

# Supervision of Bank Foreign Lending

*By John E. Young*

Foreign lending by U.S. commercial banks increased greatly in size and geographical scope from the mid-1970s to the early 1980s as U.S. banks recycled dollars from oil-exporting to oil-importing nations. While extensive U.S. bank lending helped oil-importing countries maintain economic growth, global recession and high international interest rates made it difficult for them to service their foreign debt in the early 1980s. The culmination of these difficulties led, in turn, to the international debt crisis in late 1982.

The 1982 debt crisis raised numerous questions about whether foreign lending by U.S. banks was effectively supervised. Subsequently, U.S. bank supervisory agencies developed a more comprehensive system for supervising bank foreign lending. The system was mandated in late 1983 by the International Lending Supervision Act (ILSA).

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This article describes the principal features of the current system for supervising bank foreign lending, with the focus primarily on the ILSA. The first section provides a brief background on bank foreign lending supervision before the ILSA. The second section discusses principal provisions and objectives of the ILSA. The final section describes other regulatory actions affecting bank foreign lending supervision.

## **Background on bank foreign lending supervision**

Three federal agencies—the Federal Deposit Insurance Corporation (FDIC), the Comptroller of the Currency, and the Federal Reserve System—supervise banking activities in the United States, including bank lending. The supervision and regulation of banks help ensure monetary stability, promote an efficient and competitive financial system, and protect consumers and depositors. In the strictest sense, banking regulation refers to the framework of laws and rules under which banks

operate, and supervision refers to the monitoring of financial conditions at banks and to the enforcement of banking regulations and policies.<sup>1</sup> Disclosure refers to information banks are required to make available to the public. Disclosure is intended to promote market discipline. Market discipline refers to the limitations placed on a bank's lending behavior by investors. Investors may impose market discipline by withholding or withdrawing their deposits, demanding a higher yield on their uninsured deposits, or paying a lower price for bank debt and bank stock.

Though bank lending has been supervised for some time, only recently has foreign lending been supervised separately from domestic lending. Separate supervision of bank foreign lending began after the 1973-74 oil embargo. With the embargo and the associated sharp increase in oil prices, lesser developed countries (LDC's) that imported oil began to borrow heavily from banks in industrial countries to finance their rising oil-import bills.<sup>2</sup> Following this rapid buildup of LDC debt, congressional hearings were held in 1977 to discuss bank foreign lending and its supervision. Changes were subsequently made in the supervision of bank foreign lending. Bank supervisors developed a country exposure lending survey and initiated a uniform system for the examination of country risk.

Developed jointly by the three federal bank supervisors, the country exposure lending survey was implemented in 1977. This survey allows collection of information on U.S. bank

foreign lending. The aggregated information is made available to the public. The survey is also used by bank supervisors in the uniform system for the examination of country risk.

The uniform system for the examination of country risk was developed by the bank supervisors and introduced in 1979. The system is administered by the InterAgency Country Exposure Review Committee (ICERC), which consists of members from the FDIC, the Comptroller, and the Federal Reserve System.

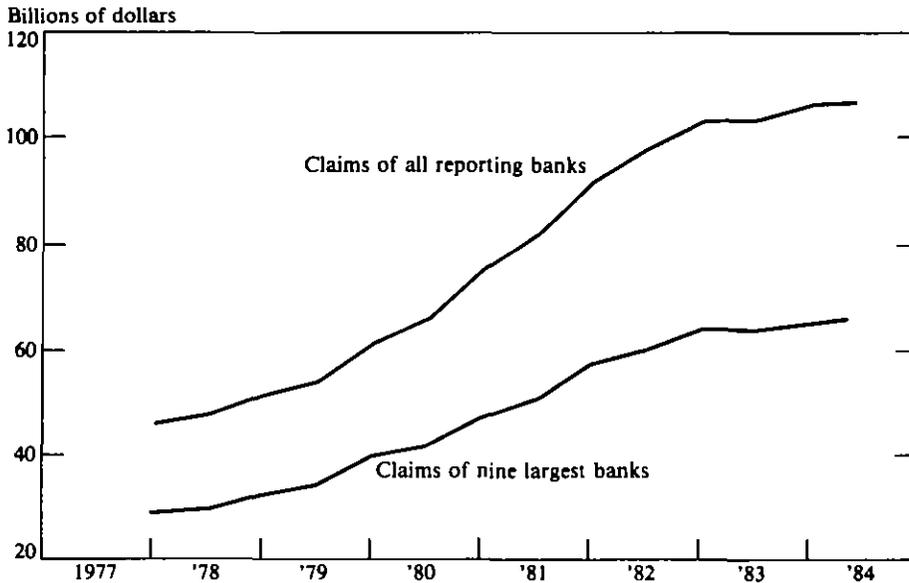
The uniform system was designed to improve the supervision of bank foreign lending. The primary objectives of the system are to encourage diversification of foreign lending and to develop uniform practices for examining country risk. Country (transfer) risk refers to the economic, legal, political, and social conditions within a country that may prevent its domestic borrowers from repaying foreign creditors. These conditions include social or political unrest, government repudiation of external debt, nationalization, exchange controls, and an inability to obtain foreign exchange. Country risk is what distinguishes foreign lending from domestic lending and gives rise to the need for separate examination procedures for foreign loans.

The uniform system and the country exposure lending survey were partially ineffective prior to the ILSA. The survey provided no mechanism for market discipline, since it provided investors with no bank-specific foreign lending data. The uniform system was advisory only, with no mechanism for ensuring that examiners' comments and recommendations were acted on. Although the system brought uniformity to the examination of country risk, it was generally unsuccessful in bringing about greater diversification in foreign lending. In mid-1982, for example, about three years after the uniform system was adopted, loans from the nine largest U.S.

<sup>1</sup> For more discussion of the objectives of bank supervision, see Kenneth Spong, *Banking Regulation. Its Purpose, Implementation, and Effects*, Federal Reserve Bank of Kansas City, January 1983, pp 5-10

<sup>2</sup> For a discussion of the origins of the international debt problem, see William R. Cline, *International Debt and the Stability of the World Economy*, Institute for International Economics, September 1983, pp. 21-31.

**CHART 1**  
**U.S. bank claims on non-oil exporting LDC's\***



\*Includes Mexico

Source: Country Exposure Lending Survey, Federal Financial Institutions Examination Council

banks to Argentina, Brazil, and Mexico amounted to 137 percent of their capital, compared with 114 percent in early 1979.<sup>3</sup> Exposure of all reporting U.S. banks to the three countries increased from 12 percent of their total foreign loans in June 1979 to 15 percent in June 1982.

### The International Lending Supervision Act

Following the sharp increase in oil prices in 1979-80, non-oil exporting LDC's increased their borrowings from U.S. banks. Chart 1 traces the increase. Chart 2 shows that, as a percentage of bank capital, claims on non-oil

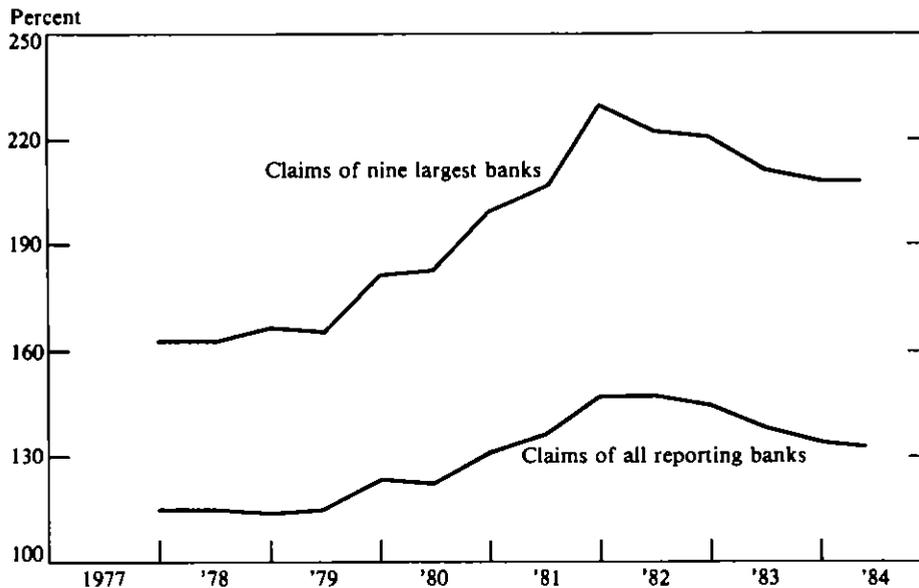
exporting LDC's were substantial, especially for the nine largest U.S. banks.

This heavy borrowing along with the sharp rise in international interest rates placed a heavy debt servicing burden on non-oil exporting LDC's. The burden was made worse by the recession in industrial countries in 1981-82 because it lowered their demand for LDC exports. By August 1982, the debt servicing burden on Mexico was too great and the Mexican government announced it could not meet payments due on its debt to banks. Soon after, when Argentina and Brazil were unable to meet payments due on their debts, the international debt situation moved from the problem stage to the crisis stage.

Following these developments, Congress in late 1983 passed the ILSA in conjunction with legislation allowing for increased U.S. partici-

<sup>3</sup> Richard Dale, Brookings Institute Hearings, Committee on Banking, Finance and Urban Affairs, House of Representatives, "International Financial Markets and Related Matters," February 2, 8, and 9, 1983, p. 388.

**CHART 2**  
**U.S. bank claims on non-oil exporting LDC's**  
**as a percentage of capital\***



\*Includes Mexico

Source: Country Exposure Lending Survey, Federal Financial Institutions Examination Council

pation in the International Monetary Fund. The general objectives of the ILSA are to encourage the diversification of risk and the maintenance of financial strength adequate to deal with unexpected contingencies.<sup>4</sup> The law directs bank supervisors and banks to take steps to strengthen existing programs on bank foreign lending supervision.<sup>5</sup> Several provisions of the law are discussed below.

<sup>4</sup> Paul Volcker, *Federal Reserve Bulletin*, Board of Governors of the Federal Reserve System, April 1983, p. 277.

<sup>5</sup> The Federal Reserve has jurisdiction over state chartered banks that are members of the Federal Reserve System, bank holding companies, and Edge and Agreement Corporations engaged in banking. The Comptroller has jurisdiction over banks with national charters, and the FDIC has jurisdiction over state chartered banks that are not members of the Federal Reserve System.

### *The country exposure lending survey*

This provision of the ILSA, implemented in February 1984, calls for continuation of the country exposure lending survey, but with some changes. The survey is now conducted quarterly and covers banks with a foreign office and more than \$30 million in outstanding foreign loans. The survey collects information similar to the information collected before the ILSA. This includes bank claims on individual countries, the type of borrowers, and the maturity distribution of those claims. The survey data are published quarterly by the Federal Financial Institutions Examination Council (FFIEC). Table 1 gives an example of information in the survey.

Pursuant to the ILSA, the country exposure lending survey contains a special public dis-

**TABLE 1**  
**Amounts owed to U.S. banks by selected foreign borrowers, September 1984**  
(in millions of dollars)

Country	Total Claims	Claims on			Maturity Distribution of Claims		
		Banks	Public Borrowers	Private Nonbank Borrowers	1 Year And Under	Over 1 to 5 Years	Over 5 Years
Argentina	8,229.2	1,884.4	4,075.0	2,269.8	5,739.8	2,159.3	330.1
Brazil	23,621.0	8,529.3	11,096.3	3,995.3	8,579.1	8,596.5	6,445.3
Mexico	26,570.8	4,438.1	13,376.3	8,756.2	8,355.4	12,225.1	5,990.2

Source: Country Exposure Lending Survey, Federal Financial Institutions Examination Council

closure supplement in which banks list claims on a country when the claims exceed 1 percent of the bank's assets or 20 percent of its capital. The type of borrower is also identified and maturity distribution is given. A bank is required to list countries where claims are between 0.75 percent and 1.0 percent of the bank's assets or 15 percent to 20 percent of capital, along with the aggregate claims on these countries.

The survey supplement is available to the public on request. This supplement provides investors with bank-specific data on foreign lending that had not been generally available. By segmenting the geographical distribution of bank foreign lending exposure, the supplement allows investors to make judgments about bank exposure to country risk as economic and political conditions in debtor countries change. It also allows investors to pressure bank management through market discipline when bank exposure to country risk becomes excessive.

***Strengthened examination procedures for country risk***

Another provision strengthens the uniform system for the examination of country risk. The system, still administered by the ICERC, was

modified to improve the identification of troubled foreign loans and increase bank management's awareness of exposure to country risk.

Under the strengthened system that went into effect in December 1983, examiners continue to draw on information from the country exposure lending survey and to list and comment on banks' foreign exposures in bank examination reports. The purpose is to increase bank management's awareness of country risk and, possibly, effect a change in lending policy. Examiners also continue to evaluate banks' internal systems for managing exposure to country risk. As was the practice prior to the ILSA, the ICERC classifies loans adversely affected by country risk, which in turn affects the bank's overall asset quality rating.

Three categories are currently used to classify loans that have been adversely affected by country risk. These categories are "loss," "value-impaired," and "substandard." Foreign loans classified as loss are considered uncollectible. A foreign loan is classified as value-impaired when the quality of the loan has been impaired by a protracted inability of the borrower to make payments on the loan and there is no definite prospect for the orderly restoration of debt service in the near future. A foreign loan is classified as sub-

standard when the borrower has not been complying with its debt service obligations as evidenced by arrearages or forced restructurings. In addition, the category of "other transfer risk problems" is used to highlight loans that are judged to be adversely affected by country risk problems, but not affected seriously enough to be classified as substandard. Loans in this category are considered by examiners as a judgmental factor in their general assessment of a bank's asset quality and the adequacy of its reserves and capital.

As a follow-up to examinations, bank examiners still discuss country risk problems and foreign loan concentrations with members of the boards of directors of banks involved in heavy foreign lending. Such discussions are intended to heighten the awareness of country risk and encourage prudent foreign lending.

### *Reserves*

Pursuant to the reserves provision of the ILSA, a special reserve called an Allocated Transfer Risk Reserve (ATRR) is established for foreign loans classified as value-impaired.

Bank supervisors jointly decide at least once a year what foreign loans are subject to risks that warrant establishing an ATRR. They also determine the size of the ATRR, and whether a previously established ATRR should be increased or decreased due to a change in the quality of the loan. Although the amount of the ATRR may be adjusted at the supervisors' discretion, it is normally 10 percent of the loan principal in the first year it is classified as value-impaired and 15 percent in subsequent years. Instead of establishing an ATRR, banks can write down (reduce the book value of) the loan by an amount equal to the ATRR.

The objective of establishing ATRR's is to strengthen banks by requiring them to carry reserves sufficient to offset possible foreign

loan losses. Since ATRR's are not counted as capital for supervisory purposes, a bank is in a better position to absorb a foreign loan loss without reducing its stated capital.

### *Foreign loan fees*

The fees provision of the ILSA deals with how banks can treat the fees they receive for originating and restructuring foreign loans. Under the provision, fees banks receive in excess of the administrative costs of originating or restructuring a foreign loan must be deferred and amortized over the effective life of the loan. Until the implementation of the provision in April and June 1984, banks often took these fees into income immediately.

One reason for requiring banks to defer a part of their restructuring fees is to avoid excessive debt servicing burdens on debtor countries. With a typical restructuring fee of 1 percent of the loan principal, borrowers expected to pay the entire fee immediately could incur a sizable increase in their debt servicing burden. The banks involved in the 1982 restructuring of Mexico's debt, for example, received roughly \$200 million in fee income.<sup>6</sup>

A second reason for the fees provision is to remove an artificial incentive to foreign lending. By taking the whole loan fee into income immediately, banks could boost their current earnings. As a result, there was an incentive to originate or restructure foreign loans. The purpose of the fees provision is not to discourage foreign lending but to discourage foreign lending undertaken for the purpose of boosting banks' current income.<sup>7</sup>

<sup>6</sup> Hearings, Committee on Banking, Finance and Urban Affairs, House of Representatives, "International Financial Markets and Related Matters," February 2, 8, and 9, 1983, pp. 163-164.

<sup>7</sup> William Isaac, Federal Deposit Insurance Corporation Hearings, Committee on Banking, Finance and Urban Affairs, House

## *International coordination of supervision*

This provision, which became effective with passage of the ILSA, directed the bank supervisors to review the laws, regulations, and examination and supervisory procedures covering foreign lending in major industrial countries.<sup>9</sup> The bank supervisors were then to consult with their counterparts in these countries to promote international coordination of bank foreign lending supervision.

There are two reasons for this provision. First, if U.S. banks are more regulated in their foreign lending than banks in other industrial countries, they may be at a competitive disadvantage. Second, lack of similar supervision of foreign lending by other countries could undermine the effectiveness of the ILSA in promoting the safety and soundness of the U.S. banking system. If bank foreign lending in other countries is not properly supervised and excessive foreign lending follows, it could lead to additional international debt problems. This could jeopardize the foreign loans of U.S. banks and, consequently, the safety and soundness of the U.S. banking system.

## *Capital requirements*

The capital requirements provision of the ILSA gives the bank supervisors authority to establish and enforce minimum capital requirements for banks. This provision represents a subtle but important change. Until the ILSA, the regulation of bank capital lacked uniformity and stringency. Regulators issued capital guidelines

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of Representatives, "International Financial Markets and Related Matters," April 20-21, 1983, p. 219.

<sup>9</sup> The major industrial countries are Belgium, Luxembourg, Canada, France, Germany, Italy, Japan, Sweden, United Kingdom, and the Netherlands.

but it was not clear that they had enforcement power.<sup>9</sup>

The ILSA directs bank supervisors to make sure that a bank's capital position is adequate to accommodate the risks of large country exposure and foreign loan restructuring. Banks with large concentrations of loans in particular countries are expected to maintain higher capital ratios than well-diversified banks.

## **Additional elements of foreign lending supervision**

In addition to steps taken under the ILSA, other regulatory actions by bank supervisors and the Securities and Exchange Commission (SEC) are related to bank foreign lending. These actions are aimed at stricter accounting treatment of nonaccrual foreign loans and increased disclosure of foreign lending.

## *SEC disclosure requirements*

The SEC helps protect investors by requiring the disclosure of material information. Disclosure allows investors to make more informed investment decisions. More than 760 bank holding companies (BHC's)—with subsidiaries including the 100 largest banks—are subject to SEC disclosure provisions.<sup>10</sup>

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<sup>9</sup> Under those capital guidelines, existing since December 1981, the FDIC, Comptroller of the Currency, and the Federal Reserve System set minimum capital requirements for banks under their respective jurisdictions. However, these capital guidelines varied to some extent across bank size and supervisory agency. Although supervisory agencies could issue cease and desist orders when banks failed to comply with capital guidelines, they rarely did and there was uncertainty about supervisors' authority to enforce their guidelines. For collaboration of this point, see Karlyn Mitchell, "Capital Adequacy at Commercial Banks," *Economic Review*, Federal Reserve Bank of Kansas City, September/October 1984, pp. 19-20.

<sup>10</sup> See John S.R. Shad, Securities and Exchange Commission, Hearings, Committee on Banking, Finance and Urban Affairs, House of Representatives, "International Bank Lending," April 20-21, 1983, p. 350.

In 1976, the SEC imposed requirements on certain BHC's that they disclose information on their foreign lending activities.<sup>11</sup> The information must include a breakdown of aggregate foreign loans outstanding into the following categories: government and official institutions, commercial and industrial entities, banks and other financial institutions, and others. The amount of foreign assets, as well as foreign revenue and income, is also disclosed for each significant geographical area in which the BHC does business, such as Europe or Latin America. Yields on average foreign assets and the allowance for foreign loan losses are also disclosed.<sup>12</sup>

With the Latin American debt crisis of 1982, it became apparent that loans to countries with liquidity problems might involve unusual risks and uncertainties for banks. Consequently, the SEC established additional disclosure requirements in 1982, 1983, and 1984. Under these recent disclosure requirements, BHC's must disclose exposures to foreign countries that amount to more than 1 percent of their assets. BHC's with foreign country exposures that equal 0.75 percent to 1.0 percent of their assets must disclose the names of the countries and the aggregate exposure to the countries.<sup>13</sup> BHC's with loans outstanding to borrowers in a foreign country

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<sup>11</sup> A BHC is required to disclose information on its foreign lending activity if over each of the past two years: 1) the pre-tax income associated with foreign banking operations exceeded 10 percent of total pre-tax income, or 2) the assets associated with foreign banking operations exceeded 10 percent of total assets.

<sup>12</sup> *SEC Docket*, Vol. 10, September 16, 1976, pp. 316-321. See also John S.R. Shad, Securities and Exchange Commission. Hearings, Committee on Banking, Finance and Urban Affairs, House of Representatives, "International Bank Lending," April 20-21, 1983, p. 344.

<sup>13</sup> *Washington Financial Reports*, "SEC Revises Disclosure Requirements on BHCs' Foreign, Nonperforming Loans," Vol. 41, August 15, 1983, pp. 286-287. Preliminary research suggests that these SEC foreign loan disclosure requirements do pro-

ceed 1 percent of their assets must disclose information on loan restructuring.<sup>14</sup> BHC's must also disclose the amounts in their ATRR.<sup>15</sup>

### *Nonaccrual loan rule*

In June 1984, amid growing concern over Argentine debt, the Comptroller of the Currency and the Board of Governors of the Federal Reserve System sent a joint statement to banks clarifying their policy regarding loans classified as nonaccrual. Generally, a nonaccrual loan is one on which the borrower has fallen behind on principal or interest payments. Before this clarification, some banks classified loans as nonaccrual only if the interest or principal payments were more than 90 days overdue on the day the bank was filing its income statement. Consequently, some banks would record uncollected interest as income, even on loans that had been on nonaccrual status and were clearly not performing according to the terms of the contract. As a result, there was an overstatement of earnings on these banks' income statements.

The policy was clarified to make sure that banks correctly followed established procedures for classifying loans as nonaccrual. Under the clarification of policy, a loan is to be placed on nonaccrual status the day that interest or principal payments become 90 days past due. When this happens, any interest

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mote market discipline. See Steven C. Kyle and Jeffrey D. Sachs, "Developing Country Debt and the Market Value of Large Commercial Banks," *NBER working paper 1470*, September 1984, p. 7. See also Jeremy A. Gluck, "The Impact of LDC Loan Exposure on U.S. Commercial Bank Stock Prices and Borrowing Rates," mimeo, Federal Reserve Bank of New York, October 1984.

<sup>14</sup> *SEC Docket*, Vol. 27, February 4, 1983, pp. 63-64.

<sup>15</sup> *Washington Financial Reports*, "SEC Staff Says Risk Reserve for Banks May Not Satisfy Federal Securities Laws," Vol. 42, February 13, 1984, p. 301.

accrued but not actually collected must be subtracted from income and any additional interest will be counted as income only when interest payments are actually received. A loan remains classified as nonaccrual until all interest and principal payments are brought up to date.<sup>16</sup>

This policy had an immediate and substantial effect on bank earnings. The policy became effective in the third quarter of 1984, however, many banks chose to apply it in the second quarter. For example, the largest U.S. lender to Argentina classified \$638 million of its Argentine loans as nonaccrual during the second quarter of 1984. As a result, the lender had a net loss of \$21.4 million that quarter. Another large bank placed many of its Argentine loans on nonaccrual status during that quarter and suffered a \$3.1 million loss.<sup>17</sup> By the fourth quarter of 1984, the big banks had placed 40 to 60 percent of their Argentine loans on nonaccrual status.<sup>18</sup>

## Conclusion

Supervision of bank foreign lending has evolved substantially over the past decade. Early efforts to supervise foreign lending—such as the original country exposure lending survey and the uniform system for the examination of country risk—did not prevent exces-

sive foreign lending because they did not provide mechanisms for forcing banks to behave more prudently.

Recent supervisory measures are designed to use both regulatory power and market pressure through disclosure to promote prudence. By empowering bank supervisors to require special reserves and minimum capital, the ILSA encourages banks to scrutinize their foreign lending programs and, thereby, strengthens the banking system against foreign loan losses. The ILSA promotes market discipline by requiring banks to disclose detailed data on foreign lending through the country exposure lending survey. The SEC disclosure requirements also promote market discipline by providing investors with material information. More prudent accounting practices, which also may promote market discipline, are promoted by recent changes in the treatment of foreign loan fees and nonaccrual foreign loans.

Steps taken pursuant to the ILSA and other recent regulatory steps come at a time when bank foreign lending has already curtailed due to the international debt crisis of 1982. It is unclear, therefore, what effect these steps have had on bank foreign lending. It is clear, however, that the current system of supervising bank foreign lending has evolved in a manner designed to help ensure the safety and soundness of the U.S. banking system.

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<sup>16</sup> *Washington Financial Reports*, "Banks May Take Hit on Foreign Loans After Interest Accrual Loans Clarified," Vol. 46, June 25, 1984, pp. 1065-1066.

<sup>17</sup> Suzanna Andrews, "Accounting for LDC Debt," *Institutional Investor*, August 1984, p. 193.

<sup>18</sup> Dan Hertzberg and S. Karene Witcher, "Republic New York, RepublicBank Put Argentine Loans on Non-Accrual Status," *Wall Street Journal*, January 17, 1985, p. 2.