

BANK REGULATORS' VIEWPOINTS

A. Supervisory Attitudes in the USA*

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I would like to make a few remarks about my current thinking concerning supervisory issues related to bank exposure to LDCs, including supervisory attitudes toward new instruments such as those which will be part of the Mexican financing package. Before turning to those supervisory issues, allow me to make several more general observations on the LDC debt situation. As a matter of perspective, several points are worth stressing even if in summary fashion. They are:

First, despite all the problems, the frustrations and the setbacks, I believe that more progress has been and is being made than is often recognised. Certainly, when we look at individual countries — a process which has always been at the heart of the case-by-case philosophy — there are a number of instances in which progress has been dramatic.

Second, now as in the past and in the future, sound macro and structural economic policies in the debtor countries are the necessary pre-conditions for lasting success. But, as in many things, necessary conditions are not always sufficient. To bridge the gap between the necessary and the sufficient, we must keep firmly in mind that cooperative efforts between the debtor countries, the commercial banks, the IFIs and the creditor countries remain essential. It is still a package deal such that if any of these groups fails to fulfill its responsibilities, all will suffer including the one that by its short-sightedness triggered the unravelling in the first instance.

Third, obviously debt reduction and debt service reduction have an important and necessary role to play in the process. However, debt reduction or debt service reduction, no matter how well conceived and executed, are not a *full* substitute for the extensions of fresh credits to the debtor countries by *both* official institutions and commercial banks. This is the very essence of the approach laid out by Secretary Brady in his speech in March of this year.

Stated differently, absent access to private sources of finance over time, the longer run capacity of the debtor countries to finance growth and development would be in further jeopardy, especially since it seems to me self evident that governments in the industrial world are not willing or able to take on that task in isolation. Thus, what we need is a balanced approach

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to financing in which fresh credits, public and private — operating in tandem with elements of debt and debt service reduction — remain an important part of the process.

In this regard, I would note that the proposed Mexican and Philippine financing packages both contain options providing for fresh credits. In each case modest amounts of new money from the international commercial banking community will be vitally important to the ultimate success of these financing packages.

Fourth, having emphasised the importance of fresh credits, let me also stress the very considerable benefits of debt or debt service reduction. In the case of Mexico, for example, the permanent cash flow benefits growing out of the contemplated debt and debt service reduction transactions are truly significant. But, as important as the cash flow gains may be, there are other important benefits to Mexico. For example, the principal amount of a very sizable fraction of Mexico's external debt will be fully secured at maturity and it is likely that tens of billions of dollars of such debt will have an interest rate of 6.25 per cent locked in for 30 years — not an inconsequential element of protection against the vagaries of the interest rate cycle over time. Needless to say, to the extent Mexico benefits from these arrangements, it follows that creditors, both current and prospective, should also benefit. That, too, is the essence of the Brady initiative.

Let me now turn to my current thinking about supervisory attitudes toward LDC debt in general and to the specific supervisory treatment in the US of Mexican-type transactions and instruments. Let me stress that these views are a reflection of my own thinking, but they are not necessarily the last words on this subject. My comments fall into four major points:

First, the overall thrust of policy with respect to reserves against country exposures is unchanged. Banking organisations are expected to have adequate capital reserves to cover the risks associated with all forms of lending, including country exposures. In exercising this responsibility to assess the adequacy of an organisation's reserves, account will be taken of a bank's overall financial condition, focusing particularly on its asset quality, capital, and management, against the background of current and prospective financial and economic conditions. These assessments

of reserve adequacy will continue to be made on a case-by-case basis.

We want very much to emphasise this case-by-case philosophy in a manner that avoids the perception that there is a single reserve or provision ratio that is 'right' for all institutions at all times.

Second, sovereign risk related provisions or reserves can be viewed in the following framework:

The measure of exposure will be the amount of credit outstanding to all countries that are 'criticised' or 'classified' by the Federal bank supervisory agencies in accordance with the appropriate provisions of US law and regulation. However, when measuring overall commercial bank exposure to such countries, it would not be unreasonable to deduct the amount of performing trade credits outstanding to all such countries. In other words, performing trade credits can be viewed as outside the framework of any special reserving or provisioning requirements. It should be noted also that there are a few countries that, by virtue of their economic and financial performance, have been upgraded from the list of criticised or classified. As such, existing and new credits to such countries can be seen as outside the need for any special requirements so long as their improved status is maintained.

The measure of reserves or provisions against exposure will include the amount of funds taken out of current earnings or charged against retained earnings for this purpose. In addition, the assessment of reserve adequacy can, within acceptable bounds, take account of prospective tax benefits available to individual banks as a result of loan loss provisions taken against such exposures.

For US banks, taxes paid are generally not reduced when provisions or reserves are *established*. However, as actual charge-offs occur, taxes may be reduced, providing the opportunity to replenish the reserve without additional charges against net income. Thus, the after-tax level of reserves can be significantly greater than the stated level of reserves. The purpose of the tax adjustment to the reserve coverage ratio is to take account of this consideration and in the process make reserve ratios for US banks more comparable with international practices. For example, based on developments prior to the current quarter, this tax adjustment factor raises the average effective reserve coverage ratio of US money centre banks by almost 5 percentage points.

The measure of reserve coverage may also take account of the *present value* of any collateral or interest guarantees growing out of Mexican-type swaps of loans for new debt instruments carrying such collateral or guarantees. For reserve adequacy purposes, it is quite reasonable to treat this amount as an addition to reserve coverage so long as the new

bonds are being serviced in an orderly fashion and the guarantees are intact. This too will have the effect of raising effective reserve coverage beyond that suggested by a simple ratio of exposure to reserves.

Third, taking account of these definitions and concepts, and in circumstances in which reserves for individual banks are judged to be at acceptable levels, additional reserves need not be automatically established in connection with fresh credits extended to the debtor countries in connection with internationally supported financing programmes. Any such judgement will, of course, be subject to continuing review, a process which will become all the more straightforward in a setting in which economic policy and performance in the debtor countries is strengthened.

Finally, with regard to debt or debt service reduction transactions such as will be part of the Mexican financing package, the following additional comments will apply.

When a bank participates in debt reduction transactions, a lower level of reserves can be quite acceptable so long as the new debt instrument is booked at par and appropriately enhanced (collateralised at maturity with interest support) and is being serviced in a timely manner. In particular, where such transactions are essentially an exit instrument and reserves are otherwise at acceptable levels, the present value of the collateral and interest guarantees may suffice as adequate reserve coverage depending on the overall circumstances unique to individual banks.

In instances involving debt service reduction transactions, the new bonds may, for supervisory purposes, be booked in the investment account at par so long as the *sum* of reserves (as defined above and taking account of the present value of collateral and interest guarantees) and the 'fair value' of such bonds equals or exceeds their par value. In the alternative, banks may follow the guidance recently provided by the Securities and Exchange Commission regarding the accounting treatment of such instruments.

While other treatment of these transactions may be appropriate, banks should consult with the appropriate Federal bank supervisor regarding the supervisory and prudential merits of any alternate approach in advance of utilising such approaches.

This approach is intended to balance a number of considerations in a context of providing the maximum degree of flexibility to individual banking institutions. It starts with the premise that prudential standards must be just that — prudent. However, it also recognises that reserves or provisions are not charge-offs or write-downs. Indeed, what we are all striving for is a result in which the great bulk of these reserves will not be needed and as conditions improve banks

will be able to recoup elements of such reserves into future income or devote them to other prudential purposes. Aside from these prudential considerations, the approach is designed to (1) recognise countries whose performance has resulted in their 'promotion' out of the classified or criticised categories; (2) recognise the special nature of trade credits; (3) provide very flexible treatment for debt or debt service reduction transactions of the Mexican type; and (4) provide the necessary flexibility within which banks can, consistent with their own business and credit judgements, choose new money options without having to provide further reserves so long as their overall reserve position is adequate.

There is one final point to be emphasised in regard to reserving or provisioning practices. Namely that reserves or provisions provide an important cushion against possible losses in the principal amount of bank exposure to debtors. They are, in other words, a cushion in balance sheet terms. However, reserves (or for that matter write-downs) do not reduce the bank's

claim against the debtor. For this reason and others, debtors should not conclude that the mere existence of such reserves constitutes a license to ignore their fundamental obligations to their creditors. By the same token, major creditors should remain mindful that even a generous level of reserve coverage does not mean that they can walk away from the process. Neither the balance sheet nor the income statement — to say nothing of the risks to the well-being of the global economy including its implications for both the balance sheet and the income statement — would be well served by such neglect.

The months immediately ahead will not be easy. There are 10 or more developing countries in some stage of discussion, negotiation or syndication of new financing packages with official and private creditors. However difficult it may be, it should be very clear that now is not the time to cut and run. With flexibility, with commitment, and with a renewed sense of that commonality of purpose of which I spoke earlier, I believe we can and must see it through.