe it would needlessly limit their flexibility. They believe that secondary market prices are not a substitute for the judgment of experienced bank examiners in assessing the adequacy of reserves.

LDC debt on the secondary market sells at large price discounts, principally because investors believe it to be particularly risky. Our analysis shows that market imperfections cause even these discounted prices to be too high relative to risk. Consequently we continue to believe that market-based reserves are a conservative estimate of needed reserves. Adjustments to reserve requirements, based on other considerations, can be made by the regulators if analysis indicates a convincing reason to do so.

As illustrated in table 2, the principal cause of the low level of required reserves is that regulators have required them only for loans rated "value-impaired" and "loss," which comprise only 16 percent of loans owed by countries incurring debt servicing problems (i.e. countries rated less than "weak"). We continue to believe that the regulators should require reserves for all loans rated less than "weak." They have authority to do so under ILSA.

Country Debt Ratings

In our May 1988 report, we examined the agencies' uniform ranking of countries since October 1979. We found that ICERC's ranking of countries has been very close to that of major international banks and to one derived from prices on the secondary market.

When ICERC made forecasts, they were quite accurate. However, it did not forecast, nor does its rating scale allow it to forecast (with one minor exception), whether debt servicing problems will develop or be eliminated. In addition, it did not make forecasts for countries with "weak" loans, the category in which 23.8 percent of all ICERC ratings fall. As illustrated in table 3, this is particularly important, because countries with "weak" loans were more likely than not to develop debt servicing problems within 3 years. Identification of the probability of incurring debt servicing problems, if communicated to banks, will facilitate decisionmaking by bank management on what action to take.

Using information publicly available at the time of ICERC's ratings, we were able to identify those "weak" countries that were most likely to incur future debt servicing problems as well as those least likely to incur these problems. Consequently, it is possible for ICERC to expand its forecasts to countries rated "weak," as we demonstrate in table 3.

In our 1988 report, we recommended that the regulators communicate "weak" ratings to banks immediately after ICERC meetings along with estimates of the future probabilities of debt servicing problems. To date, the regulators have not implemented this recommendation.

Information Sources

Information sources used by ICERC to decide these ratings were generally useful, but we found that some of the sources, especially the country studies and a mathematical model called a "screen," had shortcomings, which could have caused ICERC to rate some banks' foreign loans incorrectly. The country studies did not adequately discuss monetary policy, the status of country compliance with International Monetary Fund policy constraints, or key political and social factors. They also did not project future developments for key economic data. The screen was quite inaccurate in forecasting debt servicing problems. Using only information available at the time ICERC made its decision, we developed simple models that were much more accurate than the screen in forecasting debt servicing problems. These models were based on the ratings of major international banks as published in a leading financial magazine.

Our follow-up conversations with officials indicates that the Federal Reserve Bank of New York has an economist actively evaluating the use of alternatives to the present screen. We also understand that most of our recommendations for the country studies have been implemented.

Bank Examinations

We reviewed all available bank examination reports and workpapers prepared during December 1983 to May 1986 for 56 banks which held 88 percent of reported U.S. bank foreign loans. We did not find documentation that demonstrated that the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Federal Reserve examiners adequately

-- considered country risk and country exposure concentrations in assessments of capital adequacy;

-- examined bank compliance with required reserves, bank accounting for profits from loan rescheduling fees, and bank public disclosure requirements;

-- reviewed the accuracy of banks' country exposure reports of international loans;

-- reviewed banks' country exposure management systems; and

-- commented on assets rated "weak" and highlighted significant bank assets owed by foreigners in reports to banks' boards of directors and upper management.

Our inquiries indicate that at least one of the regulators is taking actions to address these issues.

Mr. Chairman, this completes my statement. We will be happy to respond to any questions you may have.

Table 1: ICERC's Definitions of Risk Ratings

1. "Strong - The country does not experience economic, social, or political problems which could interrupt repayment of external debt.

2. "Moderately strong - The country experiences a limited number of identifiable economic, social, or political problems which do not presently threaten orderly repayment of external debt.

3. "Weak - The country experiences many economic, social, and political problems. If not reversed, these problems could threaten the orderly repayment of external debt.

4. "Other transfer risk problems - Countries not complying with their external debt-service obligations, as evidenced by arrearages or forced restructuring or rollovers, but which are taking positive actions to restore debt service through economic adjustment measures, such as an International Monetary Fund (IMF) program; countries meeting their debt obligations but whose non-compliance appears imminent; or countries previously classified (categories 5, 6, and 7 below) which now demonstrate sustained resumption of orderly debt service.

5. "Substandard - Countries not complying with their external debt service obligations and (a) not in the process of adopting or adequately adhering to an IMF or other economic adjustment program or (b) not negotiating a viable rescheduling of their debts to banks or likely to do so in the near future.

6. "Value-impaired - Countries having prolonged debt-servicing arrearage as evidenced by more than one of the following: (a) have not fully paid their interest for 6 months, (b) have not complied with IMF programs and there is no immediate prospect for compliance, (c) have not met rescheduling terms for over 1 year, and (d) show no definite prospects for orderly restoration of debt service in the near future.

7. "Loss - Countries whose loans are considered uncollectible, such as, a country which has repudiated its obligations to banks, the IMF, or other lenders."

Table 2: Market Based and Required Reserve Rates[a]

Rating	Debt Owed U.S. Banks (billions)	Market-Based Reserve Rate (percent)	Required Reserve Rate (percent)
OTRP	$37.9	56.2	0.0
Substandard	21.6	67.8	0.0
Value-impaired	11.2	82.6	32.7[b]
Loss	[c]	98.5	100.0
total	$70.7	avg 63.9	avg 7.4[d]

[a] Book value of debt as of December 1988; market based reserve rates based on prices as of May 1989; required reserves up to June 1989; market and required reserve rates based on weighted average of book value.

[b] Because banks generally respond to reserve requirements by writing down assets by the required amounts, a decline in book value of the assets results. Therefore in order to compare required reserves to a meaningful base, we used the book value of exposure just prior to the setting of reserve requirements.

[c] Total exposure was less than $0.1 billion, but not presented in order to prevent disclosure of confidential, individual country reserve requirements.

[d] Based on exposure as of December 1988 and in a form comparable to the market based reserve rates presented above. However, the reader is unable to derive this figure from other information in the table because the required reserve rate for "value impaired" loans does not use December 1988 exposure as a base.

Source: The ratings and required reserve rates for a particular country's debt collected from federal bank regulators. Debt owed U.S. banks obtained from Federal Financial Institution Examination Council's Country Exposure Lending Survey, April 1989. Market based reserve rates derived from weighted average of bid-offer May 1989 prices collected from a financial institution that trades LDC debt.

Table 3: Probability of Incurring Debt-Servicing Problems in 1 to 3 years

ICERC Rating[a]	1 year[b]	2 years[c]	3 years[d]
		(percent)	
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Strong	0.5	3.6	8.9
Moderately Strong	2.9	9.5	16.5
Weak	21.8	39.2	53.4
Weak Plus	12.5	30.8	43.5
Weak Middle	17.5	34.2	49.7
Weak Minus	72.0	88.0	88.0
OTRP-Loss	98.7	98.4	98.3

[a] "weak plus," "weak middle," and "weak minus" are GAO's groupings of loans in ICERC's "weak" category.

Time periods evaluated:

[b]October 1979-June 1986
[c]October 1979-June 1985
[d]October 1979-June 1984

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