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STATEMENT OF

CHARLES A. BOWSHER
COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE THE

HOUSE COMMITTEE ON BANKING, FINANCE
AND URBAN AFFAIRS

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE

ON

BANK EXAMINATION FOR COUNTRY RISK AND INTERNATIONAL LENDING

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our report "Bank Examination for Country Risk and International Lending," issued on September 2, 1982, our assessment of the regulatory changes proposed by the Federal bank authorities to address the problem of country risk, and other issues.

A high level of international lending is needed to support international economic growth and to expand U.S. exports. However, increased international lending has intensified exposure of U.S. banks to country risk (also known as "transfer risk")--the possibility that adverse economic, social, or political circumstances may prevent a country's borrowers from making timely (or in the extreme, any) repayment of interest or principal. In recent years, country risk has increased as a widening number of countries have developed balance-of-payments difficulties, including countries where U.S. bank exposure is very large.

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Because the need for new international lending will likely continue and existing concentrations of foreign loans made by U.S. banks are not likely to be reduced in the near term, we believe bank regulators should have two primary objectives with respect to country risk:

- --a short-term one of strengthening the ability of U.S. banks to cope with the current situation; and
- --a long-term one of avoiding future overexposures.

Strengthening bank regulation for country risk can help to achieve these objectives. However, there are inherent limitations; even well-designed bank regulation and examination cannot ensure that there will be no future threats to the liquidity of banks from international lending. Bank regulations cannot avert or solve worldwide economic problems. Furthermore, some events that affect country risk can develop very quickly and with little advance warning. Bank regulators and examiners are no better able than anyone else to predict potentially disruptive events, such as oil price increases, oil market gluts, revolutions, wars, etc. Furthermore, bank regulation is not intended to replace bank management. The regulators can take steps to improve individual banks' abilities, and thereby the industry's ability, to handle the risks they are supposed to be taking, but, they cannot guarantee that bank management will always be prudent nor that every loan will remain sound. Within the context of these reservations, we believe that steps can be taken to cope with the current situation and reduce the likelihood of future crises.

THE COUNTRY RISK EXAMINATION SYSTEM

We reviewed the country risk examination system used by the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Federal Reserve to evaluate U.S. commercial banks' lending to foreign borrowers. This system, which is advisory for banks, is part of the broader bank examination activities of the supervisory authorities and was designed to help bring about adequate diversification of bank loans among countries. Because the quality of loans to foreign borrowers (whether individuals, companies, or government entities) can be very much affected by the debt-servicing abilities of the countries themselves, country risk assessment must focus on the U.S.banks' total lending to borrowers in foreign countries and the debt service capabilities of those countries.

The country risk examination system, which became effective in the spring of 1979, in essence consists of

--identifying countries with actual, imminent, and potential debt-servicing problems;

--calling loans to countries with actual or imminent debt problems to the attention of bank management in examination reports;

--including "special comments" in bank examination reports when loans to countries with potential debt problems exceed certain levels in relation to bank capital; and

--evaluating the internal systems used by banks to manage country exposures.

It is worth emphasizing that this system includes elements concerned with large amounts of loans to borrowers in countries with potential loan repayment problems as well as those with actual problems.

The system is managed by the Interagency Country Exposure Review Committee, composed of representatives of each of the three bank regulatory agencies. The Committee selects the countries with actual or potential debt-servicing problems. It also prepares country developments descriptions for bank examiners to use in commenting on bank exposures in "problem" countries, and has prepared guidelines and procedures for them to use in analyzing bank systems for managing country exposures.

Before the present system was established, examiners of different bank regulatory agencies were handling country risk in different ways in their bank examinations.

Our study examined the objectives, standards, and administration of this system and assessed its impact upon banks. Although examiners of different agencies now treat country risk in a consistent manner, we found a number of weaknesses in the system; principal among them were:

--the system's objectives were not being clearly communicated to bankers; it was unclear what authorities wanted banks that receive "special comments" on foreign exposures to do, and

--there was no demonstrable impact in restraining the growth in bank lending to countries with potential payments problems.

Other problems we identified include:

--the system was identifying more countries as having potential debt-servicing problems than was necessary, thereby possibly reducing the significance of examiner comments in the eyes of bank management;

--there was little consistency in highlighting specially commented exposures; i.e., putting them on page 1 of examination reports; and

--the analyses used by the Interagency Committee to make country selections could be improved; for example, most country studies did not adequately cover near-term future developments, deal with longer term developments, or fully analyze monetary and fiscal policies.

IMPROVING SUPERVISION AND REGULATION OF INTERNATIONAL LENDING

Mr. Chairman, in your letter requesting this testimony, you asked us to assess the adequacy of the Comptroller of the Currency's response to the findings in our report. We believe that the Comptroller's response and the reform proposals contained in the joint memorandum submitted by all three regulatory agencies on April 7, 1983, could enhance the effectiveness of bank examination for country risk in international lending. Our assessment is preliminary because the agencies' proposals have not been fully developed and because their ultimate success will depend on how well they are implemented. However, we agree with the general thrust of the proposals and believe that some of them attempt to rectify the two major problems identified in our report: the lack of clarity about the objectives of special comments and the inability of special comments to restrain the growth in banks' lending to countries with potential problems.

We plan to make another complete assessment of the country risk examination system after the proposed modifications have been fully developed and implemented. We will look at how the country risk examination system identifies countries with actual and potential debt-servicing problems, calls such loans to the attention of bank management, and evaluates bank country exposure management systems. We will also review how the system provides for remedial action in response to classified loans, high concentrations of foreign loans in countries with potential problems, and deficient bank systems for managing country exposure. We have the following comments on the individual proposals.

Impact of Loan Concentrations on Ratings and Capital Requirements

It is proposed that concentrations of exposures be included in banks' composite ratings. Banks will generally be expected to increase their capitalization, and therefore, their ability to withstand losses, if foreign lending to individual countries is high in relation to capital. We believe that such a change is desirable because it clarifies what action should be undertaken by banks in response to high concentrations of exposures, and that action should serve to strengthen the more vulnerable banks. We would point out, however, that determining clear criteria for capital adequacy has been a continuing problem for the bank regulators. Therefore, the specifics of how this proposal will be implemented are critical to evaluating its ultimate benefit.

Increased Loan Loss Reserves

It is also proposed that special reserves be required for some classified loans for which reserves are not now required. The proposal for special reserves gives genuine weight to the Interagency Country Exposure Review Committee's classification of foreign lending because of country risk and provides for more graduation among the classification categories. The present country risk system has no explict loan writeoffs or reserves for loans classified as "substandard" and "doubtful" due to transfer risk. A 100 percent loan writeoff is required for the category of "loss." Because countries do not become bankrupt in the same way as do companies, the "loss" category has not been used to classify foreign loans due to country risk. Consequently, banks have not been required to write off or establish reserves for loans to countries with severe debt problems. The proposed new system would eliminate the categories of substandard and doubtful and replace them with "debt service impaired" and "reservable". Loans classified as reservable would require that reserves of 10 percent or more be established by charges to bank earnings. The evidence that the authorities would require for a reservable classification--such as non-payment of interest for more than 6 months--appears to be reasonable. Such a change would more accurately portray the financial condition of banks and reflect the risk to investors that flows from management decisions.

As I have said, this does not mean that if the system functions well the current exposure will be reduced or that there will be no new threats to bank liquidity because of international lending. However, we believe that an improved system will contribute to the banks' ability to better withstand financial adversity.

We believe that the other proposals made by the regulators also help, even though they are not a part of the examination system. Our comments on these proposals follow.

Accounting for Fees on Syndicated International Losses

We agree that front-end fees, other than those received as compensation for identifiable direct costs, should be treated as interest. Banks can appear more profitable than they actually are when loans are rescheduled and large rescheduling fees are posted to current income. This result is especially anomalous when loan portfolios have typically become riskier and less profitable.

Augmented Bank Foreign Loan Disclosures

We welcome the proposals for more frequent filing of Country Exposure Reports and increased public disclosure of banks' foreign exposures. Quarterly, rather than semiannual, filings of Country Exposure Reports will provide the country exposure system with more current information on which to make analyses. Dated information was a problem we identified in our review. We feel, however, that modern communications and computer capabilities should allow for even more frequent reporting, which would permit up-to-date analysis on a real-time basis. With respect to the public disclosure proposal, we question why the criteria for public disclosure does not conform to that used by examiners when evaluating large concentrations of foreign loans. For examination purposes, concentrations of foreign exposure are evaluated relative to bank capital, while for the proposed public disclosure requirements, the criterion is foreign exposure relative to bank assets. If bank examiners consider loans relative to capital to be the proper perspective for evaluating foreign exposures, then should not the public also have the benefit of assessing foreign exposure from that perspective?

International Cooperation

The U.S. bank regulators propose increasing the exchange of information and other international cooperation with overseas bank regulators. They also envision enhanced roles for international agencies. Any increase in the flow of information and cooperation should improve the ability of bank regulators and managers to make better decisions.

GAO ACCESS TO PRIMARY DOCUMENTS AND INFORMATION

GAO does not have direct access to the books and records of international agencies. Such access is not consistent with the charters of such agencies, which do not permit audits by member states. GAO's role concerning multilateral programs and institutions is to review the manner in which the U.S. agencies participate in such activities and discharge their responsibilities; that is, how they develop their positions on issues as well as how they monitor implementation of decisions taken by those bodies. In order for the U.S. agencies to carry out those responsibilities, they need adequate information from the international bodies. If that information is not sufficient for the U.S. agencies to carry out their responsibilities, GAO does not have sufficient information to carry out its review responsibilities.

With a view toward increased accountability, we have supported efforts to get international bodies to establish independent external audit boards. Examples of how this can be done are the arrangements for oversight at the World Bank and the Asian Development Bank. The U.S. Congress passed legislation calling for the President to propose to the banks' directorates that professionally qualified groups be established to provide independent examination, review, and evaluation of the programs and activities of such international organizations. Under U.S. leadership, such groups were created and are directly responsible to the organizations' boards of executive directors. We contribute to the workings of the review boards by preparing proposed audit and reporting standards, which were adopted, and by reviewing issued reports and related information.

It should be stressed that such an arrangement does not give GAO direct access to an international agency. However, it does increase the information and independent analysis available to the Congress on international activities.

We would like to emphasize that data - whether available in the executive branch or the IMF - is only as good as the basic information systems and review processes in the individual reporting countries. Therefore, consideration should be given to directing the U.S. Executive Director of the IMF to assure himself that such systems and processes are yielding good information. To the entent that they are not, one way to develop them is to require that efforts to improve such reporting systems and review processes be a condition of new loan agreements.

Quite apart from GAO's access to the books and records of international organizations, GAO's ability to perform reviews is also limited by restrictions on access to Federal Reserve data on U.S. international financial activities. The Federal Banking Agency Audit Act of 1978 does not permit our reviews at the

Federal Reserve Board and Federal Reserve Banks to include matters regarding transactions for or with a foreign central bank, foreign government, or nonprivate international financing organization. To the extent that the Federal Reserve is involved in matters to which our access is restricted by law, we do not have the information on which to perform evaluations. We believe the Congress should consider amending the Federal Banking Agency Audit Act to give GAO necessary access with appropriate safeguards, and we will be pleased to work with you on appropriate statutory language.

HOUSE JOINT RESOLUTION 208

Mr. Chairman, you also asked us to comment on H.J. Res. 208, which calls on the United States to use the upcoming Economic Summit in Williamsburg, Virginia, to indicate a willingness to pursue monetary and fiscal policies to stimulate growth; to include in the summit's agenda the coordination of monetary and fiscal policies, extention of the maturity of LDC debt, and promotion of uniformity in the regulation and supervision of international lending.

We support the goal of greater coordination in the formulation and implementation of economic policies called for in the joint resolution. Coordinating monetary and fiscal policies among major developed nations would contribute to solving many problems--unemployment, exchange rate misalignment, and rising protectionism. U.S. leadership in this regard would contribute to useful discussions. However, we should not forget that the United States has paid a terribly high price to bring inflation down. Weight should also be given to formulating a policy that explicitly considers how to prevent inflation from again becoming a major problem.

We also support extending the maturity of loans for those developing countries that need it. We note that the problem of developing nation debt involves many LDCs, but not all of them. Furthermore, the cause of the debt service problems, and hence, the required adjustments, may vary from country to country. Under these circumstances, we do not think that it is necessary to deal with the issue of LDC debt on a uniform global basis; however, on an individual country basis, lengthening the term structure of the loans may be necessary and appropriate.

We understand that attempts have been made (for example, through the Bank for International Settlements) to strengthen international cooperation in the area of supervision of international banking. U.S. bank regulators have proposed to step up such cooperation. As previously stated, any increase in the flow of information and cooperation should improve the ability of regulators to make better decisions.

FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

Finally, you asked that we comment on the actions of the Federal Financial Institutions Examination Council in the area of international banking and the advantages and disadvantages of allocating more responsibility for international regulation and supervision to the Council. We are currently completing a review of all Council activities. In its 4 years of existence the Council has not played an active role in the regulation and supervision of international lending, and we do not recommend that it be given additional responsibilities such as those included in H.R. 2378, because:

1. Our review of Council activities during its 4-year existence disclosed that it has made little progress in accomplishing the objectives already established by the Congress; one reason may be reluctance of its member agencies to fully support common programs in which they must relinquish some control. In a controversial area such as international lending, we question whether the Council could promote effective and uniform supervision.

2. The Council is not designed to effectively carry out the responsibilities set forth in H.R. 2378. The bill would, among other things, provide that the Council require banks to increase their loan loss reserves under certain conditions and to establish limits on the total amount of short-term loans which any bank may make to public and private borrowers in any one country. The bill would require the Chairman of the Council to determine whether additional short-term lending would be authorized for individual banks in order to preserve the soundness and stability of the world financial system. The Council was created to be basically a policymaking organization. It does not deal directly with banks and has only a very small staff.

The Interagency Country Exposure Review Committee has achieved a high level of cooperation and uniformity among the three agencies on the issue of country risk. The Council, under its existing legislative authority, could recommend policy statements to the regulatory agencies for assessing international lending levels. We believe, however, that administration of these policies should rest with the regulatory agencies.

Mr. Chairman, this concludes my prepared statement, and I will be happy to answer any questions you may have.