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Dorothy A. Sable

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International Lending Supervision

Robert R. Bench and Dorothy A. Sable*

The international debt crisis and other tumultuous events have resulted in significant changes in the supervision of U.S. banks' international lending.1 In particular, new requirements have been applied to international loans since the passage of the International Lending Supervision Act of 1983 (ILSA).2 Because these changes and new requirements affect, for the most part, all international loans and not merely those to borrowers in less developed countries (LDCs), it is important for banking law practitioners to understand these changes.

Although supervision of U.S. banks' international lending had been an important part of federal banking regulation since the 1960s,3 the Mexican debt crisis in August, 1982 prompted the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) (the agencies), to review their existing policies and procedures in order to strengthen supervision in an era of international debt problems. Congress, then in the midst of considering the Administration's request for approval of an increased quota at the International Monetary Fund (IMF), was equally concerned about the risks to the U.S. banking system posed by foreign loans.4

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1 The terms "international lending," "international loans" and "foreign loans" basically mean extensions of credit to a foreign government, or to an individual, a corporation, or other entity not a citizen of, resident in, or organized or incorporated in the United States. 12 C.F.R. § 20.7(d) (1986). International loans include those denominated in the local currency of the country of the borrower, but more typically, such loans are denominated in dollars or one of the other international reserve currencies.


3 For example, the Office of the Comptroller of the Currency (OCC) established an international division and an overseas examination program (1965), opened a London office (1972), required global consolidated accounting and disclosure (1973), began evaluating total loans to foreign governments (1974), required semi-annual reporting of bank exposures in foreign countries (1977), and revised rules pertaining to international lending (1979).

In the spring of 1983, as a result of their review and in response to congressional concerns, the agencies announced a five-point program to strengthen the supervision of international lending. The program consisted of: (1) improving the existing system of country risk examination and evaluation in order to alert bank management to country risk and concentration problems, and to better evaluate bank capital adequacy in terms of country exposure concentration; (2) increasing disclosure of banks' country exposure by requiring reports on a quarterly, rather than a semi-annual basis; (3) requiring special reserves for certain international loans; (4) establishing supervisory rules in bank accounting for fees received in connection with international loans; and (5) strengthening existing international cooperation with both foreign banking regulators and the IMF.

The agencies specifically rejected country lending limits per se, and advised that no new statutory authority was necessary to enable the agencies to implement the program. Although Congress supported the program proposed by the agencies, it did not agree that statutory authorities or statutory requirements were unnecessary. In view of U.S. banks' substantial international lending exposure, particularly their exposure on loans to the LDCs, the banking committees of both the Senate and House agreed that specific legislative action was needed to mandate a permanent improvement in the supervision and regulation of international lending.

Although the Senate adopted the program as announced by the agencies, the House, initially, made several more stringent modifications. These included vesting authority in the Federal Financial Institutions Examination Council (FFIEC) to develop capital adequacy standards for country exposure concentrations, and extending the proposed system of special reserves to include uniform reserves for all loans needing rescheduling, rather than just those to which rescheduling was deemed unlikely and/or noncompliance with rescheduling was found. The House-proposed measures were not adopted and the final legislation embodies the agencies' five-point program and certain additional measures, in a series of legislative

The House Report was particularly critical of the agencies' supervision of international lending.

5 The program was set forth in a joint memorandum accompanying an April 7, 1983 letter from the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, and the Chairman of the Board of Governors of the Federal Reserve System to Senator Jake Garn, Chairman of the Senate Committee on Banking, Housing and Urban Affairs.
8 The Council consists of representatives of the three federal banking agencies plus representatives of the Federal Home Loan Bank Board and the National Credit Union Administration. See generally 12 U.S.C. §§ 3301-08 (1982).
requirements: (1) improved international coordination of supervisory policies and practices with respect to international lending; (2) strengthened domestic supervision of international lending by U.S. banks; (3) special reserves; (4) rules on accounting for international loan fees; (5) increased disclosure requirements; and (6) foreign loan evaluations.\textsuperscript{11}

I. International Supervisory Cooperation

Although effective cooperation among bank supervisors internationally has existed since the early 1970s,\textsuperscript{12} the importance of such cooperation and coordination of policies was specifically recognized by Congress in ILSA. Section 3901(b) requires that: "The Federal banking agencies shall consult with the banking supervisory authorities of other countries to reach understandings aimed at achieving the adoption of effective and consistent supervisory policies and practices with respect to international lending."\textsuperscript{13}

It is noteworthy that the statute itself uses the term "understandings" because legally controlling agreements regulating transnational banking operations are the exception rather than the rule. The fact that agreements lacking legal force and effect are generally nonexistent does not mean, however, that there are no "understandings" having a practical effect on the conduct of international banking operations.\textsuperscript{14}

Moreover, although there are no transnational supervisory bodies, a number of cooperative international bank supervisory groups exist. These groups typically are composed of the central banking and bank supervisory authorities (when not one and the same) of each of the member countries in the particular group. International bank supervisory groups have been formed both by countries with related interests (for example, the industrial countries represented in the Basle Supervisors' Committee, or countries allowing offshore banking represented in the Offshore Group of Banking Supervisors), and by countries in the same geographic area (such as the Latin American supervisors' group). Many countries; particularly the United States, are members of or participants in more than one of these groups. In addition, all of the groups are in frequent contact with one another so that principles or supervisory techniques stud-

\textsuperscript{11} Id. §§ 3903-06, 3908. The Act also includes a provision requiring the agencies to establish minimum levels of capital necessary for all banks under their supervision. Id. § 3907 (1982). This provision will not be discussed here since it is not specifically applicable to international lending.

\textsuperscript{12} The Cooke Committee was established in 1974. See infra notes 16-17 and accompanying text.

\textsuperscript{13} 12 U.S.C. § 3901(b) (Supp. II 1984).

\textsuperscript{14} See infra notes 18-19 and accompanying text for a discussion of the Concordat, a set of principles developed by and agreed upon by members of the Cooke Committee.
ied, developed, or adopted in one group are rapidly communicated to each of the other groups.

Despite the fact that none of these groups, with the exception of the Banking Advisory Committee of the European Economic Community (EEC), has a legal charter or other international or national legal mandate, the groups nonetheless exert a considerable influence over the conduct of transnational banking operations. They do so in a number of ways.

First, through the adoption of agreed-upon supervisory principles, such as the framework for shared supervisory responsibilities for the operations of multinational banking organizations set out in the Concordat of the Cooke Committee.15

Second, by facilitating the exchange of information on requirements and supervisory procedures for banking institutions in each of the member countries and working toward consensus on minimum international requirements for multinational banking organizations.

Third, by facilitating the exchange of information between banking supervisors concerning individual multinational banking organizations.

Multinational banking organizations are not yet subject to binding international rules on such matters as capital, lending limits or permissible investments. It must be remembered, however, that before 1974, few organizations existed to facilitate coordination of regulatory requirements, and banking supervisors were primarily domestically-oriented. The considerable progress in international supervisory cooperation that has been made thus far is due to the formation of international groups of supervisors and the efforts of their members. The most prominent of these groups is the Cooke Committee.


1. Informal Cooperation: The Basle Supervisors' Committee (The Cooke Committee)

The Basle Supervisors' Committee, the best known of the groups, was established by the central bank governors of the Group of Ten countries and Switzerland at the end of 1974. This was accomplished by creation of a standing committee, the Committee on Banking Regulations and Supervisory Practices (the Committee).16 Since its creation, the Committee has met regularly three or four

15 See id.
16 The current members are: Belgium, Canada, France, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States and West Germany. The supervisory authorities of several of these countries also meet and form the Contact Group of EEC supervisory authorities. That Group works closely with, and is
times a year at the Bank for International Settlements in Basle, Switzerland. The Committee has no formal “charter” or other legal mandate.\(^\text{17}\)

The Committee’s first achievement in improving the supervision of international banking business was its agreement upon certain principles set forth in the document known as the Concordat, issued in 1975.\(^\text{18}\) As a result of ongoing work and discussions with other supervisory authorities, the Concordat was revised in 1983.\(^\text{19}\) Two major principles of both the original and revised Concordat are that no aspect of a banking organization’s operations should be unsupervised, and that responsibilities for supervision of the solvency and liquidity of banks’ foreign operations should be allocated between host and headquarters’ authorities, with full cooperation between the two. The most important principle of the revised Concordat is that banking organizations should be supervised on a consolidated basis by their headquarters’ authority. The revised Concordat is being implemented in the Basle Committee’s member countries and has been endorsed by other supervisors worldwide.

The Committee has undertaken studies of several topics concerning problems affecting banks operating internationally, including the supervision of banks’ foreign exchange positions, the monitoring of country risk, control of country exposure by international banks, and off-balance sheet risks. Currently under consideration is the capital adequacy of banks operating internationally and convergence towards a broad, common definition of capital for supervisory purposes. The Committee members concur that the capital positions of banks operating internationally should be strengthened and on no account allowed to deteriorate.

In addition, the Committee has encouraged contacts and cooperation between its members and other bank supervisory authorities. It circulates information on its work to supervisors throughout the world and actively seeks their input. It has sponsored and coordinated studies of various countries’ bank regulatory systems. Finally, formally recognized by, the European Economic Community’s Banking Advisory Committee.

\(^{17}\) The existence and importance of the Committee was, however, indirectly recognized by Congress in several sections of ILSA. For example, 12 U.S.C. § 3911 (Supp. II 1984) states: “[a]s one of the three Federal bank regulatory and supervisory agencies, and as the insurer of the United States banks involved in international lending, the Federal Deposit Insurance Corporation shall be given equal representation with the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency on the Committee on Banking Regulation and Supervisory Practices of the Group of Ten Countries and Switzerland.” \(^{18}\) The text of the first Concordat is reprinted in International Monetary Fund, Occasional Paper No. 7, International Capital Markets 29 (1981).

\(^{19}\) The text of the revised Concordat is reprinted in Bank Administration Institute, The New Concordat: Principles for the Supervision of Banks’ Foreign Establishments, Issues in Bank Reg., Summer 1984, at 25.
the Committee sponsored worldwide conferences of banking supervisors in 1979, 1981 and 1984.20

2. The EEC: Cooperation and Agreement Under a Legal Framework

In contrast to informal cooperation between supervisors through groups such as the Cooke Committee, the EEC can promote harmonization of banking legislation and supervisory cooperation by law, through the use of "Directives." Directives are orders of the EEC Council, provided for in article 189 of the EEC Treaty, which "bind any Member State to which they are addressed as to the result to be achieved, while leaving to domestic agencies a competence as to form and means."21 The treaty specifically provides for the freedom of banking institutions to be established and to provide services in the Member States,22 and for coordination of banking legislation.23

With respect to coordination of banking laws, the EEC's first step was issuance of a Directive containing minimum requirements for the establishment of banking institutions in the Member States, and requiring that the Member States calculate, according to a uniform method, the solvency and liquidity of their banking institutions for observation purposes.24 The EEC permitted existing national rules on reporting to remain in force.25

In 1983, the Council of Ministers approved a Directive requiring supervision on a consolidated basis of banking institutions holding a majority interest in another credit or financial institution.26 This Di-

20 Other groups of international supervisors include the Commission of Latin American and Caribbean Banking Supervisory and Inspection Authorities, with 23 members from the area; the Expert Banking Group of the OECD consisting of supervisory officials from the 24 industrialized countries; the Nordic Supervisory Group consisting of the banking authorities of Denmark, Finland, Iceland, Norway and Sweden; the Offshore Group of Banking Supervisors, open to supervisors from the offshore banking centers who endorse the principles of the revised Basle Concordat; the SEANZA Forum of Bank Supervisors from the Indian sub-continent, Southeast Asia and the Pacific Basin; and the Gulf Coordinating Council of Central Banks, which promotes contacts among banking authorities in the Middle East.


22 Id. arts. 52-66.

23 Id. art. 57. "[T]he Council . . . shall . . . issue directives regarding the co-ordination of legislative and administrative provisions of Member States concerning the engagement in and exercise of non-wage-earning activities. A unanimous vote shall be required . . . on measures concerning the protection of savings, in particular the allotment of credit and the banking profession . . . ." Id.


25 Id. art. 6.

rective also requires the Member States to eliminate all legal obstacles to the exchange of information necessary for consolidated supervision.\textsuperscript{27}

Although the EEC Treaty, particularly article 57,\textsuperscript{28} provides a legal framework for coordinated international supervision in the EEC, progress generally has not been more substantial or significant than progress under the informal bank supervisors’ groups. For example, under articles 8 and 57 of the treaty,\textsuperscript{29} the coordination of banking legislation should have been accomplished by 1970. Coordination and harmonization have proceeded slowly, however, in part because objective criteria for matters such as capital ratios do not exist, and it is necessary to reach mutual agreement on judgmental standards. Moreover, harmonization of EEC standards must take account of other countries’ requirements to prevent any competitive disadvantage. On the positive side, however, this legal and institutional framework actively supports and spurs the harmonization process, and has at a minimum resulted in informal coordination of the policies of the Member States’ supervisory authorities.

\textbf{B. Prospects for Future Action}

Despite the progress made through international supervisory cooperation, much remains to be done. Because an interdependent multinational banking system with its mutual vulnerability is now a reality, however, both banks and bank supervisors have a real incentive to develop uniform, or at least harmonized, rules of the game. The future agenda includes harmonizing consolidated accounting and financial statements and establishing agreed-upon principles regarding liquidity, capital adequacy and its measurement, and treatment of non-performing loans. Although disparities exist in all of these areas, they are not so great as to foreclose the possibility of agreement. Work on all of these issues is proceeding actively in the international supervisors’ groups and, given the incentives for progress, the ultimate goal of minimum international standards is not beyond reach.

\textbf{II. Federal Banking Agencies’ Supervision of International Lending}

U.S. banks’ overseas assets exceed 300 billion dollars, and foreign assets often comprise a substantial portion of an individual bank’s total assets. Analyzing country risk—the whole spectrum of risks that rise from the social, economic, legal, and political conditions in a foreign country—is therefore an important concern to U.S.

\textsuperscript{27} Id.
\textsuperscript{28} Treaty of Rome, \textit{supra} note 21, at art. 57.
\textsuperscript{29} Id. art. 8.
Two supervisory approaches are used to assess country risks. One approach categorizes international social-economic-political risks into traditional U.S. bank supervisory classifications for asset quality. The second approach quantifies and evaluates a bank's country exposure management system.

A. Supervisory Evaluations of Country Risks

In 1974, the OCC established a structured approach for assessing foreign government loans in national banks' portfolios. The OCC formed a Foreign Public Sector Credit Review Committee that evaluated the credit facilities made available by national banks to foreign governments, their agencies, or their instrumentalities. During 1979, the Federal Reserve and FDIC joined the Comptroller in establishing the Interagency Country Exposure Review Committee (ICERC). This shifted the supervisory focus from classifying specific foreign public sector borrowers to evaluating banks' transfer risk. The purpose of ICERC is to evaluate the ability of countries to generate foreign exchange necessary to enable borrowers in those countries to repay debt denominated in other than local currency. The ICERC also establishes categorizations to be uniformly applied by the three agencies in the examination of all insured U.S. banks.

The ICERC is comprised of nine federal bank examiners, three from each agency, who base their assessments and classifications on a wide assortment of data and information. First, the ICERC receives detailed country studies prepared by the Federal Reserve System. The studies discuss economic, social, and political risk factors.

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30 It is also important to Congress. ILSA requires the Federal banking agencies, in accordance with their five point program, to "evaluate banking institution foreign country exposure and transfer risk for use in ... examination and supervision [and] ... assure that factors such as foreign country exposure and transfer risk are taken into account in evaluating the adequacy of the [bank's] capital ..." 12 U.S.C. § 3903 (Supp. II 1984).

31 Loans and other assets considered problematical from a credit standpoint are "classified" by bank examiners into different categories depending upon the degree of risk of loss which they pose. See COMPTROLLER'S HANDBOOK FOR NATIONAL BANK EXAMINERS § 215.1 (Aug. 1985). Loans and other assets that appear sound and likely to be repaid in accordance with their terms are not classified. The amount of classified assets in relation to a bank's total assets and capital is a critical factor in evaluating a bank's condition and determining whether corrective supervisory action is necessary. Id. § 503.

32 For a full discussion of the Comptroller's approach and why it was necessary, see Bench, How the Comptroller of the Currency Analyzes Country Risk, EUROMONEY, Aug. 1977, at 47.

33 "Transfer risk" means the possibility that an asset cannot be serviced in the currency of payment because of a lack of, or restraints on the availability of, needed foreign exchange in the country of the obligor. 12 C.F.R. § 20.7(h) (1986). The reasons for the formation of ICERC and its emphasis on transfer risk are discussed in A New Supervisory Approach to Foreign Lending, FED. RES. BANK OF N.Y. Q. REV., Spring 1978, at 1.

34 ICERC classifications also form the basis for special reserve requirements. See infra notes 40-49 and accompanying text for a discussion of Allocated Transfer Risk Reserves.

35 This composition reflects the fact that all decisions on loan classifications are made by bank examiners.
in a country, and provide statistical information about a country's external debt, balance of payments, and general economic conditions. Second, the Federal Reserve Bank of New York prepares and sends a list to the ICERC that statistically ranks countries by ability to service external obligations. Third, the ICERC members visit U.S. money center banks to review the banks' country files and discuss country conditions with the banks' senior international officers. Finally, the examiners gather U.S. government information about countries to confirm other information ICERC has received. U.S. government sources can also reveal any bilateral or multilateral financial assistance that may be in progress for a particular country.

ICERC meets in Washington, D.C. three times a year to assess country risk. The Committee evaluates the information it has gathered and then categorizes countries on the basis of economic-social-political conditions that may affect the country's flow of foreign exchange necessary to repay U.S. banks' exposures in that country. ICERC may determine that one category applies to all U.S. bank loans in a country, or that several categories apply depending on the types of maturities of exposures U.S. banks have in the country.

The ICERC country categorizations are:

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 that do not presently threaten orderly repayment of external debt.
3. **Weak.** The country experiences many economic, social, or political problems. If not reversed, these problems could threaten orderly repayment of external debt.
4. **Other Transfer Risk Problems.** This category applies when:
   a. A country is not complying with its external debt service obligations, as evidenced by arrearages, forced restructuring, or rollovers; the country is, however, taking positive action to restore debt service through economic adjustment measures, generally as part of the IMF program.
   b. A country is meeting its debt obligations, but noncompliance appears imminent.
   c. A country has been classified previously, but recent debt service performance indicates classification no longer is warranted. For instance, the country is complying with the terms of IMF and rescheduling programs, but sustained resumption of orderly debt service needs to be demonstrated.
5. **Substandard.** This category applies when:
   a. A country is not complying with its external service obligations, as evidenced by arrearages, forced restructuring, or rollovers; and

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36 Different countries are usually reviewed at each of the meetings.
37 For example, short term trade credits usually pose little risk and thus, may be excluded from the overall classification of loans to borrowers in a particular country.
b. the country is not in the process of adopting an IMF or other suitable economic adjustment program, or is not adequately adhering to such a program; or
c. The country and its bank creditors have not negotiated a viable rescheduling and are unlikely to do so in the near future.

(6). **Value Impaired.** This category applies when a country has protracted arrearages, as indicated by more than one of the following:
   a. The country has not fully paid its interest for six months;
   b. The country has not complied with IMF programs and there is no immediate prospect for compliance;
   c. The country has not met rescheduling terms for over one year;
   d. The country shows no definite prospects for an orderly restoration of debt service in the near future.

(7). **Loss.** This category applies when the loan is considered uncollectible and of such little value that its continued reporting as a bankable asset is not warranted. An example is an outright statement by a country which repudiates obligations to banks, the IMF, or other lenders.

The ICERC categorizations are then provided to examiners who use them in their reviews of banks' loan portfolios.

**B. Supervisory Evaluations of Banks' Country Exposure Management Systems**

In addition to the ICERC assessments, the agencies also consider bank management's policies for diversifying risks and the bank's capacities for analyzing risks.

The ICERC categorizations of Substandard, Value Impaired, and Loss are traditional U.S. supervisory classifications for problem assets that are listed and discussed in a *Report of Examination* made available to bank directors.\(^{(38)}\) In addition, when a bank has exposures to Weak, Moderately Strong, or Strong countries, respectively, in excess of 5%, 10% or 25% of a bank's capital funds, then the examiners schedule the exposures in the *Report of Examination* as concentrations of risk for the information of bank directors. If Weak or Moderately Strong exposures exceed 10% or 15%, respectively, of a bank's capital funds, then the examiners discuss the exposures in detail in their *Report of Examination*.

U.S. bank examiners also look at various country exposures and individual assets in a bank's portfolio to determine whether there are groups of country or borrower exposures at risk due to common economic, social, or political factors. For instance, the cash flow of a

\(^{(38)}\) Assets in the Other Transfer Risk Problems category are not regarded as classified assets. Rather, exposures in this category are considered by examiners as a judgmental factor in the general assessment of a bank's asset quality and the adequacy of its reserves and capital.
diverse group of borrowers may depend on the world market conditions for the same commodity, such as oil, shipping services, or steel. Therefore, when federal bank examiners find a group of a bank’s assets that rely on the same essential repayment factor, and when the assets exceed 25% of a bank’s capital funds, the examiners consider the group exposure a concentration of risk. This concentration is detailed in their Report of Examination. The 25% inclusion does not, however, necessarily trigger examiner criticism. Any criticism of a group concentration depends on the on-the-spot opinions of the bank examiner, who decides whether a bank’s concentration is immoderate or unwarranted. This decision is based upon the bank’s traditional relationship with the concentration, the level of bank management’s expertise, and the quality of a bank’s supervision over the concentration, evidenced by credit file analysis and the depth of calling programs to the areas or borrowers.39

To reach supervisory conclusions about the adequacy of a bank’s management of country exposures, U.S. bank examiners evaluate a bank’s international credit administration process during their on-site examinations to determine: (1) if policies, practices, procedures, and internal controls for country risk management are adequate and prudent; (2) if bank officers are operating in conformance with the guidelines the bank has established for country risk administration; and (3) the effect of country risk on the overall quality of the international loan portfolio. Bank examiners expect three basic components in every bank’s country risk management system: (1) evaluation of economic, political, and social trends in countries where the bank has asset exposures; (2) country exposure limits established by executive bank management; and (3) current, accurate, and complete internal reporting systems to monitor and control country risk. Finally, the examiners inspect a bank’s reports, committee minutes, and other records to determine the quality and frequency of a bank’s country evaluations, the quality of internal country exposure reporting, and the bank’s compliance with its own internal limits.

These factors taken together enable the banking supervisor to reach an overall assessment of the degree of risk in a bank’s international lending and other international activities, and to determine whether any corrective supervisory action—informal or formal—is necessary.

III. Allocated Transfer Risk Reserves (ATRR)

The agencies’ proposal to establish a system of special reserves for international loans that had not been serviced for an extended

39 See COMPTROLLER’S HANDBOOK FOR NATIONAL BANK EXAMINERS, §§ 205-19, 805-09.
period was adopted, essentially unchanged, by the Senate.\textsuperscript{40} The House version, however, would have required that uniform reserves be established for loans in need of rescheduling, a much broader standard than that proposed by the agencies.\textsuperscript{41} Recognizing the adverse impact the House provision would have on the needed continuation of international lending, Congress ultimately adopted the Senate version, based upon the agencies’ proposal. Under this version,\textsuperscript{42} each federal banking agency must require the banks under its supervision to establish and maintain a special reserve whenever, in the agency’s judgment, the quality of certain loans made by the bank has been impaired by a protracted inability of public or private sector borrowers in a foreign country to make payments on their external indebtedness as indicated by various factors. Such factors include failure to comply with the terms of a restructuring, or the absence of definite prospects for the orderly restoration of debt service. Thus, reserves are not required for most LDC loans because, in most cases, there are either definite prospects for the orderly restoration of debt service, or the country is complying with either the terms of a restructuring agreement or with an IMF or other suitable adjustment program. In addition, most such borrowers have made strenuous efforts to continue to meet their interest payments while restructuring their debt obligations.\textsuperscript{43}

\textsuperscript{40} S. Rep., supra note 4, at 13-14. “The bill provides that each appropriate federal banking agency shall require a banking institution to establish and maintain a special reserve whenever, in the judgment of the agency, the institution’s exposure in a particular country has become subject to a level of transfer risk that indicates a protracted inability of borrowers to make schedule payments on external indebtedness.” Id. at 14.

\textsuperscript{41} H.R. Rep., supra note 4, at 40. The House version required “that the agencies establish a uniform loan reserve standard and phase-in schedule for loans where there is a substantial likelihood the loan will not be repaid as expected without additional borrowing or major restructuring.” Id.


\textsuperscript{43} Arguably, the House version of the special reserve provision should have been adopted; that is, banks should be forced to reserve against or write down loans subject to multiple rescheduling agreements. The theories behind this argument are that such loans are not marketable at face value and should not be carried as such on the books of the bank, and that, but for subsequent reschedulings, the borrower would not have been able to comply with the terms of the original rescheduling and the loans would then have been subject to a special reserve.

This argument, however, overlooks several important points. First, the special reserve provision does not replace or detract from the general obligation of banks and their auditors to assure that a bank establishes and maintains a loan loss reserve adequate to provide for potential losses. In the past few years, U.S. banks, including the multinationals most involved in international lending, have substantially increased their capital, including loan loss reserves. Thus, the fact that loans to a particular LDC are not subject to a special reserve does not mean that no provision has been made against potential losses arising from them. Secondly, bank loans generally are not required to be, and are not, “marked to market.” Nor are restructured loans necessarily required to be written down. Finally, it is often anticipated that multiple reschedulings will occur, to take account of both changes in the economic condition of the borrower, including improvements, and changes in market terms for loans. Therefore, a special reserve requirement for all rescheduled loans is not warranted.
The joint regulations required by section 3904(c) were published in final form by the agencies on February 13, 1984.\textsuperscript{44} These regulations incorporate the statutory standards for determining when a special reserve should be required. Essentially, the purpose of such a reserve is to reflect the transfer risk and diminished value of international loans which have not been serviced over an extended period of time. Under current procedure, a reserve requirement is imposed by a joint decision of the agencies on those international assets that have been classified for transfer risk reasons as "Value Impaired" by the ICERC. The minimum ATRR amounts are determined jointly by the agencies on a regular basis.\textsuperscript{45}

Not all loans outstanding to borrowers in a particular country are necessarily covered by the reserve. For example, loans guaranteed elsewhere or loans in local currency matched by local currency liabilities, as well as other types of credit, such as short-term trade financings, often are excluded from the reserve requirement. In addition, the reserve does not automatically apply to new loans made to borrowers in the country. Rather, such loans are later evaluated on their merits in accordance with their servicing history.

The reserves generally are established at a rate of 10\% of the loan amounts outstanding during the first year and 15\% in subsequent years.\textsuperscript{46} No reserve is required if the bank already has written down the amounts of the loans by an equivalent percentage.\textsuperscript{47} In accordance with the statute, these reserves must be established by a charge against income, and they are not considered as part of capital and surplus or the allowance for possible loan losses.\textsuperscript{48} Accordingly, the normal practice of banks is to charge-off or write down that percentage of the loan subject to reserves, in lieu of creating the special reserve. If, subsequently, there is improvement in the quality of the loans or if in subsequent evaluations they are classified less severely, additional percentage reserves may not be required and/or the agencies can allow banks to reverse the reserves.

Since passage of the statute and promulgation of the regulations, the agencies have required reserves in several instances. Like other examination information and classifications, country debt classifications are not publicly disclosed. Rather, banks having outstanding loans subject to the reserves are notified individually by their supervisory agency.

The Allocated Transfer Risk Reserve system was not intended to, and does not substitute for the obligation of banks and their audi-

\textsuperscript{45} See, e.g., 12 C.F.R. § 20.8(b) (1986).
\textsuperscript{46} See id. § 20.8(b)(2)(ii)(B).
\textsuperscript{47} Id. § 20.8(c)(4).
\textsuperscript{48} Id. § 20.8(c)(1).
tors to appropriately value and reserve against possible losses in their loan portfolio. Moreover, the statute also requires that each banking agency analyze the results of foreign loan rescheduling negotiations, assess the loan loss risk reflected in rescheduling agreements, and ensure that the capital and reserve positions of U.S. banks are adequate to accommodate potential losses on their foreign loans.49 Accordingly, while the system of special reserves does assure that provision is made for the most likely international loan losses, both banks and the agencies are attentive to the need to increase bank capital to provide for the remaining risks.

IV. Accounting for Fees on International Loans

Both Congress and the agencies were concerned that the bank practice of accounting for fees received in connection with international loans as income in the year received provided an artificial incentive for banks to make international loans without consideration of their longer-term consequences.50 Therefore, Congress adopted the applicable portion of the agencies' five-point program and required that the agencies promulgate regulations dealing with bank accounting for fees received in connection with international loans.51 In accordance with the statute, the rules apply to both fees associated with the restructuring of international loans, and fees charged by banks in connection with all other international loans. Therefore, unlike the statutory and regulatory provisions concerning special reserves, which are limited to loans to borrowers in countries experiencing severe foreign exchange shortages and foreign debt repayment problems, the statute and rules on accounting for fees encompass all international loans, including those to borrowers in the industrial countries of the world.

The statute and the regulations distinguish, however, between fees received in connection with a restructuring and those received in conjunction with other international loans. For restructured loans, the rules are rather strict: all fees in excess of administrative costs must be amortized over the term of the loan.52 A restructuring is not an ordinary refinancing. Rather, a restructuring within the meaning of the rules occurs when a foreign country reschedules pub-

50 S. Rep., supra note 4, at 14-15. "In general, under these rules or regulations, any portion of a fee that is deemed to represent interest income should be amortized over the effective life of the loan, recognizing that the effective life may differ from the loan's stated term." Id.; H.R. Rep., supra note 4, at 31. Banks have "a tendency ... to behave in an almost herd-like fashion much of the time and to have difficulty assessing longer term supply-demand relationships." Id.
52 See 12 C.F.R. § 20.9(a) (1986).
lic, and generally private debt, due to the general inability of public and private sector obligors to timely meet their external debt obligations because of a lack of or restraints on the availability of foreign exchange in that country. A restructuring consists of either extending the original schedule of payments or reducing the stated interest rate, or loaning new funds to the borrower so that the existing debt may be serviced or refinanced.\textsuperscript{53}

With respect to other international loans, the rules require that all fees, including a portion of syndication fees, that represent an adjustment to yield be treated as interest and amortized over the loan period.\textsuperscript{54} Commitment fees, however, are treated differently. They are taken into income over the term of the commitment period alone.\textsuperscript{55} Agency fees also are separately treated. The rules provide that such fees are to be recognized as income at the time of the loan closing or as the service is performed.\textsuperscript{56} Although the fee accounting rules are, for the most part, in accordance with Generally Accepted Accounting Principles (GAAP), Congress intended that they not govern accounting or disclosures under the federal securities law.\textsuperscript{57}

V. Collection and Disclosure of International Lending Data

Like the rules on accounting for fees, the rules on collection and disclosure of international lending data apply to all international loans and not merely those to troubled LDC debtors. In accordance with the agencies’ proposal, the statute requires that each bank with foreign country exposure submit, no fewer than four times each calendar year, information regarding such exposure. The information must be in a format prescribed by agency regulations.\textsuperscript{58} In addition, banks must disclose information to the public regarding material foreign country exposure in relation to assets and capital.\textsuperscript{59}

The banking agencies’ joint final rules on reporting and disclosure of international assets require banks to submit, at least quarterly, information on the amounts and composition of their

\textsuperscript{53} \textit{Id.} § 20.7(g).
\textsuperscript{54} \textit{Id.} § 20.9(b), (d).
\textsuperscript{55} \textit{Id.} § 20.9(c). This treatment of commitment fees does not apply to restructured international loans. In connection with such loans, commitment fees, like all other fees which do not represent administrative costs, must be amortized over the term of the loan.
\textsuperscript{56} \textit{Id.} § 20.9(f).
\textsuperscript{57} \textit{S. REP.}, \textit{supra} note 4, at 15. “The Committee ... has determined that nothing in this legislation should be construed as setting disclosure requirements under the federal securities laws or accounting principles for GAAP.” \textit{Id.}; \textit{H.R. REP.}, \textit{supra} note 4, at 42. “The Committee considered the possible impact of the legislation, specifically reserves and fees, on the Federal securities laws and generally accepted accounting principles (GAAP), and intends that nothing in this Act should be construed as setting disclosure requirements under the Federal securities laws or accounting principles for GAAP.” \textit{Id.}
\textsuperscript{59} \textit{Id.} § 3906(b).
international assets, as specified in the *Instructions for Preparation of the Country Exposure Report*, (FFIEC Report 009). These reports break down information on bank loans or other exposure to borrowers in different foreign countries by both types of borrower, public sector or private sector, and by maturity. A separate portion of the report, available to the public, sets forth information on concentrations that are considered material in respect to total assets and capital. This pertinent information includes details regarding exposures exceeding 1% of the bank's assets as well as more generalized information on exposures ranging between three-quarters and one percent of the bank's assets.

VI. Foreign Loan Evaluations

Due to concern that U.S. banks' financing of foreign mines and metal fabricating plants may have contributed to a surplus of certain metal commodities and adversely affected U.S. industries, the House proposed, and Congress adopted a provision in ILSA requiring bank economic evaluations of such projects. As a part of their normal credit analyses, banks routinely evaluate the economic prospects for projects financed with bank loans. The statutory provision makes such evaluations mandatory in the case of certain types of projects and further specifies factors which must be considered and included in such evaluations. This statutory requirement is not limited to loans made to LDCs. Rather, an economic feasibility evaluation is required by the statute for any project in which one or more U.S. banks extend credit which either individually or in the aggregate exceeds 20 million dollars "to finance any project which has as a major objective the construction or operation of any mining operation, any metal or mineral primary processing operation, any fabricating facility or operation, or any metal-making operations (semi and finished) located outside the United States or its territories and possessions . . .".

The evaluation is to be prepared and approved in writing by a senior official of the bank, or by a senior official of the lead bank if

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60 49 Fed. Reg. 5,586-87 (1984) (codified at 12 C.F.R. §§ 20.10 (OCC), 211.44 (FRB), 351.3 (FDIC) (1986)). This supervisory survey requires all U.S.-insured banks with at least one foreign branch (including an International Banking Facility) and foreign assets exceeding $30 million to report their foreign assets by broad categories on a global consolidated basis to their federal banking supervisor. The banking agencies publish the survey data in aggregate form. The banking agencies also computerize and analyze the data by bank and by peer groups for internal supervisory purposes, including use by bank examiners.

61 For analogous public disclosure requirements applicable to publicly-held bank holding companies see 17 C.F.R. pt. 231 (1986) (Guide 3—Statistical Disclosures by Bank Holding Companies, III. C. 3).


63 Id.

64 Id. § 3908(a)(1).
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more than one bank is involved, prior to the making of the loan. The evaluation must include the profit potential of the project, the impact of the project on world markets, the inherent competitive advantages and disadvantages of the project over its entire life, and the likely effect of the project upon the overall long-term economic development of the country in which it is located. In addition, the evaluation must consider whether the loan can be repaid from revenues generated by the project without regard to any subsidy provided by any government. The evaluations are to be reviewed during the course of bank examinations.

The statutory language is not a model of clarity in specifying which projects require an evaluation. For example, is an auto body manufacturing plant a finished metal-making operation? The agencies have not yet issued any interpretations concerning this section. However, because economic feasibility evaluations normally are done for all major project loans and because the statute specifically excludes a private right of action, this section should not result in problems for the banking industry.

VII. Conclusion

ILSA and the rules issued thereunder build upon and enhance the agencies' existing programs and policies for the supervision of international lending by U.S. banks. Because the majority of ILSA provisions apply to international loans wherever made, it is important that the statute and implementing rules be reviewed and considered in the context of all international loans.

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65 Id.
66 Id. § 3908(a)(2).
67 Id. § 3908(b).
68 Id. § 3908(c)(2).