

# Evaluation of Risk in International Lending: A Bank Examiner's Perspective

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It is indeed a pleasure to have been invited to join this distinguished group to discuss "Key Issues in International Banking." I will begin with a very brief synopsis of recent events leading to the situation as it exists today; regress in time slightly to explain some corresponding supervisory developments within the Office of the Comptroller of the Currency and, finally, offer some comments about what bankers can expect from examiners down the road.

The rapid increase in international lending by U.S. banks since the mid 1960s has proven to be a lucrative business. Losses have been few and in most of our larger banks international earnings have contributed a substantially greater share of net income than the ratio of international to domestic assets would suggest. This development has not been unhampered, however, and the long-range effects of many crucial decisions which must be made today are not as clear as most of us would hope.

The quadrupling of oil prices by the oil-exporting countries, in 1973, found the Eurocurrency markets the single means of financial intermediation between the oil rich surplus nations and rest of the borrowing world. Private banks suddenly were being called upon to finance balance-of-payments deficits and even to grant long-term development loans, both of which had been previously considered functions of the then inadequately funded IMF and World Bank.

Being the only acceptable depositories for the vast OPEC surpluses, banks continued to expand their international portfolios, offering loans to an expanding list of new borrowers and at rapidly narrowing spreads. Many less developed countries as well as a few already financially troubled industrialized countries saw private banks as anxious lenders for virtually condition-free balance-of-payments financing and optimistically budgeted long-term project loans, only some of which were export-development oriented.

A reawakening occurred during the fall of 1974 when several of the world's largest banks lost enormous sums in their foreign-exchange operations. It suddenly became apparent to everyone that the meager interest margins no longer justified the barely quantifiable credit and liquidity

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risks inherent in both the high volume foreign exchange and Euro-lending functions then being performed. Both markets contracted somewhat as exchange trading lines were reduced, second tier banks were required to pay higher costs for their Euro-funds, and country exposure limits were narrowed in recognition of mounting deficits of oil-importing countries. Inflation was high in most countries of the world and a global recession had already begun.

The reduction in market activity seemed a blessing at the beginning of 1975 as U.S. banks advantageously redirected their resources toward the development of more selective credit policies, improved operational and credit-reporting systems and increased control over foreign-exchange activities. Banks which previously had relied on their bigger brothers to judge the quality of loans to foreign public sector entities, began strengthening their own country analysis programs both for risk assessment and marketing strategy purposes. New policies reflected philosophies emphasizing "manageable" growth. This is reflected, in part, by the relatively modest growth in foreign branch assets of national banks of 11.7 percent during 1975, compared to an average annual increase of 26.9 percent for the years 1970-74.

Despite neither strong nor consistent economic recovery globally, lending and interbank activities increased significantly during 1976. Foreign branch assets of national banks grew by 20.9 percent to \$135 billion. Foreign branch assets of all U.S. banks increased by 24.3 percent to \$219 billion. Total international assets are now estimated at \$150 billion for national banks and near \$230 billion for U.S. banks in the aggregate. These figures represent 30 to 60 percent of the assets of many of our major banks, individually, and contribute in even greater proportion to their annual earnings.

Many observers contend that our banks have been excessively zealous in their desires for growth and earnings, culminating in a serious over-dependence on assets due from the poorest of countries whose deficits surely will widen and whose loans will never be repaid. Doom is predicted for both the Eurocurrency markets and our private banking system.

The Office of the Comptroller of the Currency does not share these views. This is not to say that the OCC is entirely comfortable with some of the broader issues involved, e.g., the appropriate role of commercial banks relative to the IMF and the World Bank, or the numerous lending limit implications for U.S. banks. But the OCC does not consider any national bank to be "endangered" because of its international loans in general, its loans to LDCs as a group or its exposure to any single LDC. The point is, however, that the questions being asked today by the media and the public are justified by the numbers alone. It is now the responsibility of the banks and the bank regulatory authorities to provide the proper perspective for those people who presently insist upon drawing absolute conclusions from the aggregates.

Certainly, great contributions have already been made by individual

banks and by the Association of Reserve City Bankers in terms of explaining the art of "country risk" analysis. This, in itself, is of limited value, however, in monitoring the international exposure of the U.S. banking system. Significant improvements in the quality and characteristics of pertinent data are essential.

At this point, I would like to explain how the OCC views its role with regard to "country risk" analysis, and what the bank regulatory agencies are attempting to contribute in terms of "country exposure" data.

The Office of the Comptroller of the Currency does not view its primary responsibility as one of determining the relative risk involved in lending to one country vs. that of another, i.e., studying marketing alternatives and allocating credit. It does have a responsibility, on the other hand, to evaluate loans on their own merits, in order to determine the quality of the loan portfolio of each national bank. The OCC, through its examining staffs in the United States and in London, is able to utilize data generated by analytical systems employed in all national banks for purposes of monitoring global changes. Therefore, the emphasis of the OCC system, itself, centers on loans to those countries whose difficulties are pronounced or whose social, political and economic trends indicate potential debt service problems.

#### *The OCC's Foreign Public Sector Credit Review Committee*

##### *Background*

Prior to July 1974, national bank examiners were required to evaluate, independently, all credits involving country risk just as they always have been required to evaluate domestic loans. With the increase in international lending by an increasing number of national banks during the late 1960s and early 1970s it became apparent that a few examiners in various parts of the country had reached different conclusions regarding similar, and sometimes the same, loans. The banking industry justly complained about this dissimilar treatment and the OCC shared the bankers' concern. Analysis indicated that the problem centered in large, syndicated, unsecured, public sector credits. The differences were due primarily to diverse levels of examiner experience regarding country risk analysis as well as a vast difference in the quality of credit information encountered among banks. The solution to the immediate problem appeared to require the formation of a committee which, given a broader information base, could study each situation in question and render a uniform opinion to be applied to each such credit during every national bank examination. In July 1974, the responsibility for evaluating foreign public sector loans was placed with a committee comprised of the OCC's most experienced international examiners from Washington, New York, Chicago, and San Francisco. These examiners continually examine, both in the United States and overseas, our country's major multinational banks. Through their examinations, they have developed the skills necessary to evaluate properly foreign public sector loans and it is emphasized here that these major banks'

international portfolios generally contain every type of such loan. Therefore, the perspectives which the committee members develop through their examinations of these major banks are applicable to the examination of all national banks which lend internationally.

### *Purpose*

The OCC recognizes that countries normally do not disappear as can corporate borrowers, and that, traditionally, foreign public sector loans in national banks have an excellent record of ultimate repayment. The OCC also recognizes, however, that historically national banks have not held in portfolio the increased levels of foreign public sector loans which they hold today. The primary purpose of the committee, therefore, is to evaluate these loans not only for ultimate loss potential but, more appropriately, for early identification of those large credits or blocks of credits which could become illiquid and remain in banks' portfolios in some form, long after their currently scheduled maturities. The committee evaluations result in loans being placed into one of five categories relating to the liquidity and soundness of the asset.

- 1) *Pass* — The loan is being repaid as structured and analysis of the loan indicates no foreseeable interruption in regular payments or eventual payout.
- 2) *Especially Mentioned* — The loan is being repaid as structured but analysis indicates factual inherent conditions which could lead to an interruption of regular payments.
- 3) *Substandard* — Orderly repayment is jeopardized or has been interrupted, resulting in a slow paying loan. Ultimate payment in full is expected.
- 4) *Doubtful* — There is no performance and full repayment appears tenuous.
- 5) *Loss* — There is no performance and no repayment is expected during the near future. The loan is not bankable, requiring its removal from the bank's assets. A loss classification does not mean that principal never will be recovered.

The committee disseminates its decisions to all national bank examiners who apply them uniformly during their examinations.

### *Procedures*

The committee's evaluation procedures represent an extension of the traditional OCC examination process. The three committee examiners from New York, Chicago, and San Francisco, independently of each

other, continually conduct examinations of the major national banks in those cities. Examiners outside of New York, San Francisco, and Chicago often receive, through their examinations of regional financial center banks, information relevant to the committee purpose. These examiners document their findings and forward their information to OCC headquarters for use and research by the committee. Thus, all areas in the Nation have access to the committee process.

The committee's examiners begin their examinations of foreign public sector loans by determining the amounts of each borrower's liabilities due the bank under examination. The examiners also determine the structure of the loans, e.g., whether the loans are payable in the borrower's local currency or in an external currency; whether the loans are short or long term; or whether the loans are secured or unsecured. The examiners then review the borrower's financial information held by the bank as support for making the loans. The examiners next analyze the financial condition of the borrower in relation to the loans outstanding. Finally, the examiners discuss their analysis with the bank's lending officers in order to obtain information about the loans which may not yet be on file, and in order to receive the officers' opinions about the borrowers' ability to pay those loans.

The committee members meet quarterly in Washington to discuss their individual findings from examinations conducted during the quarter. The members also review data in OCC headquarters' files including that available from other U.S. government sources. The members then evaluate, as a committee, the foreign public sector loans repayable in currencies external to that of the borrowers, and assess whether the borrowers have or likely will have the external currency available to pay the national bank loans when payments are due.

Generally, the committee first looks to external economic information, e.g., balance-of-payments trends over the last few years, the expected results for the next 12 months (the short term), and the external debt structure as well as the service requirements for the same period. The committee's evaluations of loans maturing within 12 months are heavily influenced by the anticipated current account balance and current year's debt service in relation to such factors as available IMF facilities, reserve levels, official and private loan commitments, foreign investment trends and the attitude among bankers toward further lending. Generally, if a borrower appears to have the capacity to repay short-term loans and appears willing to honor the indebtedness, the committee will "pass" the loans. Should a borrower appear to face a critical short-term shortage of foreign exchange and lack availability of credit, the committee may "especially mention" the short-term loans. The committee normally does not criticize short-term trade credits unless they become delinquent or require refinancing.

The committee's evaluations of medium- and long-term loans place greater emphasis on the social/political effects of prevailing economic trends, and their impact on prospective cash flows for external debt service. The committee weighs such things as the borrower's external debt

size and structure in relation to consistency of revenues; realism in projections relative to global commodity consumption and prices; attractiveness to foreign investors; natural and human resource potential; willingness and ability to recognize economic/budgetary problems and formulate appropriate remedial or long-term plans; the anticipated social impact of remedial actions; and, finally, the feasibility of implementing such actions, given the form of government and the internal political climate.

The uncertainties involved in judging long-term risks are apparent. However, it is the degree of these uncertainties that is of concern to the committee. Generally, the committee does not criticize long-term loans which are paying as agreed and which show positive trends for continued performance. If social, political and economic trends are adversely affecting the availability of foreign exchange for debt service, long-term loans might be "especially mentioned." The committee classifies more severely loans which are not meeting scheduled payments, and/or which show trends indicating protracted repayment difficulties.

It is emphasized that the committee evaluations do not apply to foreign public sector loans denominated in the currency of the country where the borrower is located. The committee evaluations also do not apply directly to foreign private sector loans. As a practical matter, the committee is not in a position to evaluate the financial condition of every private borrower, or to determine whether a private borrower in a particular country can generate sufficient exchange outside that country to service its own obligations. Therefore, independent examiner judgment is required to determine whether private sector credits are lesser or greater quality than those loans evaluated by the committee.

Finally, the OCC's Foreign Public Sector Credit Review Committee is an in-house bank examination vehicle. It is important that the committee's determinations be recognized, not as some sort of credit allocation device nor as an order to cease lending within a particular country but as only one source of objective opinion regarding specific types of credit. The Comptroller of the Currency believes that decisions to grant or refuse loans are best left to the discretion of qualified professional lenders. For these reasons, the OCC does not distribute committee criticisms nationwide but communicates those criticisms only to bankers during the normal course of a regular bank examination.

### *Country Exposure*

I believe the point has been sufficiently made that countries cannot be grouped into blanket categories, e.g., all industrialized countries are creditworthy and LDCs are not. Indeed, we are all aware of cases which appear to be contrary to these general assertions.

The same holds true with regard to evaluation of risk within banks' portfolios and for the U.S. banking system as a whole. More current and comprehensive aggregate data are needed. Banks need it to determine their positions relative to other creditors. Bank regulators need it to monitor the health of our banking system. International financial institutions

and the U.S. Government need it if official, bilateral and multilateral assistance is to be synchronized properly.

The OCC, in cooperation with the Federal Reserve System and the Federal Deposit Insurance Corporation, has developed a new Country Exposure Report which is designed to provide a more comprehensive view of all "credit exposure" to, or within, any country, industrialized or otherwise. The report requests 19 categories of data on the different types of credit extended, their maturities, whether to public or private sector borrowers, and whether denominated in a currency local or foreign to the country of the borrower. It will provide cross-border data as was requested by the Federal Reserve System and the Bank for International Settlements earlier this year, but will also permit reallocation of debt from the country of the primary obligor to third country parent companies or guarantors.

In summary, the Country Exposure Report will permit proper delineation (by credit type, by maturity, and by currency) of the varying degrees of risk involved in the aggregate numbers about which so many inappropriate generalizations have been made.

The report has been tested in the format attached as Appendix I. Adjustments will be made to the report based on comments solicited from bankers. Minor adjustments also will be required to iron out any remaining differences with other regulatory reports in terms of country groupings and applicable definitions.

I assure you that we are committed to consolidating existing reports as much as possible and to minimizing the reporting burden on banks as quickly as we can. In the meantime, we thank you for your cooperation and promise you a useful product in return.

#### *Diversifying and Monitoring Global Risks*

As discussed thus far, national bank examiners are responsible for the evaluation of the creditworthiness of individual borrowers and for analysis of banks' exposures in specific countries. These processes assist examiners in performing their broader assessments of risk diversification and portfolio management within individual banks. Examiners are interested in the banker's familiarity with each customer's operating environs, the bank's representation in, or frequency of visits to, each market area, and the adequacy of related communication and internal reporting systems.

Examiners must consider the quality and timeliness of statistical and qualitative data upon which country risk analysis is based. This information must be adequate to determine how credits need be, or can best be, structured within each country. Information also must be adequate to develop sound primary and optional global-marketing strategies.

I'm sure we all agree that prudent risk diversification involves a great deal more than the simple allocation of a portfolio among distinct geographic areas. Synchronization of all activities is required and in many instances this can only be done centrally. For example, national bank examiners will continue to expect bankers to be aware of all "concentrations of

credit" in the traditional application of the term, e.g., combinations of loans to parent companies and their subsidiaries, loans to principals and partners, and loans to central governments and their instrumentalities. Moving forward, however, examiners and senior-level bankers must insist upon the centralization of credit information sufficient to determine the existence of concentrations such as those within a specific industry, those reliant on a single commodity, those involving countries joined in economic or political alliances, and countries experiencing a common economic problem. Only brief mention of such things as REITs, shipping, oil and copper prices should be sufficient to establish this point. Perhaps with greater awareness and a certain degree of imagination, reoccurrence of many of our recent problems might be avoided.

It goes without saying that examiners must continue to analyze credits to single borrowers and groups of related borrowers in order to judge compliance with a bank's legal lending limit (Appendix II). Serious problems in this regard can usually be avoided if bankers are willing to assist individual borrowers in structuring their credits within any of the applicable exceptions to the limit. Lending limit complications involving groups of related borrowers, e.g., central governments and their instrumentalities, need not be troublesome provided that bankers obtain adequate credit information to determine that each borrower within a group has the financial ability, over time, to service its own debt obligations and provided further that the loan proceeds are used by the borrowing entity, not by other members of the group. Otherwise, examiners might be compelled to view the group as a single entity for legal limit purposes.

A final point of particular importance is that adequate risk diversification is not applicable only to the asset side of the balance sheet, but the liability side as well. Banks must limit their dependence on any existing sources of funds and examiners will expect bankers to have some idea of their borrowing potential without having to abuse any single funding source in times of need.

We have discussed the bank examiner's approaches to analyzing "country risk," measuring "country exposure" and monitoring overall risk diversification. It is emphasized that these approaches have evolved over several years through open communication between bankers and regulators. The OCC is confident that these procedures may constantly be improved in a manner equitable to all concerns, but in a manner which, first and foremost, is consistent with existing laws and which insures the continuing soundness of our banking system.



## APPENDIX I

Comptroller of the Currency  
Administrator of National Banks

Washington, D.C. 20219

July 1, 1977

TO: THE PRESIDENT OF THE NATIONAL BANK ADDRESSED

The Office of the Comptroller of the Currency is seeking to develop a comprehensive country exposure report in cooperation with the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation. This report is designed to provide bank supervisors with complete and accurate information which would permit the regular systematic monitoring of overseas lending by United States banks. This Office also believes that the aggregate data could be helpful to the banking industry in its lending decisions.

We recognize that no one form can suit every bank's system yet we believe that our proposed report is a reasonable attempt to develop and reflect more accurate information about country exposure. We expect that the proposed format will easily accommodate data from existing bank reporting systems.

As part of the process for developing this report, this Office initially is requesting the national banks with assets in excess of \$300 million, to complete, to the best of their ability, the attached form, as of June 30, 1977. Please return the completed form to the Comptroller of the Currency, International Operations Division, Washington, D.C. 20219, by August 15, 1977.

In addition to completing the proposed form, we invite your comments about any difficulties which you encounter during its preparation. We also invite your suggestions as to possible improvements in the report and most appropriate reporting dates.

This report will be held in strictest confidence. Information which might reveal the activities of individual banks will not be disclosed. Appropriately, aggregated data for all banks may be publicly released at the end of each reporting period.

We thank you for your cooperation on this project and your continued interest in contributing to strengthening the flow of mutually beneficial information between the banking industry and the banking agencies.

Very truly yours,

H. Joe Selby  
First Deputy Comptroller for Operations

*Country Exposure Report*

## Part I — Introduction

This report is designed to provide current data on the geographic and maturity distribution of commercial bank international assets and contingent liabilities for supervisory analysis.

The Office of the Comptroller of the Currency is of the opinion that individual bank information reported in this form is exempt from public disclosure under section (b)(8) of the Freedom of Information Act (5 USC 552 (b)(8)). Accordingly, individual bank information reported in this form will be considered confidential and will not be voluntarily disclosed by the Office of the Comptroller of the Currency. Aggregate data derived from this form may be published or otherwise disclosed in a manner which will not reveal the amounts reported by any individual reporting bank.

## Part II — General Information

## A. Consolidation of Data.

The information is to be derived from all United States offices, foreign branches, and majority-owned domestic and foreign subsidiaries. Data should be reported on a consolidated basis, using the same consolidation procedures and test of significance as for the consolidated Domestic and Foreign Bank Report of Condition.

## B. Direct Obligations and Guarantees.

This report is designed to reflect the geographic location of the borrowing recipient of direct extensions of credit (columns 1 through 4), as well as the geographic location of the ultimate source(s) of repayment (columns 9 through 12). Columns 1 through 4 will include the total direct extensions of credit granted to or within the designated country. Externally guaranteed and indirect obligations are identified and reallocated in columns 9 through 12. Letters of awareness or intent, comfort letters, and other similar documents are not considered "guarantees" for the purposes of this report.

## C. Implied Guarantees.

Obligations due to the reporting bank from branches and/or wholly-owned subsidiaries of other multinational banks are assumed to contain an implied head office or parent guarantee and should be reallocated in columns 9 through 11. Wholly-owned subsidiaries of these banks are treated in the same manner as are branches, unless, in the opinion of the reporting bank, unguaranteed obligations of such subsidiaries likely would not be honored by the parent institution. Externally guaranteed claims are reallocated in columns 10 and 12.

D. Who Must Report.

All national banks with total assets of \$300 million or more as of the date of the last Consolidated Report of Condition (including domestic and foreign subsidiaries).

E. Filing of Reports.

This report will be prepared semiannually, as of March 31 and September 30 and filed not later than 30 days thereafter with the Comptroller of the Currency, International Operations Division, Washington, D.C. 20219.

F. Rounding.

All data entries should be rounded to the nearest million of U.S. dollars. Do not use decimals.

Part III — Specific Instructions and Definitions

1. "United States" includes the States of the United States, the District of Columbia, the Commonwealth of Puerto Rico and the following: American Samoa, the Canal Zone, Guam, Midway Island, the Virgin Islands and Wake Island.
2. "Extensions of Credit" includes loans and discounts, overdrafts, own acceptances purchased, acceptances of other banks purchased, discounted trade bills and other accounts generally designated as LOANS and representing funds actually advanced. Also include bank placements, direct lease financing, customer's liability on acceptances outstanding, all deferred payment of letters of credit and past due or refinanced acceptances executed and outstanding. Also include Federal funds sold or extensions of credit to U.S. branches or wholly-owned subsidiaries of foreign banks.
3. "Securities" includes certificates or other evidences of ownership or participation in central banks, clearing houses, governmental entities and development banks, as well as those of private entities. This definition generally refers to either those securities required by the law of a country, to be held by branches and subsidiaries in that country, or those purchased for investment, and is *not* meant to include actual investments in subsidiaries of the reporting bank. Foreign securities holdings which bear the guarantee of the U.S. Government should also be shown in column 17.
4. "Bank Placements" include all interest or non-interest bearing deposits due from other banks whether at demand, call, or for a specified term (includes Federal Funds Sold to U.S. branches and wholly-owned subsidiaries of foreign banks).

5. "Public" includes all governments in a country, whether central, provincial or municipal, and their departments and agencies as well as banks, corporations or other entities which are majority-owned (either directly or indirectly) or deemed, by the reporting bank, to be majority-controlled by those governments. Extensions of credit to private entities which bear a foreign public entity guarantee should not be reported as public obligations. Bank Placements with branches of publicly-owned banks located outside their home country will be reported as "Public Bank Placements" (column 1) under the country in which that branch is located.
6. "Private" includes individuals, partnerships, corporations and other entities not included under "Public" above. Include private extensions of credit bearing the guarantee of foreign public entities.
7. "Maturities." Amounts reported under columns 6, 7 and 8 must reflect amortization or final maturity dates, as appropriate, rather than interest adjustments or "roll-over" dates.
8. "Commercial Letters of Credit" include those credits covering the movement of goods, whether issued or confirmed. Amounts reflected should be exclusive of deferred payment letters of credit and past due or refinanced acceptances which are reported under "Extensions of Credit" and standby letters of credit which are reported under "Other Commitments."
9. "Other Commitments" includes all fee-paid commitments to grant loans, undisbursed portions of loans contracted, standby letters of credit and guarantees issued.
10. "Portions of 5, 13, 14, 15 and 16 Guaranteed by U.S. Government Agencies" includes obligations guaranteed and/or insured by any department or agency (e.g., the Department of Defense, the Export Import Bank of the United States (including FCIA), the Commodity Credit Corporation) and shall represent only those portions actually guaranteed or insured.
11. All claims on branches and subsidiaries of foreign banks in the United States should be reported in column 9 and reallocated to the country of their head office or parent in column 11.
12. Note that local currency activities are to be reported *only* in columns 18 and 19. Claims of the foreign offices of the reporting bank on residents of the country in which they are located and denominated in the currency of that country will be reported only in column 18 and should not be included in columns 1 through 17. Local currency liabilities of those offices will be reported in column 19.
13. A work copy of the report is included for your convenience.
14. Questions as to the preparation of this report should be directed to the Office of the Comptroller of the Currency, International Operations Division, telephone (202) 447-1747.

## APPENDIX II

## Lending Limits

12 U.S.C. 84 — The total obligations to any national banking association of any person, copartnership, association, or corporation shall at no time exceed 10 per centum of the amount of the capital stock of such association actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund. The term "obligations" shall mean the direct liability of the maker or acceptor of paper discounted with or sold to such association and the liability of the endorser, drawer, or guarantor who obtains a loan from or discounts paper with or sells paper under his guaranty to such association and shall include in the case of obligations of a copartnership or association the obligations of the several members thereof and shall include in the case of obligations of a corporation all obligations of all subsidiaries thereof in which such corporation owns or controls a majority interest. Such limitation of 10 per centum shall be subject to the following exceptions:

- ( 1 ) Obligations in the form of drafts or bills of exchange drawn in good faith against actually existing values shall not be subject under this section to any limitation based upon such capital and surplus.
- ( 2 ) Obligations arising out of the discount of commercial or business paper actually owned by the person, copartnership, association, or corporation negotiating the same shall not be subject under this section to any limitation based upon such capital and surplus.
- ( 3 ) Obligations drawn in good faith against actually existing values and secured by goods or commodities in process of shipment shall not be subject under this section to any limitation based upon such capital and surplus.
- ( 4 ) Obligations as indorser or guarantor of notes, other than commercial or business paper excepted under (2) hereof, having a maturity of not more than six months, and owned by the person, corporation, association, or copartnership indorsing and negotiating the same, shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus.
- ( 5 ) Obligations in the form of banker's acceptances of other banks of the kind described in section 13 of the Federal Reserve Act shall not be subject under this section to any limitation based upon such capital and surplus.
- ( 6 ) Obligations of any person, copartnership, association, or corporation, in the form of notes or drafts secured by shipping documents,

warehouse receipts, or other such documents transferring or securing title covering readily marketable nonperishable staples when such property is fully covered by insurance, if it is customary to insure such staples, shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus when the market value of such staples securing such obligation is not at any time less than 115 per centum of the face amount of such obligation, and to an additional increase of limitation of 5 per centum of such capital and surplus in addition to such 25 per centum of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 120 per centum of the face amount of such additional obligation, and to a further additional increase of limitation of 5 per centum of such capital and surplus in addition to such 30 per centum of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 125 per centum of the face amount of such additional obligation, and to a further additional increase of limitation of 5 per centum of such capital and surplus in addition to such 35 per centum of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 130 per centum of the face amount of such additional obligation, and to a further additional increase of limitation of 5 per centum of such capital and surplus in addition to such 40 per centum of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 135 per centum of the face amount of such additional obligation, and to a further additional increase of limitation of 5 per centum of such capital and surplus in addition to such 45 per centum of such capital and surplus when the market value of such staples securing such additional obligation is not at any time less than 140 per centum of the face amount of such additional obligation, but this exception shall not apply to obligations of any one person, copartnership, association, or corporation arising from the same transactions and/or secured by the identical staples for more than ten months. Obligations of any person, copartnership, association, or corporation in the form of notes or drafts secured by shipping documents, warehouse receipts, or other such documents transferring or securing title covering refrigerated or frozen readily marketable staples when such property is fully covered by insurance, shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus when the market value of such staples securing such obligation is not at any time less than 115 per centum of the face amount of such additional obligation, but this exception shall not apply to obligations of any one person, copartnership, association, or corporation arising from the same transactions and/or secured by the identical staples for more than six months.

- ( 7 ) Obligations of any person, copartnership, association, or corporation in the form of notes, or drafts secured by shipping documents or instruments transferring or securing title covering livestock, or giving a lien on livestock when the market value of the livestock securing the obligation is not at any time less than 115 per centum of the face amount of the notes covered by such documents shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus. Obligations arising out of the discount by dealers in dairy cattle of paper given in payment for dairy cattle, which bear a full recourse endorsement or unconditional guarantee of the seller and are secured by the cattle being sold, shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus.
- ( 8 ) Obligations of any person, copartnership, association, or corporation secured by not less than a like amount of bonds or notes of the United States issued since April 24, 1917, or certificates of indebtedness of the United States, treasury bills of the United States, or obligations fully guaranteed both as to principal and interest by the United States, shall (except to the extent permitted by rules and regulations prescribed by the Comptroller of the Currency, with the approval of the Secretary of the Treasury) be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus.
- ( 9 ) Obligations representing loans to any national banking association or to any banking institution organized under the laws of any State, or to any receiver, conservator, or superintendent of banks, or to any other agent, in charge of the business and property of any such association or banking institution, when such loans are approved by the Comptroller of the Currency, shall not be subject under this section to any limitation based upon such capital and surplus.
- (10) Obligations shall not be subject under this section to any limitation based upon such capital and surplus to the extent that such obligations are secured or covered by guaranties, or by commitments or agreements to take over or to purchase, made by any Federal Reserve Bank or by the United States or any department, bureau, board, commission, or establishment of the United States, including any corporation wholly owned directly or indirectly by the United States: *Provided*, That such guaranties, agreements, or commitments are unconditional and must be performed by payment of cash or its equivalent within sixty days after demand. The Comptroller of the Currency is hereby authorized to define the terms herein used if and when he may deem it necessary.

- (11) Obligations of a local public agency (as defined in section 1460(h) of Title 42) or of a public housing agency (as defined in the United States Housing Act of 1937, as amended) which have a maturity of not more than eighteen months shall not be subject under this section to any limitation, if such obligations are secured by an agreement between the obligor agency and the Secretary of Housing and Urban Development in which the agency agrees to borrow from the Secretary, and the Secretary agrees to lend to the agency, prior to the maturity of such obligations, monies in an amount which (together with any other monies irrevocably committed to the payment of interest on such obligations) will suffice to pay the principal of such obligations with interest to maturity, which monies under the terms of said agreement are required to be used for that purpose.
- (12) Obligations insured by the Secretary of Agriculture pursuant to the Bankhead-Jones Farm Tenant Act, as amended, or the Act of August 28, 1937, as amended (relating to the conservation of water resources), or sections 1471-1485 of Title 42, shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus.
- (13) Obligations as endorser or guarantor of negotiable or non-negotiable installment consumer paper which carries a full recourse endorsement or unconditional guarantee by the person, copartnership, association, or corporation transferring the same, shall be subject under this section to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus: *Provided, however,* That if the bank's files or the knowledge of its officers of the financial condition of each maker of such obligations is reasonably adequate, and upon certification by an officer of the bank designated for that purpose by the board of directors of the bank, that the responsibility of each maker of such obligations has been evaluated and the bank is relying primarily upon each such maker for the payment of such obligations, the limitations of this section as to the obligations of each such maker shall be the sole applicable loan limitation: *Provided further,* That such certification shall be in writing and shall be retained as part of the records of such bank.
- (14) Obligations of the Student Loan Marketing Association shall not be subject to any limitation based upon such capital and surplus.

#### *Combining Loans to Separate Borrowers*

7.1310. Loans to corporations and their subsidiaries.



## (a) Law — 12 U.S.C. 84

“The total obligations to any national banking association of any person, copartnership, association, or corporation shall at no time exceed 10 per centum of the amount of capital stock of such association actually paid in and unimpaired and 10 per centum of its unimpaired surplus funds. The term ‘obligations’\*\*\* shall include in the case of obligations of a copartnership or association the obligations of the several members thereof and shall include in the case of obligations of a corporation all obligations of all subsidiaries thereof in which such corporation owns or controls a majority interest.\*\*\*”

## (b) Purpose

The section is intended to prevent one individual, or a relatively small group, from borrowing an unduly large amount of the bank’s deposits for the use of the particular business enterprises in which they are engaged. It is intended to safeguard the bank’s depositors by spreading the loans among a relatively large number of persons engaged in different lines of business.

## (c) General rules

- (1) Obligations of a parent corporation shall be combined with obligations of all subsidiary corporations in which the parent owns or controls a majority interest.
- (2) If the parent corporation is not borrowing, obligations of subsidiary corporations are generally not combined except in the following situations.
  - (i) Bank is looking to a single source for repayment of the loan.
  - (ii) One or more loans is for the accomodation of the parent corporation or other subsidiary.
  - (iii) The borrowing corporations are not separate concerns in reality but merely departments or divisions of a single enterprise.
- (3) Obligations of a corporation must be combined with any other extension of credit the proceeds of which are used for the benefit of the corporation.

## 7.1320. Loans to members of a partnership or association.

- (a) Under 12 U.S.C. 84 the obligations of the several members of a partnership, regardless of the purpose or the use of proceeds, are required to be combined with obligations of the partnership.
- (b) In addition, where persons engaged in a common enterprise, whether in the form of a partnership, joint venture, or other association, individually borrow funds which are to be used in that enterprise, the loans must be considered as a single credit.

BANK \_\_\_\_\_

CHARTER NO. \_\_\_\_\_

AS OF \_\_\_\_\_

**COUNTRY EXPOSURE REPORT**  
(in millions of U.S. dollars)

Local  
Currency  
Activities

**Non-Local Currency Activities**

Code	Area and Country	Claims Outstanding										Contingent Claims		Portions of (5), (13), (14), (15) and (16) Guaranteed by U.S. Government Agencies (17)	Local Currency Claims (18)	Local Currency Liabilities (19)							
		Extensions of Credit and Securities			Maturities			Claims on "banks" in This Country With Head Office or Parent in Another Country (9)	Externally Guaranteed Claims from Column (5) (10)	Claims on "banks" in Other Countries With Head Office or Parent in This Country (11)	Claims on Borrowers in Other Countries Guaranteed by Residents of This Country (12)	Commercial Letters of Credit					Public (13)	Private (14)	Public (15)	Private (16)			
		Bank Placements		Total Extensions of Direct Credit (5)	Estimated Breakdown of Column (5) by Time Remaining to Maturity		Over 5 years and over (8)					Over 1 year and under (7)	Other Public (3)								Other Private (4)	Other Public (1)	Other Private (2)
		Public	Private		1 year and under (6)	Over 1 year to 5 years (7)																	
100	WESTERN EUROPE																						
101	Austria																						
103	Belgium																						
105	Denmark																						
107	Finland																						
109	France																						
111	Genoa																						
113	Iceland																						
115	Ireland																						
117	Italy																						
119	Luxembourg																						
121	Norway																						
123	Netherlands																						
125	Portugal																						
127	Spain																						
129	Sweden																						
131	Switzerland																						
133	United Kingdom																						
135	West Germany																						
199	Other																						

## Discussion

### Herbert G. Grubel\*

The historic reason for the establishment of the Office of the Comptroller of the Currency has been to protect the American public from criminals enriching themselves through fraudulent schemes involving banks. Nineteenth-century banking history abounds with examples where criminals have stripped banks of cash and invested in schemes of obviously questionable profitability or of completely fraudulent design. The development of financial disclosure regulation, greater public sophistication brought about in part by the communications revolution and self-policing among banks have made it much more difficult in today's world to defraud the public through the manipulation of banking business. The need for the services of the Office of the Comptroller of the Currency therefore is much less today than what it was originally.

However, like all bureaucratic institutions, the Office of the Comptroller of the Currency has adapted to the environment and found a modified reason for its existence. Instead of examining banks' behavior and portfolios to prevent fraud, it has now taken on the responsibility to pass qualitative judgment on the merit of banks' investment decisions. In this role, the Comptroller of the Currency faces an impossible task. In his speech, Mr. Schuler practically admitted to this fact when he stated that the Office cannot evaluate the merit of the thousands of domestic loan decisions made by U.S. banks every day. It does not take much sophistication to realize that the only operative principle in this context is to assume that bankers, putting on line their careers and wealth, are the best judges of the merit of individual and aggregate portfolio decisions.

Such an operating principle for the Comptroller of the Currency, of course, does not mean that there would never be any bank failures. They have continued to occur as men make errors of judgment. It is difficult to assess whether or not the rate of failure would have been much greater in the absence of the supervisory work by the Comptroller, but it is clear that failures could not be prevented.

The American public has not been upset by the record of performance of the Comptroller of the Currency because bank failures have lost much of the sting they had in the turbulent past of U.S. banking history. The Federal Deposit Insurance Corporation and the discounting facilities of the Federal Reserve System have prevented the development of financial panics and waves of bank failures in the wake of isolated bankruptcies.

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*New Developments*

While the U.S. banking community and public have learned to live with the Office of the Comptroller of the Currency and its normal activities, occasionally the development of new financial institutions and practices results in the creation of some problems. The new financial practices and institutions which have given rise to such problems are, of course, the development of international banking and the loans of U.S. banks to national governments.

Mr. Schuler in his speech and paper presented us with useful insights about how he and his staff evaluate the merit of loans made to national governments. His description sounds reasonable and I am certain that the evaluation process makes excellent use of the most current information on the financial condition of countries available from the vast resources of the Federal Government and the banking industry. Yet, as the remarks of representatives of the banking community at the Conference have shown, there is considerable dissatisfaction with the work done by Mr. Schuler's office. The official evaluation of country risk has important, direct implications for the official rating of the quality of portfolios of banks which have made loans to some countries, while the banks have no recourse to challenge the judgment of country risks made by the bureaucrats.

Thus, the Comptroller of the Currency who in practice admittedly is incapable of evaluating the merit of all private loans and largely depends on the principle of self-interest to guide its supervisory task has decided not to rely on this principle in the case of loans to foreign governments. In my view, this reaction to the development of the new loan practices of U.S. banks is not sensible. It assumes implicitly that the Comptroller is in a better position to evaluate country risk than are the banks who are putting on the line their own money. Moreover, he makes his judgments in the light of information which may have become available only after the original bank investment decisions have been made. Banks simply cannot protect themselves against the bureaucratic consequences of such second-guessing with the help of superior information and hindsight. Nor should they have to for the sake of economic efficiency or stability. I see no easy way in which the Comptroller of the Currency can circumvent the law requiring him to evaluate bank loans to foreign countries as part of his overall mandate. However, there must be some bureaucratic way of shielding banks from the consequences of such country evaluations. If this is not possible, remedial legislative action may be necessary.

*Implications of the Analysis*

The preceding analysis and judgments do not imply that the development of international banks and loans to governments are not a potential source of bankruptcies and economic instability. All innovations in financial markets are accompanied by such risks. What the analysis does imply is that the second-guessing of banks' investment decisions by the

Comptroller of the Currency is not the most efficient way of dealing with the problems arising from international banking and loans to governments.

The most efficient method for dealing with these problems is for the Comptroller of the Currency, or some other Federal agency, to assemble, analyze, and present information relevant for making private decisions about the risks of lending to individual countries. Such knowledge can be produced with the benefit of enormous economies of scale, especially since the Federal Government has collected the intelligence for many other purposes.

This information must be made available promptly and readily. It would be certain to increase the quality of the investment decisions made by U.S. banks and therefore reduce the risk of illiquidity and bankruptcy with accompanying social benefits in greater financial stability in the long run. The externalities of this sort are the price-theoretic justification for the public production of the knowledge.

I am pleased to note that Mr. Schuler reports on a new data survey by the Comptroller of the Currency which will do much to provide information relevant for banks lending to foreign countries. This data survey permits the publication of global data of U.S. banks' assets in different currencies, maturities and by types of borrower. I hope that these data will be published promptly and made readily available. It is unfortunate that analogous information is not collected by the same Office about the liabilities of international banks, as well as their forward exchange commitments. Such information could be used to produce quickly data on the maturity and exchange risk of U.S. international banks, in analogy with such data published by the Bank of England. Many analysts have found the British data a source of comfort because they revealed that international banks in Britain, including the U.S. banks, act more like brokers than banks and show an almost perfect match in the maturity of assets and liabilities in different currencies. Monitoring and public availability of analogous data for U.S. banks could do much to allay fears about potential problems of illiquidity and failure due to it, though the problem of default risk remains.

#### *Some Long-Run Problems Caused by Innovators*

Let me conclude my remarks with some reflections on the most worrisome problem facing all official regulatory and supervisory agencies. The recent concern over private bank lending to foreign government and quasi-public institutions, together with the innovative responses of the Comptroller of the Currency in its data collection and evaluation procedures indicates the fact that no effective mechanism exists to detect dangers from new practices of financial intermediaries until they have developed into a more or less substantial risk. Regulatory agencies are much like generals. They are equipped superbly to fight the last war. Bank

supervisors do a fine job of monitoring the potential risks emanating from traditional banking practices. But the most serious problems in war and the supervisory business tend to develop as a result of unforeseen innovations. It could be, though I doubt that it is, that the risks from international bank lending are substantial and cannot be eliminated by anything that can be done now, after the fact.

Unfortunately, there are no easy ways for generals or bank supervisors to anticipate all dangerous future innovations. Limiting financial intermediaries legally to doing business only in the traditional ways is not a viable method of control for obvious reasons. Constant vigilance, the exchange of information among government employees, the industry and academics are the only ways to minimize the risks from innovation.

## Response

### Harold D. Schuler\*

I appreciate Mr. Grubel's observations that bank supervisors, like generals, are able to learn from past experiences and that since they possess no crystal ball, bank supervisors must rely upon "constant vigilance" in order to minimize risks from innovation. Mr. Grubel's final statement indicates some understanding of the need for bank supervisors to conduct regular examinations of banks and to provide continuous monitoring as well as feedback through published results of data reports submitted by banks. Yet, those observations are in direct conflict with statements made earlier in his critique.

Mr. Grubel's perceptions of both the reason for the establishment of the Office of the Comptroller of the Currency as well as its intended and present purpose suffer from a serious misunderstanding of historic fact. In this regard, I extend a warm welcome to Mr. Grubel to visit our offices in order that he may acquire a better understanding of OCC's role in bank supervision and I have made a note to send him a copy of a handy little history book entitled *The Comptroller and Bank Supervision*.

Mr. Grubel remarks that I practically admitted that the Comptroller of the Currency faces an impossible task in evaluating the merit of thousands of domestic loan decisions made by U.S. banks every day. What I, in fact, said (and I quote from page 141 of my paper) is that, "As a practical matter, the Committee is not in a position to evaluate the financial condition of every private borrower, or to determine whether a borrower in a particular country can generate sufficient exchange outside that country to service its own obligations. Therefore, independent examiner judgment is required to determine whether private sector credits are of lesser or greater quality than those evaluated by the Committee." He again misquotes me, in his third paragraph under the section *New Developments*.

Mr. Grubel suggests that "It does not take much sophistication to realize that the only operative principle in this context (bank supervision) is to assume that bankers, putting on line their careers and wealth, are the best judges of the merit of individual and aggregate portfolio decisions." We seem to have lost sight of depositors and their interests somewhere

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along the line. This oversight occurs, again in the third paragraph under *New Developments*, where he states:

It assumes implicitly that the Comptroller is in a better position to evaluate country risk than are the banks who are putting on the line their own money. Moreover, he makes judgments in light of information which may become available only after the original bank investment decisions have been made. Banks simply cannot protect themselves against the bureaucratic consequences of such second-guessing with the help of superior information and hindsight. *Nor should they have to for the sake of economic efficiency or stability.*

I must say that I have never met a banker who shares Mr. Grubel's views. Bankers are all well aware that loans can go bad after they are made and responsible bankers welcome an independent appraisal of their portfolios.

Finally, I am not aware of the precise data which lead Mr. Grubel to believe that "international banks in Britain, including the U.S. banks, act more like brokers than banks and show an almost perfect match in the maturity of assets and liabilities in different currencies." I submit, however, that loans were reported not by final maturity but by interest adjustment dates or funding rollover dates for purposes of compiling such data.