[redacted] 121 2 25X1

Central Intelligence Agency

Washington, D.C. 20505

NOV 3 1983

DIRECTORATE OF INTELLIGENCE

MEMORANDUM FOR: Mr. Gary R. Edson
Special Assistant to the Deputy
Secretary of State
Department of State

FROM : [redacted] 25X1
Chief, Economics Division
Office of Global Issues

SUBJECT : International Banking Regulations

1. I recently asked one of my analysts to take a look at changes in OECD country banking supervision which may affect lending to debtor countries. I thought you might find the results of interest. [redacted] 25X1

2. I know your schedule has been extremely busy the past few months. It seems that Ken has been involved in a steady stream of crises. If you get a chance, however, give me a call so we can try to get back on track on our biweekly meetings. [redacted] 25X1

[redacted] 25X1

Attachment:
GI M 83-10271, November 1983,
The Debt Crisis and Bank Regulatory
Policies

[redacted] 25X1

25X1

[redacted]

[redacted] 25X1

GI M83-10271

[redacted] 25X1

Central Intelligence Agency

Washington, D.C. 20505

NOV 2 [illegible] 1983

DIRECTORATE OF INTELLIGENCE

MEMORANDUM FOR: Douglas P. Mulholland
Special Assistant to the
Secretary for National Security
Department of the Treasury

FROM : [redacted] 25X1
Chief, Economics Division
Office of Global Issues

SUBJECT : International Banking Regulations

1. I have attached a copy of a study we recently completed on changes in OECD country banking supervision which may affect future lending to debtor countries. We have sent a copy of this report to Kevin Coyne. I thought you might find this typescript timely because of passage by Congress last week of measures which tighten regulation of foreign lending by US banks. [redacted] 25X1

[redacted] 25X1

Attachment:
GI M 83-10271, November 1983,
The Debt Crisis and Bank Regulatory
Policies

[redacted] 25X1

25X1

[redacted]

[redacted] 25X1

[redacted] 25X1

Central Intelligence Agency

Washington, D.C. 20505

NOV [illegible] 1983

DIRECTORATE OF INTELLIGENCE

MEMORANDUM FOR: Mr. Kevin Coyne
Special Assistant to the Deputy
Secretary of the Treasury
Department of the Treasury

FROM : [redacted] 25X1
Chief, Economics Division
Office of Global Issues

SUBJECT : International Banking Regulations

1. I recently asked one of my analysts to take a look at changes in OECD country banking supervision which may affect lending to debtor countries. I thought you might find the results of interest. [redacted] 25X1

2. I hope the material [redacted] sent you last week was useful. If you think any additional scenarios would be worth running before the 1 December meeting just let me know. [redacted] 25X1

[redacted] 25X1

Attachment:
GI M 83-10271, November 1983,
The Debt Crisis and Bank Regulatory
Policies [redacted] 25X1

[redacted] 25X1

[redacted]

[redacted] 25X1

[redacted] 25X1

SUBJECT: International Banking Regulations

OGI/ECD/T [redacted] 28Nov83 [redacted] 25X1

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Original - Gary R. Edson, State Department
3 - Douglas P. Mulholland, Treasury
1 - Kevin Coyne, Treasury Department
1 - SA/DDCI
1 - Executive Director
1 - DDI
1 - DDI/PES
1 - NIO/ECON
2 - [redacted] CEA 25X1
1 - CPAS/ILS
1 - D/OGI, DD/OGI
1 - Ch/ECD
1 - Ch/ECD/IF
2 - Ch/ECD/T
1 - Ch/EURA/EI/EI
1 - Ch/OEA/J
8 - OGI/PS

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Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

# THE DEBT CRISIS AND BANK REGULATORY POLICIES

## Summary

*The regulatory climate faced by banks lending to debt-troubled countries has been characterized by inconsistancy this year. While regulatory agencies are trying to encourage continued private capital flows to debtor LDCs, they have had to follow their legal duty to monitor bank soundness and safeguard investor and depositor interests. Bankers have complained loudly about being pulled in two directions whenever regulators have supported rescue efforts while also pointing out concerns over exposure. Integrated regulatory strategies have been difficult to achieve, and either inaction or halfway measures have usually resulted. However, continued slow and cautious implementation of additional controls is likely. In our judgment it is still too soon to assess the effect proposed regulatory changes will have on lending to LDCs.* [redacted] 25X1

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*This memorandum was prepared by* [redacted] *Office of Global Issues. Comments and Queries are welcome and should be addressed to the Chief, Economics Division, OGI* [redacted] 25X1 25X1

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GI M 83-10271
November 1983

[redacted]

[redacted]

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## The Debt Crisis and Bank Regulatory Policies

### Recent Regulatory Actions

Regulatory measures that commercial bank regulators have undertaken at least partly in response to the 1982-83 international debt crisis fall into three areas:

* Improving the quality of information regulators receive on worldwide activities of banks.
* Increasing bad debt reserves.
* Lowering the ratio of loans to bank capital. 25X1

### Information

Banking regulators -- central banks, finance ministries, or specialized banking supervisory agencies -- in major OECD countries have kept an attentive eye on commercial bank exposure while confronting the past year's LDC and East European liquidity crises and reschedulings. To date, regulators have devoted most of their effort to improving the flow of information they receive. With improved information national government regulators can more effectively monitor the exposure and soundness of individual banks and better coordinate their own activities with bank regulators in other countries. 25X1



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Thus far, the major push for improved information has come from banking supervisors working as a committee of the Bank for International Settlements (BIS) and from The European Community (EC). In June the BIS Committee on Banking Regulations and Supervisory Practices, known as the Cooke Committee,* reformulated its 1975 international bank supervisory guidelines, the "Basel Concordat." The committee has tried to eliminate gaps in reporting to supervisory authorities that developed as a result of the rapid internationalization of banking. Under the new agreement, responsibilities of the various national banking authorities for supervising parent banks, branches, subsidiaries, nonbanking subsidiaries or joint ventures are defined in detail. For example, bank holding companies, such as the Luxembourg operation of Banco Ambrosiano, will report to banking supervisors for the first time. [redacted] 25X1

The principle of consolidated supervision is central to the Cooke Committee's effort: the parent's supervisory authorities should monitor the combined balance sheet of the parent and off-shore operations. Host country regulators also have supervisory responsibilities, particularly in monitoring liquidity. The agreement, however, contains no guidelines on capital ratios, reserves, or lender of last resort policies. Some leading West European bankers have indicated that even if all Cooke Committee guidelines are followed, there still will remain the substantial

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*The Cooke Committee comprises banking supervisors from the United States, Japan, West Germany, France, the United Kingdom, Italy, The Netherlands, Belgium, Canada, Sweden, Switzerland, and Luxembourg. [redacted] 25X1



[redacted] 25X1

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problem of the comparability of various national philosophies of banking supervision. 25X1

The EC has drafted a directive, approved by the member states in June, requiring credit institutions to report on a consolidated basis -- already the rule in the United States. The directive obliges member states to introduce within two years national legislation requiring reporting by banks to include results of foreign subsidiaries. The directive, if implemented, would eliminate legal obstacles to the exchange of information on banking operations among EC member states. A related draft directive, still in its early stages and not yet approved by the EC Banking Advisory Commission, would require bank branches with head offices outside countries in which they are located to report annual accounts of the parent. 25X1

From an individual country perspective, West Germany has recently begun to bolster its reporting requirements. The West German Finance Ministry recently proposed legislation that would require banks to report consolidated balances including results of all majority-held subsidiaries. Under a 1982 gentlemen's agreement with regulators, about 40 West German banks already voluntarily report loans made by their subsidiaries. Other provisions would make it easier for West German regulators to share information with bank supervisors in other countries. According to Embassy reporting the proposals are expected to come into force by 1 July 1985. 25X1

Elsewhere, the Swiss Federal Banking Commission this year began to require reporting by banking groups on a consolidated



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basis. According to diplomatic reports, UK officials have acknowledged that recent sovereign debt problems have stimulated reviews within the Bank of England of adequacy of information on bank exposure, supervisory practice, and country risk analysis. [redacted] 25X1

In the private sector, commercial banks from Western Europe, Japan, the United States, Canada, and Brazil established in January the Institute for International Finance, to be located in Washington, D.C. It is designed to aid sovereign risk assessment by the member institutions by supplying them with information on the economic condition of debtor governments and potential borrowers. Japanese financial institutions have established a similar organization among themselves. [redacted] 25X1

Bad Debt Reserves

General bad debt reserves based on debtor performance are required in most countries, and sometimes specific reserves are required for individual loans or problem debtors. So far this year two countries have altered policies in this area. In October the Swiss Federal Banking Commission asked Swiss Banks voluntarily to set aside bad debt reserves for problem debtor countries amounting to 20 percent of outstanding loans. The financial press has reported that the action follows from the Commission's belief that a number of Swiss affiliates of foreign banks have inadequate provisions against sovereign risk. Managers of some of these foreign banking operations in Switzerland have objected to the new guideline which is stricter than those of parent countries. According to Embassy reporting,



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most major Swiss banks already have hidden reserves beyond legally required levels and are not expected to be affected by the move. Virtually all banks in Switzerland will probably treat the recommendation on bad debt reserves as binding. [redacted] 25X1

Embassy Tokyo reports that since March the Japanese Ministry of Finance has encouraged banks to establish larger bad debt reserves against overseas lending. Banks are permitted to place in the new reserves between 1 and 5 percent of outstanding loans to problem debtor countries. At present, banks may deduct from taxable income 0.3 percent of all lending, or an amount reflecting average bad debts over the past three years, as a bad debt reserve. The new reserves can be applied to debtors that fall one month behind in payment of principal or interest or have arranged or requested rescheduling. [redacted] 25X1

According to Embassy reporting some MOF officials favor making the new reserves tax deductible in order to place Japanese banks on an equal footing with foreign banks which receive favorable tax treatment for such funds. However, MOF tax officials oppose such a move. [redacted] 25X1



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Capital Ratios

Among the OECD countries, only West Germany has recently moved to lower the ratio of loans to bank capital. Legislation recently proposed by the West German Finance Ministry would limit by 1988 a bank's consolidated lending to 18 times capital -- the ratio now required for unconsolidated reporting. [redacted] 25X1

Leading bankers have criticized the capital ratio proposal, noting that current consolidated ratios can be as high as 24 to one. They have suggested a ratio of 20 to one as less likely to restrict domestic or international lending and have asked for a longer transition period. According to Embassy reporting, an official of one of the three largest West German banks said that his bank's strategy would be to freeze loans as a percentage of the bank's loan portfolio and raise capital whenever the market permits. [redacted] 25X1 Embassy Bonn reports that West German bankers identify their participation in the recent lending package for Brazil as an undertaking they may not be able to duplicate unless authorities avoid rigorous application of capital ratios. [redacted] 25X1

West German government officials, however, assert they do not want banks to curtail international lending, but only wish to improve their soundness. According to Bundesbank officials, legislation is being sought because the government and private bankers could not agree on terms for a voluntary regime and

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[redacted]

because the provisions on reporting in the draft law would formally conform to changes in EC regulations on consolidated reporting. They believe that a five-year transition period can bring the foreign activities of West German banks under control without disturbing international lending activities. [redacted] 25X1

In Canada recent publicity over very large domestic loans, such as rescheduled loans to Dome Petroleum, has led to increased internal scrutiny of foreign loans by Canadian banks. According to the financial press the Inspector General of Banks has indicated that general guidelines on capital adequacy will be issued. [redacted] 25X1

Regulatory Outlook

Concerned that overreaction could threaten lending to debtor LDCs, most OECD banking regulators have acted cautiously while reviewing policies and improving the quality of information available to them. Some countries -- Switzerland, West Germany, and Japan -- have taken measured regulatory actions designed to limit exposure or guard against loss. Others, such as Britain and France, have not altered standing policies. [redacted] 25X1

As long as concerns over bank soundness prompted by the Third World debt crisis remain, slow and cautious implementation of additional controls is likely. Predictions by West German bankers that controls will have serious consequences for international lending are clear attempts to influence legislation, but they probably also represent genuine concerns of bankers. Despite such indications that lending to LDCs might be



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affected if the current, tentative regulatory trend continues and accelerates, it is still too early to assess its effects on lending. 25X1

Criticism of Proposed US Actions

Over the past year most criticism of banking law changes affecting Third World lending was focused on major legislation pending in the US Congress.* In July, British bankers complained to US bank regulators that the earnings of UK banking operations in the United States would be seriously affected if major South American countries are included in proposed special reserves. 25X1

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*In April, US regulators announced a five point program that included a special bad debt reserve requirement on problem foreign loans, strengthened country risk examination, expanded disclosure of country risk exposure, increased cooperation with foreign bank regulators, and a rule that loan fees be charged over the life of a loan. Subsequently, differing House and Senate versions of these provisions were incorporated into the IMF funding legislation. Both chambers passed bills last summer, and on November 17 and 18 Congress approved the conference report. Major provisions of the final version will require banks to: (1) set up special bad debt reserves, with the amount to be specified by regulators, whenever regulators determine that a foreign borrower is unable to meet its loan obligations, and (2) maintain adequate capital ratios, as determined by regulators. A House provision restricting new lending to a problem debtor country if a bank's public and private loans to that country exceed its capital was dropped from the version agreed to in conference. 25X1



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stricter regulation of foreign lending, if approved in the United States, could spread to Western Europe and Canada. They feared that such a trend might be sustained by increased US influence resulting from current efforts to broaden coordination among regulatory authorities. The London Financial Times expressed concern that Congressional proposals threaten to curb lending to LDCs and argued that despite mistakes made by commercial banks in sovereign lending, judgments about credit allocation should be left to bankers and not to politicians. 25X1



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# APPENDIX

## Current Work On International Banking Supervision

### OECD

A series of six monographs on international banking are being produced by the OECD Secretariat. The Internationalization of Banking has been published. A second monograph, Prudential Supervision, will be completed around the end of 1983 or beginning of 1984. Other monographs will deal with electronic funds transfers, asset and liability management, banking and monetary policy, and banking competition. The OECD monograph series is an attempt to describe major changes that have occurred in the banking and financial intermediary environment in the OECD countries over the last 15 to 20 years. These papers are not designed to be policy documents; they will only be descriptive. They will include particular emphasis on the development and workings of multilateral fora to deal with problems of multinational bank supervision. 25X1

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A partial chapter breakdown of the prudential supervision monograph is available (there will probably be additional chapters):

| | |
|---|---|
| Chapters 1-3 | Purposes of bank supervision |
| Chapter 2 | National policies on authorizing international activities of banks, including foreign acquisitions |
| Chapter 3 | Supervisory policies with respect to country-risk limits, monitoring, concentration, accounting, disclosure, and loan loss reserves. [redacted] 25X1 |

<u>NSF Program</u>

The multi-year National Science Foundation program of research in international economics is sponsoring research on international finance by the Brookings Institution. Under direct NSF funding and through the Brookings grant, Jack M. Guttentag and Richard J. Herring of Wharton have produced several papers, either already published or in various stages of revision: <u>The Lender of Last Resort Function in an Internatinal Context</u>; <u>What Happens When Countries Cannot Repay Their Bank Loans? The Renegotiation Process</u>; <u>Credit Rationing and Financial Disorder</u>; <u>Uncertainty and Insolvency Exposure by International Banks</u>; <u>Disclosure Policy and International Banking</u>; and <u>The Current Crisis in International Banking</u>. The last two address some aspects of the prudential supervision issue. In view of current interest in the issue, Guttentag and Herring may extend their research on disclosure issues. [redacted] 25X1



[redacted] 25X1

They have also started work this year under the NSF grant on three new projects on prudential supervision and regulation of international banking:

(a) A paper on prudential supervision of, and the provision of emergency liquidity assistance to, international banks. A first draft will be available fall 1983. This paper will look at why the growth of international banking has created special difficulties in supervising the soundness of banks and in providing liquidity assistance in emergencies, current ideas for dealing with bank soundness through international cooperation (in particular through the Cooke Committee), existing arrangements for lender of last resort assistance, problems posed for regulators by methods used to consolidate accounts of banks and their affiliates, regulatory weaknesses caused by country-by-country variation in the scope and nature of regulation of liquidity positions, and the relationship between regulation of liquidity and the regulation of interest-rate risk exposure.

(b) A paper addressing the factors underlying the declining capital positions of banks heavily engaged in international banking as well as the supervisory and regulatory policies aimed at influencing these positions. A draft should be finished by spring 1984. Among the topics this paper will probably consider are the US proposal for special reserves tied to lending to problem debtors, problems in relating capital requirements to country exposures, formal (quantitative) versus informal (qualitative) capital requirements, how to define capital for regulatory purposes, effects of the location of

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capital holdings of international banks with foreign affiliates on prudential regulation, problems of coordinating bank regulation between governments, and how to consolidate accounts of banks and their affiliates for regulatory purposes.

(c) A paper on the interbank market and the management of the liquidity positions of international banks. The first written report on this project is scheduled to be available spring 1984. 25X1

The NSF program also includes projects by other scholars that address prudential supervision:

(a) Richard Dale, a Brookings visiting scholar, and Richard Mattione of the Brookings staff have produced a study, Managing Global Debt, which was published in September. This paper surveys five broad categories of policy actions that have been proposed to deal with problems that banks are experiencing with LDC and East European borrowers. One of these five categories is regulatory constraints on banks.

(b) A book-length study, The Internationalization of Banking and Its Implications for National Regulatory Policies, by Ralph Bryant, a Brookings Senior Fellow, will probably be available in draft during the first half of 1984. One of the objectives of the project is to analyze the differences between the supervisory and regulatory environments in the United States and in other major countries and the trends toward elimination of those differences. Bryant intends to examine Cooke Committee activities, as well as prudential -- and what he calls "nonprudential" -- aspects of bank regulation and supervision.

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