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The International Lending Supervision Act of 1983: A First Step Toward Responsible Foreign Lending

THE INTERNATIONAL LENDING SUPERVISION ACT OF 1983: A FIRST STEP TOWARD RESPONSIBLE FOREIGN LENDING

Recent events in international finance[1] have attracted the attention of economic experts and the public to the precarious financial situation of Less Developed Countries ("LDCs")[2] and their commercial bank creditors.[3] The bank industry practice of petro-dollar recycling[4] in the last decade contributed to the creation of enormous LDC debt obligations to foreign lenders.[5] As a consequence, commercial banks that are heavily involved in foreign lending face a substantial risk of failure should debtor nations default on their

1. *See* Bogdanowicz-Bindert, *Debt: Beyond the Quick Fix,* THIRD WORLD Q., Oct. 1983, at 828-29. In 1982, the International Monetary Fund organized a multi-billion dollar rescue package of bank debt rescheduling, new bank loans, and bridge financings in response to Mexico's claim that it could not meet its outstanding debt obligations or pursue its economic recovery plan without credit assistance. *Id.* at 829-30. Argentina and Brazil subsequently arranged for similar rescue packages. *Id.* at 830.

2. For the purposes of this article, Less Developed Countries (LDCs) include countries of the Third World and Eastern Europe which have borrowed substantial sums from Western commercial banks. References in this article to debt owed by LDCs include debt obligations of both the LDC government and its instrumentalities, as well as those of private borrowers within the LDC.

3. *See* Rohatyn, *The State of the Banks,* N.Y. REV. BOOKS, Nov. 4, 1982, at 3 (policy is needed to cope with LDC debt situation in light of serious risk of collapse of world financial system); *see also The Debt-Bomb Threat,* TIME, Jan. 10, 1983, at 42 (possibility of large-scale defaults on LDC debt exists) [hereinafter cited as *Debt-Bomb Threat*].

4. *See* Rohatyn, *supra* note 3, at 3 (commentators identify petro-dollar recycling as major cause of current world debt crisis). Following the oil price increases by the Organization of Petroleum Exporting Countries ("OPEC") in 1973 and 1979, OPEC nations deposited surplus cash generated by these price increases in Western commercial banks. *Id.* As a result of the OPEC price increases, LDCs faced significantly higher energy costs at a time when the LDCs sought to industrialize rapidly to meet the economic needs of their growing populations. *See* S. REP. No. 122, 98th Cong., 1st Sess. 3 (1983) [hereinafter cited as SENATE REPORT]. Western banks in turn lent a large share of the OPEC funds to LDC countries, some of which the LDCs used to pay for expensive imported oil. Rohatyn, *supra* note 3, at 3.

Commentators on the world debt situation have attributed the current debt crisis to factors in addition to the OPEC oil price increases. *Id.* These factors include the recent U.S. economic deflation, causing lower world raw materials prices from which LDCs derive the bulk of their foreign exchange earnings; the breakdown of the Bretton Woods system of managed foreign currency exchange ratios, causing general uncertainty in currency exchange markets and adding to the foreign exchange problems of LDCs; and, in the case of Eastern Europe, the breakdown of the U.S./Soviet detente process, souring relations between Eastern European debtor nations and their Western bank creditors. *Id.*

5. *See Debt-Bomb Threat, supra* note 3, at 42 (banks, governments and international institutions had foreign loans of $706 billion outstanding at mid-1982); *see also* Gruth, *International Debt-Crisis: The Next Phase,* BANKER, July 1983, at 25 (according to Bank of International Settlements, international banks had total debt exposure of $240 billion in problem countries by mid-1982).

foreign loans.[6] The stability of the debt situation continues to deteriorate as LDC borrowers seek additional capital to help service their existing loans at the very time that commercial banks, fearing increased loan loss exposure, are becoming reluctant to lend to LDCs.[7]

The threat of domestic bank failures from possible defaults by LDCs on their commercial debt prompted the United States Congress to enact legislation designed to promote sound banking practices among the principal United States lenders to LDCs, the United States multinational banks.[8] The International Lending Supervision Act of 1983 (the "Act")[9] requires federal banking regulatory agencies[10] to take measures to ensure greater stability of

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6. *See Debt-Bomb Threat, supra* note 3, at 50 (real possibility exists that LDCs will default on their foreign debt); *see also* Rohatyn, *supra* note 3, at 6 (radical political change in LDC could cause LDC to default on or repudiate foreign debt despite likelihood of resulting alienation from world financial markets). *But see* Wriston, *Banking Against Disaster*, N.Y. Times, Sept. 14, 1982, at A27, col. 1 (few examples in history exist of countries defaulting on their debt); *see also International Finance: An Interview with Walter B. Wriston*, 8 FLETCHER F. 249, 252 (1984) (default is not realistic option for debtor nations because defaulting nations would no longer have access to capital markets) [hereinafter cited as *Wriston Interview*].

7. *See* Special Feature, *U.S. Regulation of Bank Lending to LDCs: Balancing Bank Overexposure and Credit Undersupply*, 8 YALE J. WORLD PUB. ORD. 200, 200 (1982) (number of banks willing to lend to LDCs and new credit available to LDCs are decreasing) [hereinafter cited as *Regulation of Bank Lending*]; *see also* Bogdanowicz-Bindert, *supra* note 1, at 828-29 (banks lending to LDCs were more interested in protecting their assets by removing them from LDCs than in assuring long-term interests of debtors and fellow creditors).

Decreasing world oil prices and increasing world economic growth may mitigate in part the stifling effect that bank unwillingness to lend has on LDC growth. *Cf. The IMF Toasts the World's Recovery*, ECONOMIST, Sept. 29, 1984, at 69 (IMF raises estimate of expansion in world trade from 5.5% to 8.5% for 1984). Although the economic forecasts are reassuring, the threat of LDC default on foreign loans persists considering the lack of significant increase in the export activity of LDCs. *Id.* at 70.

8. *See* 12 U.S.C.A. §§3901-12 (West Supp. 1984) (International Lending Supervision Act of 1983 (the "Act")).

According to the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency, as of June, 1983, the 17 U.S. multinational bank holding companies included: BankAmerica Corporation; Bank of Boston Corporation; Bankers Trust New York Corporation; Chase Manhattan Corporation; Chemical New York Corporation; Citicorp; Continental Illinois Corporation; Crocker National Corporation; First-Chicago Corporation; First Interstate Bancorp; Irving Bank Corporation; Manufacturers Hanover Corporation; Marine Midland Banks, Inc.; Mellon National Corporaton; J.P. Morgan & Co., Incorporated; Security Pacific Corporation; and Wells Fargo & Company. *See* News Release, Federal Reserve Board, June 13, 1983, *reprinted in* 12 INT'L LEGAL MATERIALS 930, 931 n.1 (1983). In a Senate report, the Senate Committee on Banking, Housing and Urban Affairs stated that LDC borrowers owed U.S. banks about $100 billion. SENATE REPORT, *supra* note 4, at 5. The report also indicated that LDC loans by the nine largest U.S. banks represented 200 percent of the capital of the nine banks at mid-1982. *Id.* A 200 percent ratio of LDC loans to equity means that if LDC borrowers do not repay even half of these loans, the equity investment of the nine banks' shareholders would be destroyed and the banks surely would fail. *See Top Banks' Third World Loans Detailed*, N.Y. Times, Mar. 18, 1983, at D3, col. 1.

9. 12 U.S.C.A. §§3901-12 (West Supp. 1984).

10. *See infra* note 14 and accompanying text (listing federal banking agencies and describing functions of each agency).

the domestic banking system by imposing restrictions on the foreign lending practices of domestic banks. The Act seeks to improve the financial position of banks with significant exposure to potential LDC default by strengthening bank balance sheets,[11] removing income accounting incentives for banks to engage in unhealthy lending practices,[12] and requiring detailed reporting and disclosure of the foreign loan portion of a bank's asset portfolio.[13]

The Act delegates to the three principal bank regulatory agencies of the federal government—the Federal Reserve Board (the "Fed"), the Comptroller of the Currency (the "COC"), and the Federal Deposit Insurance Corporation (the "FDIC")[14]—the authority to establish minimum financial standards for domestic banks involved in lending abroad.[15] The Act mandates that banks with particularly high levels of LDC default exposure establish special reserves against potential losses from foreign loans.[16] Although Congress left the federal banking agencies to set appropriate reserve requirements,[17] Congress specified the accounting treatment for such special reserves.[18] Banks are to charge special reserves against their current income, and are not to include such reserves as part of capital or as part of normal loan loss reserves.[19]

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11. 12 U.S.C.A. §§3904, 3907 (West Supp. 1984).

12. *Id.* § 3905 (West Supp. 1984).

13. *Id.* §§ 3906, 3908 (West Supp. 1984).

14. *See American Bank Regulation: Different Order, Same Chaos,* ECONOMIST, Feb. 4, 1984, at 77-78. Under the Current regulatory framework, the Federal Reserve Board (the "Fed") supervises the more than 5,000 bank holding companies in the U.S. *Id.* at 78. The Office of the Comptroller of the Currency (the "COC") regulates nationally chartered banks. *Id.* The Federal Deposit Insurance Corporation (the "FDIC") insures bank deposits and regulates banks which are not members of the Federal Reserve system by setting standards which banks must meet to qualify for deposit insurance. *Id.* A vice presidential task force has reviewed the regulation of U.S. banking and has proposed reforms for the consideration of Congress. *Id.* at 77-78. *See generally* C. GOLEMBE & D. HOLLAND, FEDERAL REGULATION OF BANKING 1983-84 (1983) (historical account of development of bank regulatory system, including responsibilities of each federal banking agency) [hereinafter cited as GOLEMBE].

15. *See* 12 U.S.C.A. §§ 3904, 3907 (West Supp. 1984) (three federal banking agencies have authority under Act to establish financial standards concerning bank loan loss reserve requirements and capital adequacy ratios).

16. 12 U.S.C.A. § 3904 (West Supp. 1984). Under the Act, the federal banking agencies are to assess the quality of banking institutions' international loans when determining whether a special loan loss reserve is necessary. *Id.* § 3904(a)(1)(A).

17. *Id.* § 3904(c).

18. *Id.* § 3904(a)(2).

19. *Id.* Normal loan loss reserves, or allowances for possible loan losses, include reserves which banks maintain for regulatory, supervisory, or disclosure purposes. *Id.* The Act created a new type of loan loss reserve in addition to those which the federal banking agencies already required of domestic banks. *Id.* Allocations for the new reserves under the Act will not help satisfy existing reserve requirements. *Id.* It is not clear, however, whether the amounts banks must hold in the new, separate reserve are fungible with normal reserve funds in covering loan losses not associated with foreign lending, or whether banks can use normal loan loss reserves to cover international loan losses. A reasonable assumption is that the reserves are fungible since the Act limits the use of the new reserves only for regulatory, supervisory, or disclosure purposes. *See id.*

In determining whether to impose the special reserve requirement upon a bank, the federal banking agencies must assess the quality of the particular bank's loans to private and public sector borrowers in debtor nations.[20] The federal banking agencies are to consider each debtor country's history of foreign debt service problems among private and public borrowers when reviewing the quality of a bank's foreign loan portfolio.[21] In the event that a debtor country borrower has failed to meet its repayment schedule on a loan, the banking agencies are to assess the likelihood that the debtor country borrower will resume normal debt service.[22] If a domestic bank has loaned funds within a particular debtor nation, a failure by borrowers in that nation to meet interest payments on any external debt, to comply with any debt rescheduling program, or to abide by an International Monetary Fund ("IMF") stabilization program would indicate a weakness in the domestic bank's foreign loan portfolio and could trigger special reserve requirements.[23]

In addition to requiring the establishment of special loan loss reserves, the Act calls on the federal banking agencies to set minimum capital adequacy standards for all banks covered by the Act.[24] The Act, however, affords the agencies discretion in setting specific capital adequacy standards and in deviating from these standards in particular situations.[25] Moreover, the Act recognizes the agencies' pre-Act discretionary authority to declare a bank's failure to meet or maintain the required capital standard an unsound practice and to issue a cease and desist order requiring bank compliance with agency

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20. 12 U.S.C.A. § 3904(a)(1); *see infra* text accompanying note 23 (tests federal banking agencies are to apply in assessing quality of foreign loans).

21. 12 U.S.C.A. § 3904(a)(1). Under the Act, the federal banking agencies essentially are to examine the creditworthiness of foreign borrowers. *See id.*

22. *Id.*; *see infra* note 23 and accompanying text (tests for determining quality of foreign loans).

23. 12 U.S.C.A. § 3904(a)(1).

24. *See* Golembe, *supra* note 14, at 95-98. The Fed, the COC, and the FDIC establish capital adequacy standards for banks in terms of mandatory minimum capital-to-assets ratios. *Id.* at 96. Historically, capital adequacy ratios for banks differed depending on whether the bank qualified as a multinational organization, a regional organization having total assets in excess of $1 billion, or a community organization having total assets below $1 billion. *Id.* at 97. For example, as of July 1983, the Fed and the COC considered multinational and regional banks with total capital to total assets ratios below 6.5% as presumptively undercapitalized, whereas the minimum ratio for community banks was 7.0%. *Id.*; *see infra* note 25 (discussing Congressional intent to require federal banking agencies to set more stringent and uniform capital adequacy standards for all domestic banks).

25. *See* 12 U.S.C.A. § 3907 (West supp. 1984). While the federal banking agencies established capital requirements for banks prior to the Act, the agencies typically considered the large multinational banks on a case-by-case basis, and usually required lower capital-to-assets ratios for the multinationals than for smaller regional and local banks. *See* H.R. Rep. No. 175, 98th Cong., 1st Sess. 45, *reprinted in* 1983 U.S. Code Cong. & Ad. News 1898, 1928 [hereinafter cited as House Report]; *supra* note 24 (discussing federal banking agencies' historical approach to capital adequacy standards). The agencies justified special treatment for the large multinational banks on the ground that greater diversification of assets made the multinationals less vulnerable to default by any one borrower. *See* House Report, *supra*, at

regulations.[26] The Act further permits a banking agency to issue a directive to noncomplying banks requiring that these banks follow a plan designed to achieve safe capital adequacy ratios.[27] Finally, the Act affords the banking

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1928. The multinationals, however, generally have become more vulnerable to default by borrowers within a foreign country because of the high concentration of loans the multinations have made within particular countries, such as Mexico and Argentina. *See id.* (assumption that multinational banks are more protected from default exposure than smaller banks is false in light of recent events in international finance). Congress, therefore, rejected special treatment for the multinational banks and sought greater uniformity and objectivity in the agencies' approach to bank evaluations for reasons of equity and fairness among domestic banks and for the purpose of strengthening the banking system. *See id.* at 1928-29.

The legislative history of the Act indicates that Congress would permit the agencies to consider risk diversification, asset quality, liability composition, and other similar factors in determining the adequacy of capital ratios for particular banks. *See* SENATE REPORT, *supra* note 4, at 16 (explaining that agencies need not set uniform capital ratio for all banks). The mere size of the bank no longer determines capital adequacy requirements, and the agencies must implement a similar regulatory approach toward all domestic banks. *See* HOUSE REPORT, *supra*, at 1929 (Paul Volcker, Chairman of Federal Reserve Board, agreed that minimum capital standards should apply to all types of banks).

The Senate Committee noted that the capital adequacy provisions of the Act essentially restated existing agency authority to set capital ratios and require bank compliance. *See* SENATE REPORT, *supra* note 4, at 16 (clarification of agency authority necessary given recent Fifth Circuit decision); *see* First Nat'l Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674 (5th Cir. 1983) (setting aside Comptroller's judgment of capital adequacy). The express language of the Act, however, does not indicate what capital adequacy ratios banks must maintain, nor does the Act itself state that the banking agencies are to increase capital adequacy ratios from pre-Act levels even though such an increase clearly was Congress's goal. *See* 12 U.S.C.A. § 3907 (West Supp. 1984) (setting forth capital adequacy provisions); *see also* HOUSE REPORT, *supra*, at 1929.

26. 12 U.S.C.A. § 3907(b)(1) (West Supp. 1984). Even before the passage of the Act, if a federal banking agency deemed a bank's failure to maintain adequate capital ratios an "unsafe and unsound practice," that agency could bring a cease-and-desist proceeding under 12 U.S.C. § 1818(b) against the bank violating the regulation. 12 U.S.C. § 1818(b) (1982). If the agency determined in an administrative hearing that the bank was in violation of capital adequacy regulations, the agency could issue a cease-and-desist order requiring the bank to meet the regulations. *See* GOLEMBE, *supra* note 14, at 106 (discussing cease-and-desist procedure). Possible sanctions for a bank's failure to comply with a cease-and-desist order include civil money penalties, suspension and removal of bank officers and directors, and outright revocation of the bank's charter. *Id.* at 106-09. In 1982, the federal banking agencies issued 82 final cease-and-desist orders, assessed 45 civil money penalties, and affected 4 removals of bank officers. *Id.* at 108. In the vast majority of cases, however, the agencies enforce regulations through less formal devices. *Id.* at 109. For example, an agency often will make approval for a bank to engage in a new banking activity contingent upon correction of a regulatory violation. *Id.* Banks may obtain judicial review of banking agency actions in a federal court of appeals. *Id.* at 106.

27. 12 U.S.C.A. § 3907(b)(2) (West Supp. 1984) (provision of Act permitting banking agencies to issue directives to banks). The federal banking agencies are not limited to the cease-and-desist procedure as a means of enforcing the Act's capital adequacy requirements. The agencies also may issue a directive to non-complying banks requiring the banks to submit a plan for compliance acceptable to the agencies. *Id.* The agencies have the power to enforce a bank's adherence to an agency approved plan for compliance. *Id.* The Act, therefore, contemplates a more interactive procedure between the federal banking agencies and the banks in meeting agency capital requirements than previously available under the traditional cease-and-desist approach.

agencies broad discretion to permit an under-captialized bank to deviate from its recapitalization plan,[28] particularly in light of the bank's progress in achieving the desired capitalization levels.[29]

In addition to focusing on balance sheet tests of bank vitality, the Act seeks to reform bank income accounting practices which in the past have encouraged aggressive lending policies toward LDC borrowers.[30] Bank management, eager to report increasing profits to shareholders, usually charges substantial up-front fees[31] for restructuring or rescheduling a foreign borrower's existing debt or for granting new loans to such borrowers.[32] Prior to the Act, a bank could include in its reports to shareholders up-front fees collected during a particular quarter as part of earnings for that quarter.[33] The Act, however, requires banks to amortize over the effective life of a loan all fees above administrative costs for debt restructurings and loan originations, thereby treating extraordinary fees as interest income to the banks.[34] Amortizing such fees over a longer period of time tends to remove some of the

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28. *See id.* § 3907(b)(2)(B)(i). A recapitalization plan should specify the means and the timing by which an undercapitalized bank is to meet mandatory capital levels. *Id.* Presumably, a deviation from a recapitalization plan could involve either the means or the deadline aspects of the recapitalization plan.

29. *Id.* § 3907(b)(3). Since the Act allows deviations from capitalization plans only where progress in achieving mandatory capitalization levels is shown, a mere good faith effort on the part of a bank to meet the capital requirements likely will not suffice for the agencies to grant permission for deviation from the recapitalization plan. *Cf. id.* (federal banking agencies must assess bank's progress in meeting recapitalization plan before allowing bank to deviate from plan).

30. *See id.* § 3905(a)(1) (setting forth fee accounting provisions for foreign loans).

31. *See Proposed Solutions to International Debt Problems: Hearings on S. 502 Before the Committee on Banking, Housing, and Urban Affairs*, 98th Cong., 1st Sess. 51-52 (1983) [hereinafter cited as *Senate Hearing*]. Up-front fees are flat charges banks impose on borrowers in addition to interest charges on the loan. *See* Mendez, *Recent Trends in Commercial Bank Lending to LDCs: Part of the Problem or Part of the Solution?*, 8 YALE J. WORLD PUB. ORD. 173, 186 (1982). Up-front fees include commitment, management, and agent fees. *Id.* Banks typically charge such fees whenever a loan is rolled over (renewed) or refinanced. *Id.* Banks charge annual commitment fees for agreeing to provide funds in the future upon given terms. *See Senate Hearing, supra*, at 52. Management fees are front-end fees which banks charge as compensation for the banks' participation in the lending transaction. *Id.* at 51. Management fees generally become payable at the signing or disbursement dates of the loan. *Id.* Agent fees compensate banks for out-of-pocket expenses arising from the execution of administrative duties concerning a loan. *Id.* at 52.

32. *See* Mendez, *supra* note 31, at 186. In addition to providing short-term profits for banks engaged in LDC lending, high up-front fees allow banks to decrease their overall risk in LDC lending since banks are able to collect up-front fees early in the life of the loan. *Id.*

33. *See Senate Hearing, supra* note 31, at 60 (statement of Paul Volcker, Chairman of Board of Governors of Federal Reserve System, that no specified way existed prior to Act in which to recognize banking fees as income for accounting and regulatory purposes).

34. *See* 12 U.S.C.A. § 3905(a)(1) (West Supp. 1984). Requiring banks to spread fees over the effective life of a loan creates the problem of interpreting what constitutes the life of the loan for accounting and reporting purposes. *See Senate Hearing, supra* note 31, at 93 (questions from Senator John Heinz to C. Todd Conover, Comptroller of the Currency, indicating concern over how federal banking agencies are to determine effective life of loan). Measuring the life

competitive pressure which otherwise encourages banks to restructure continuously loan agreements with LDC borrowers or enter into new loan agreements with debtor nations.[35] Congress delegated rule-making authority to the federal banking agencies and empowered the agencies to issue orders compelling banks to comply with the new accounting procedures under the Act.[36]

Finally, various provisions of the Act call for gathering information, issuing reports and evaluations,[37] and disclosing publicly foreign lending activities.[38] To assess whether banks are complying with the capital adequacy and special reserve regulations under the Act, banks must report at least four times each year to the banking agencies on their foreign debt exposure.[39] Moreover, banks must make information concerning material foreign lending available to the public.[40] The Act further requires domestic banks to prepare feasibility evaluations whenever the banks propose to lend in excess of 20 million dollars to finance any foreign project involving the extraction or processing of metals and minerals, or the manufacturing of goods.[41]

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of a loan may be particularly difficult in the case of short-term loans that banks roll over indefinitely. *Id.* The banking agencies may have to resort to an examination of the intent of a lender and a borrower as to the expected life of a loan in roll-over cases to determine the appropriate amortization period for up-front fees. *Id.* at 93-94. In addition, banking agency officials may have to resort to asking a bank how long the bank intends a particular international loan with a roll-over provision to remain outstanding. *See id.* at 94. Senator Heinz expressed concern that banks might be able to circumvent fee-spreading requirements since banking agencies ultimately must rely on bank officers' statements regarding the intended life of a loan. *Id.* Furthermore, some banks conceivably will overstate the administrative costs of foreign lending in order to boost short term profits.

35. *See Senate Hearing, supra* note 31, at 65 (statement of William M. Isaac, Chairman of FDIC, that front-end fee-spreading would tend to remove banks' short-term profit incentive to originate or reschedule international loans).

36. 12 U.S.C.A. § 3905(a)(2)(A), (b)(3) (West Supp. 1984).

37. *See id.* § 3906(a) (authorizing banking agencies to promulgate bank reporting regulations).

38. *See id.* § 3906(b). Under the Act, the banking agencies are to promulgate regulations requiring banks to disclose to the public information regarding "material foreign country exposure" as measured against assets and against capital. *Id.* The Act left the agencies to determine what constitutes "material exposure." *See id.*

39. *See id.* § 3906(a) (banks are to report to banking agencies at least four times each calendar year).

40. *See id.* § 3906(a). Alerting bank holding company shareholders, or potential shareholders, and bank depositors to the foreign loan exposure positions of banks would tend to promote sound lending strategies among the banks through market discipline. *See Senate Hearing, supra* note 31, at 65 (statement of William M. Isaac, Chairman of FDIC). Bank regulators traditionally have avoided a market discipline approach to bank regulation, fearing that public disclosure of problem loan portfolios might lead to runs on bank deposits. *See Regulation of Bank Lending, supra* note 7, at 222 (public disclosure of bank's foreign loan exposure may conflict with goal of maintaining public's confidence in banking institutions). Bankers have argued that the public may misinterpret information concerning bank loan exposure abroad. *See* Kinkead, *Banks Tell (Not Quite) All About Foreign Loans,* FORTUNE, Nov. 29, 1982, at 75 (bankers maintain that public is likely to misinterpret foreign loan data).

41. *See* 12 U.S.C.A. § 3908 (West Supp. 1984). Banks must prepare a feasibility study whenever aggregate lending by domestic banking institutions for a single project abroad exceeds the Act's $20 million limit. *Id.* the feasibility study must evaluate the likelihood of success of

Although the Act addresses only international lending supervision, Congress linked discussion of foreign lending supervision legislation with debate over companion legislation increasing the United States' contribution to the IMF.[42] The IMF historically has acted as a lender to countries facing temporary balance of payment problems.[43] In recent years, however, the IMF arguably has taken on more of the role of a bank in financing arrangements with LDCs.[44] LDCs therefore have come to rely increasingly on both commercial bank and IMF credit to cope with ongoing balance of payment difficulties.[45]

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the project and must consider the impact the project will have on the world markets for goods of the type the planned facility is to produce. *Id.* The study also must consider the effect the project is likely to have on the economy of the country in which the facility will be located. *Id.* The federal banking agencies are to review such evaluations when making their normal bank examinations and, apparently, may take the evaluations into account when assessing the health of a bank's loan portfolio. *See id.* § 3908(b). A regulatory agency may bring a cease-and-desist action against banks operating in violation of the feasibility study requirement. *Id.* § 3908(c)(1). Although the legislative history of the Act does not set out Congress' reasons for requiring such studies, it appears that Congress wants bank loan officers to divulge to the banking agencies the sort of analysis bank officers normally should carry out within the bank where a foreign project financing is involved.

In addition to the disclosure and reporting requirements which domestic banks must satisfy, the Act requires the federal banking agencies to report to Congress within six months after the enactment of the Act on progress achieved in meeting capital adequacy standards and on the international banking supervisory practices of other developed countries. *Id.* § 3912. Furthermore, the Act authorizes the General Accounting Office to audit the federal banking agencies' regulation, supervision, and examination activities. *Id.* § 3910.

42. *See* 22 U.S.C.A. § 286 (West Supp. 1984). The November 13, 1983 amendments to § 286 provide for, among other things, an increase in the amount the United States Governor of the IMF may contribute to the fund on behalf of the U.S. *Id.* § 286e-1i. The contribution, or "quota," of an IMF member country to the IMF determines the member's voting power within the IMF. SENATE REPORT, *supra* note 4, at 2. Member countries must review their quota at least once every five years. *Id.* The most recent U.S. increase in its IMF quota prior to the November 1983 increase occurred in 1980. *Id.*

The Senate Committee on Banking, Housing and Urban Affairs discussed in its report the original Senate Bill calling for increased supervision of U.S. bank foreign lending and the Senate Bill calling for an increase in the IMF contribution. *See* SENATE REPORT, *supra* note 4, at 1 ("Bretton Woods Agreement Act Amendments and International Lending Supervision"). Similarly, the House Committee on Banking, Finance and Urban Affairs addressed the IMF contribution and bank supervision issues in a single House report. *See* HOUSE REPORT, *supra* note 25, at 1906, 1913 (Title III of House Report entitled "International Monetary Fund" and Title IV of House Report entitled "International Lending Supervision").

43. *See* F. KIRGIS, INTERNATIONAL ORGANIZATIONS IN THEIR LEGAL SETTING 103 (1977) (IMF provides members with funds to meet temporary balance of payments problems); *see also* SENATE REPORT, *supra* note 4, at 1 (IMF helps finance temporary payment imbalances of member nations).

44. *Cf. supra* note 1 (describing IMF organized rescue packages for LDC debtors). The IMF has had to assume a longer term bank-borrower lending relationship with debtor countries. *See infra* note 45 and accompanying text (IMF funds have become integral part of ongoing LDC financings).

45. *Cf.* SENATE REPORT, *supra* note 4, at 5 (arguing that increase in IMF appropriations by U.S. is essential so that IMF, in conjunction with commercial banks, can carry on its LDC financing role).

Early in the Senate Committee hearings on bank supervision,[46] Senator John Heinz, III, a sponsor of the original Senate Bill calling for international lending supervision,[47] acknowledged that it would be difficult to justify to both the Senate and the voting public an increase in the IMF contribution unless the Senate Committee took measures to ensure that commercial lending to LDCs would not prolong the current LDC debt crisis or cause other LDC debt problems in the future.[48] The American public presumably would have little sympathy for bankers who brought default problems upon themselves through aggressive lending practices and "herd mentality" behavior in making loans to LDCs.[49] Without accompanying legislation governing bank foreign lending activities, an increase in the United States' commitment to the IMF designed to shore up the world financial system might have appeared to the American public as a taxpayer-funded bank bailout.[50] The American public also would have been inclined to believe that Congress was throwing good money after bad by increasing American contributions to the IMF if Congress had not imposed restrictions on the flow of capital from commercial banks to the LDCs.[51]

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46. *See Senate Hearing, supra* note 31, at 1 (Senate Committee on Banking, Housing, and Urban Affairs considered IMF quota and international lending supervision proposals).

47. *See* S. 502, 98th Cong., 1st Sess. (1983) (Senate Bill which later became Act) [hereinafter cited as "Senate Bill"]. The co-sponsors of the Senate Bill were Senators William Proxmire and John Heinz, III, Chairman of the Senate Subcommittee on International Finance and Monetary Policy. *Id.*

48. *See Senate Hearing, supra* note 31, at 6. In addition to calling for international lending supervision reform, Senator Heinz claimed that legislation, and not mere regulatory reform, was necessary before a majority in the Senate would vote for an increase in the IMF quota. *Id.* Senator Proxmire echoed Senator Heinz's claim that legislation was necessary. *Id.* at 8. In their reports to the House and Senate, both the House and Senate Committees investigating international lending supervision concluded that legislation was necessary to effect permanent changes in the supervision process. *See* SENATE REPORT, *supra* note 4, at 13 (stating necessity of permanent improvements in regulation of foreign lending); HOUSE REPORT, *supra* note 25, 1920-21 (Congress would not be satisfied with federal banking agency assurances that agencies will improve regulation of foreign lending practices).

49. *See* HOUSE REPORT, *supra* note 25, 1914. Banks have a tendency to behave in a "herd-like fashion" by rushing into lending situations as a group without properly assessing long term prospects for repayment. *Id.*; *see also* Soros, *The Debt Crisis: Why System-Wide Reform Is Critical*, N.Y. Times, Aug. 19, 1984, at F2, col. 5 (commercial banks adopted aggressive approach to foreign lending).

50. *See Senate Hearing, supra* note 31, at 2 (opening statement of Senator Jake Garn indicating concern that some people may view IMF quota increase as bank bailout, but claiming that proposal is not bailout scheme); *see also* Mendez, *supra* note 31, at 180 n.56 (Reagan administration and Congress are worried that increase in IMF quota would generate impression of government-funded bank bailout). Although Senator Heinz argued that Congress might reject the proposal to increase U.S. contributions to the IMF unless accompanied by legislation governing domestic bank foreign lending practices, Heinz stressed that the bill concerning lending supervision was not punitive in nature. *See Senate Hearing, supra* note 31, at 6 (opening statement of Senator John Heinz, III). Instead, the drafters of the Senate Bill intended the draft legislation to ensure that another debt crisis would not occur. *Id.*

51. *See Senate Hearing, supra* note 31, at 6 (opening statement of Senator John Heinz,

Those favoring international lending supervision legislation might still complain despite Congress' decision to accompany new IMF appropriations with international banking legislation. Persons skeptical of Congress' good faith in imposing restrictions on bank lending abroad could argue that Congress merely sought an expedient scheme to gain popular approval for increased United States participation in the IMF.[52] Even assuming a good faith congressional effort to reform bank foreign lending practices, critics nonetheless might question legitimately the effectiveness of the resulting legislation.[53] While the Act ultimately amounts to more than mere window dressing for increased United States' contributions to the IMF, the Act did not make full use of techniques available for regulating commercial lending to LDCs.[54] The differences between the Act and the original Senate Bill from which the Act arose illustrate the Act's deficiencies.[55]

The most striking difference between the Senate Bill and the subsequent Act was that while the Bill sought to authorize the Fed to promulgate limits on loans domestic banks could make to foreign countries,[56] the Act does not prescribe any country lending limits.[57] The Senate Bill's country lending limit provision would have required the Fed to promulgate regulations setting the maximum percentage of any single bank's capital which that bank could lend to private and public borrowers in a particular foreign country.[58] Although the Fed's loan limit percentages would have been uniform for all domestic banking institutions, the percentages would have varied for each borrowing country based on the Fed's determination of the level of debt that each country reasonably could service.[59] Proponents of the country loan limit approach argued that limitations on the amount that any one bank could lend to a given country would force banks to diversify their lending

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III). Congress might not have passed the IMF quota increase if members of the Senate Committee did not take steps to counter possible criticism that the IMF proposal meant "throwing good money after bad." *Id.*

52. *Cf. supra* note 48 and accompanying text (Senator Heinz acknowledged that increased IMF appropriations would be unpopular unless accompanied by commercial bank legislation).

53. *See infra* notes 109-12 and accompanying text (criticizing Act for not encouraging diversification of lenders to LDCs).

54. *See infra* note 102 (several major U.S. banks have made special provisions for loan losses as result of Act's stringent regulatory requirements); *infra* notes 109-12 and accompanying text (arguing that Congress did not pursue diversification of lending pool strategy for coping with world debt problem); *see also infra*, note 60 and accompanying text (Act does not call for country lending limits).

55. *See infra* notes 56-57 and accompanying text (describing differences between Act and Senate Bill).

56. *See* Senate Bill, *supra* note 47, at § 32 (section of Bill would have amended Federal Reserve Act to authorize federal banking agencies to establish country lending limits).

57. *See supra* notes 14-41 and accompanying text (describing provisions of Act).

58. *See* Senate Bill, *supra* note 47, at § 32. The Senate Bill left the actual country lending limit percentages to the discretion of the Federal Reserve Board. *Id.*

59. *See id.* § 32(b)(2). Under the Senate Bill, the Federal Reserve Board was to decide what factors establish a borrowing country's creditworthiness. *Id.*

portfolios.[60] Diversification of a bank's foreign assets in turn would help ensure that a default by a particular foreign borrower would not result in the collapse of a particular bank or group of banks since diversification would help spread the shock from default throughout the financial community.[61]

Although the Senate Bill and the Act incorporated provisions for special loan loss reserves, a considerable difference exists between the provisions as proposed and as enacted.[62] According to the Bill, the Fed would have required special loan loss reserves whenever the Fed determined there was a substantial likelihood that a foreign debtor would not repay a loan according to the original terms of the loan agreement.[63] Under the Senate Bill, the likelihood of default or interruption of debt service payments by a foreign borrower, the additional borrowing by the foreign borrower, or the major restructuring of a foreign debtor's obligations would have triggered the reserve requirement.[64] In contrast, the Act imposes reserve requirements only when an

60. *See infra* note 61 (discussing proposed diversification strategy under Senate Bill).

61. *See Regulation of Bank Lending, supra* note 7, at 219-21 (discussing pre-Act statutory lending limits). Prior to the Act, Congress authorized the Office of the Comptroller of the Currency to issue regulations limiting to 10% of a bank's capital the amount of credit the bank could extend to a single domestic or foreign borrower. *See* 12 U.S.C. § 84 (1976) [hereinafter cited as 1976 Act]. In 1982, Congress raised the statutory limit to 15% of capital. *See* Garn-St.Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 401, 96 Stat. 1469, 1508-10 (1982). Congress sought to diversify bank loan portfolios by imposing lending limits, thereby reducing the effect a borrower's default would have on the financial health of the borrower's bank creditors. *See* 12 C.F.R. § 7.1310(b) (1982). Although the 1976 Act imposed limits on the amount any one bank could lend to a particular entity within a foreign country, including the foreign country's government, the 1976 Act did not limit the total amount a bank could lend within a particular foreign country. *Regulation of Bank Lending, supra* note 7 at 222. The Senate Bill would have given the Federal Reserve Board the authority to establish special lending limits for banks, expressed as a percentage of bank capital, governing aggregate lending within a given country by a given bank. *See* Senate Bill, *supra* note 47, at 2. The special country lending limits under the Senate Bill would have applied to all domestic banks in addition to the 15% limit under the Garn-St.Germain Depository Institutions Act of 1982. *Id.* The Senate Bill recognized the economic interdependence among all borrowing entities within a particular foreign country and the need to treat all such entities as a single borrower for regulatory purposes. *See id.*; *see Regulation of Bank Lending, supra* note 7, at 220 n.122 (LDC government authorities often allocate limited available foreign exchange to repay government debt first in time of economic crisis).

The most controversial aspect of the Senate Bill was that the Bill would have given the Federal Reserve Board the authority to assess safe lending limits for each debtor nation based upon the Board's credit analysis of each borrower country, a role traditionally left to the commercial banks. *See generally* Wriston, *Banking Against Disaster*, N.Y. Times, Mar. 18, 1983, at D3, col. 1 (defending banks' capacity to assess foreign lending risk and to lend responsibly).

62. *See infra* text accompanying notes 63-65 (discussing distinction between loan loss reserve provisions under Senate Bill and under Act).

63. *See* Senate Bill, *supra* note 47, at § 33 (section of Bill concerning loan loss reserves). The Bill does not specify what "substantial likelihood of default" actually means. *See id.*

64. *See id.* (Senate Bill in its original form would have authorized Federal Reserve Board to require banks to establish loan loss reserves prior to actual interruption of debt repayment or default on interest payments in some cases).

actual and prolonged interruption in service on foreign debt has occurred or when little hope exists for resumption of debt service.[65]

While members of the House and Senate Banking Committees argued over the provisions of the Act, others questioned the need for legislation concerning foreign lending supervision.[66] For example, the Federal banking agencies claimed that the existing regulatory framework was sufficient to enable the agencies to curtail overly aggressive foreign lending practices.[67] The three principal banking regulatory agencies issued a Joint Memorandum to the House and Senate Banking Committees setting out regulatory changes the agencies could make, within the context of existing legislation, that would tighten controls on international lending by domestic banks.[68] The House and Senate Banking Committees maintained, however, that legislation mandating the agencies' proposed regulatory reforms was necessary.[69] Moreover, members of the Senate Committee argued that legislation would ensure that

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65. *See* 12 U.S.C.A. § 3904(a)(1) (West Supp. 1984) (stating when banking agencies shall require banks to establish special reserves). Factors indicating when a foreign asset is impaired to the point of requiring a special reserve include a foreign borrower's failure to pay interest on any foreign indebtedness, failure to meet terms of restructured indebtedness, and failure to comply with an IMF or other adjustment program. The language of the Act suggests that the banking agencies may require a particular lender to establish special reserves when a foreign borrower fails to meet the terms of its indebtedness to any foreign lender, not merely indebtedness to that particular lender. *See* 12 U.S.C.A. § 3904(a)(1) (West Supp. 1984).

Another difference between the Senate Bill and the Act was that under the Bill, banks were to account for special loan loss reserves by making a corresponding deduction from assets, whereas under the Act banks are to deduct such reserves from current income. *See* Senate Bill, *supra* note 47, at § 33 (accounting adjustment for creation of special reserves under Senate Bill); 12 U.S.C.A. § 3904(a)(2) (West Supp. 1984) (accounting adjustment for creation of special reserves under Act). A deduction from current income of amounts for establishing special reserves for foreign loan losses helps eliminate the appearance of financial well-being reflected in improving bank earnings, when in fact the soundness of banks' foreign assets continues to deteriorate. *Cf.* Rohatyn, *supra* note 3, at 6 (arguing that international loan roll-over fees create dangerous illusion of sound banking system).

66. *See Senate Hearing, supra* note 31, at 18 (statement of Paul Volcker, Chairman of the Federal Reserve Board, that existing authority of banking agencies to prevent unsafe and unsound banking practices is sufficient to cope with international debt problem).

67. *See* House Report, *supra* note 25, 1918 (statement by Paul Volcker that existing bank regulatory framework regarding international lending is constructive and sound).

68. *See Senate Hearing, supra* note 31, at 24-25 (banking agencies' Joint Memorandum incorporated as part of agency officials' statements). The Joint Memorandum set forth the following five proposals for regulatory reform: (1) strengthening the existing program of country risk examination and evaluation; (2) increasing the disclosure of banks' country loan exposure; (3) establishing a system of special reserves on problem foreign loans; (4) spreading loan rescheduling fees over the life of a foreign loan; and (5) improving international cooperation with foreign bank regulators and with the IMF. *Id.* at 25. The five-part proposal in the Joint Memorandum was remarkably similar in all but its details to the International Lending Supervision Act. *See supra* note 14-41 and accompanying text (describing provisions of Act).

69. *See* House Report, *supra* note 25, at 1920-21 (past banking agency neglect of international lending issue undermines agency assurances that legislation is unwarranted); *see also* Senate Report, *supra* note 4, at 13 (Senate Banking Committee maintained that legislation was necessary but agreed with Joint Memorandum's proposals for regulatory reform).

the agencies' regulatory reforms would become permanent rather than subject to repeal under future bank regulators.[70] The House Committee, however, was much more critical than was the Senate Committee concerning the historical performance of the regulatory agencies in policing American international banking activities.[71] The House Committee expressed suspicion of the agencies' sincerity in proposing regulatory reforms, especially in light of perceived agency neglect of international lending supervision.[72] The House Banking Committee also criticized the agencies' five-point proposal[73] as overly general and short-sighted.[74] Despite the House Committee's dim view of the agencies' proposal, the International Lending Supervision Act essentially set out in legislation what the banking agencies proposed to do as a matter of regulation.[75]

From the outset of congressional hearings into the need for international lending supervision, representatives from the banking industry objected to both new legislation and any proposed increase in agency regulation of foreign lending by domestic banks.[76] Bank representatives argued that action

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70. *See Senate Hearing, supra* note 31, at 7 (opening statement of William Proxmire). Although Senator Proxmire praised the banking agency regulators for their recent efforts in proposing regulatory reform, Proxmire maintained that legislation governing U.S. bank lending abroad was necessary to ensure that future regulators would not permit a recurrence of an LDC debt crisis. *Id.*

71. *See* HOUSE REPORT, *supra* note 25, 1920-21 (House Report accused banking agencies of neglecting regulation of domestic banks' foreign lending practices).

72. *See id.* In its report, the House Banking Committee based its claim of banking agency insincerity on the agencies' failure to change their regulatory methods despite charges and evidence that the pre-Act regulatory system was inadequate, especially with respect to foreign lending. *Id.* In 1977, the General Accounting Office (GAO) published a report following its audit of the federal banking agencies' supervisory practices. *Id.* at 1915. The GAO criticized the banking agencies for inconsistent practices, failure to adequately examine lending activities of foreign branches of U.S. banks, and failure to require banks to adopt more stringent internal controls. *Id.* at 1916. In 1979, the three federal banking agencies established an Interagency Country Exposure Review Committee to assess debtor countries' ability to repay loans and evaluate domestic banks' internal risk management programs concerning foreign loans. *See* GOLEMBE, *supra* note 14, at 75.

Although the creation of the Interagency Committee represented an attempt at greater uniformity in regulation of foreign lending, commentators criticized the effectiveness of the Interagency Committee in fulfilling its supervisory role, primarily because of the Committee's limited power to control bank exposure to LDC default. *See Regulation of Bank Lending, supra* note 7, at 218-19. The Interagency Committee's sanctioning powers are limited as a practical matter to issuing non-binding comments to banks that have exceeded prudent foreign lending standards. *Id.* Banks frequently ignore Interagency Committee comments. *Id.*

73. *See supra* note 68 (setting forth five-point proposal of Joint Memorandum).

74. *See* HOUSE REPORT, *supra* note 25, at 1920 (Joint Memorandum of federal banking agencies did not set out specific reforms and addressed only short-term problems of international debt crisis).

75. *See supra* note 74 and accompanying text (House was critical of banking agency proposals in Joint Memorandum).

76. *See* HOUSE REPORT, *supra* note 25, at 1921 (representatives from Bank of America, Chase Manhattan Bank and Citibank testified in February 1983 that additional legislation or regulations concerning bank lending abroad were unnecessary).

by legislators restricting the credit available to debtor nations by discouraging commercial lending would be detrimental to the world financial system.[77] Moreover, the bank representatives argued that new foreign lending regulations would frustrate the attempts of LDCs to meet their capital needs at a time when balance of payment problems and economic development objectives made infusions of fresh capital necessary.[78] Bank representatives claimed that regulatory or legislative action imposing economic disincentives to commercial bank lending abroad could cause a severe contraction of credit available to LDCs.[79] Like the banking regulators, bankers opposed country lending limits and maintained that country risk analysis[80] performed by the commercial banks would protect banks from dangerously high levels of foreign loan default exposure.[81] The attitude of the banking industry was that although LDCs faced short-term liquidity problems, LDCs were not insolvent in the traditional sense.[82] Bankers believed that the loans on which debtor LDCs had stopped payment should not be considered in default since

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77. *See Senate Hearing, supra* note 31, at 116 (letter from George J. Clark, Executive Vice President, Citibank, N.A., in answer to questions from Senator William Proxmire concerning federal regulation of international lending activities of domestic banks). George Clark related Citibank's position that Congress and the banking agencies should not promulgate regulations which would cause banks to curtail vital lending to LDCs. *Id.* Clark also stated that bank regulators were justified in hesitating to classify loans as "lost" loans when countries failed to meet repayment schedules since countries could regain the ability to resume payments by making appropriate domestic economic adjustments. *Id.*

78. *See supra* note 77 (describing reaction of bank representatives to prospect of additional banking regulations).

79. *See id.* (regulations governing international lending might discourage domestic banks from lending abroad).

80. *See* Dale, *Country Risk and Bank Regulation,* BANKER, March 1983, at 41. Country risk is a lending bank's risk that a government borrower will be unwilling or unable to meet its debt obligations, or that a private borrower abroad will be unable to meet its debt obligations as a result of local foreign exchange restrictions. *Id. See generally* Walter, *Country Risk and International Bank Lending,* 1982 U. ILL. L. REV. 71, 71-88 (1982) (describing factors which banks consider in assessing country risk associated with lending to private or public borrower in foreign country).

81. *Cf. Wriston Interview, supra* note 6, at 253. (Walter Wriston, Chairman of Citicorp, claimed that it is up to banks, and not Congress, to allocate available credit among foreign borrowers).

82. *See International Financial Markets and Related Problems: Hearings Before the Committee on Banking, Finance and Urban Affairs of the House of Representatives,* 98th Cong., 1st Sess. 182 (1983). William S. Ogden, Vice Chairman of the Chase Manhattan Bank, N.A., testified that debtor LDCs faced a short term liquidity problem, and not a permanent solvency problem. *Id.* Ogden claimed that a world-wide economic recovery would permit LDCs to resume debt service. *Id.* William H. Bolin, Vice Chairman of Bank of America, N.T. and S.A., agreed with Ogden, arguing that debtor countries were not bankrupt in the sense that a business enterprise might be bankrupt. *Id.* at 235. Ogden referred to Argentina as a classic example of a country facing a liquidity problem. *Id.* at 302. According to Ogden, Argentina soon would post a trade surplus, but required interim debt relief. *Id.*

Insolvency problems are theoretically distinguishable from liquidity problems. *Regulation of Bank Lending, supra* note 7, at 206 n.32. Debtor nations' total liabilities do not exceed their

LDCs eventually would overcome liquidity problems and would resume payments.[83]

Since the enactment of the International Lending Supervision Act, the federal banking agencies have promulgated international banking requirements pursuant to the Act.[84] The Fed, in conjunction with the FDIC and the COC, issued a series of regulations which govern reserves against potential foreign loan losses, establish international loan fee accounting conventions, and require the disclosure and reporting of international assets.[85] The new regulations identify the reserves that banks must establish against potential losses on foreign loans as "Allocated Transfer Risk Reserves" ("ATRRs").[86] The regulations specify that ATRRs shall represent ten percent of the

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total assets, as would be the case in a traditional example of insolvency. *Id.* As a practical matter, however, the residual value of sovereign assets over liabilities should be of very little comfort to lenders since foreign governments would be most unlikely to liquidate assets to satisfy their loan obligations. *Id.* Moreover, mechanisms do not exist by which banks can compel foreign governments to liquidate national assets to service international debt. *Cf. The Debt-Bomb Threat,* TIME, Jan. 10, 1983, at 50 (commercial banks can "hardly send gunboats" to seize assets in debtor countries). Additionally, foreign government claims of sovereign immunity might hinder the banks' ability to collect amounts due on foreign government loans. *Id.*

83. *Cf. Wriston Interview, supra* note 6, at 252. Walter Wriston argues that default by a foreign country borrower on its commercial debt would prove too costly to the borrower, since that debtor nation would thereby alienate itself from world capital markets and would find it very difficult, if not impossible, to borrow again in the future. *Id.* Felix Rohatyn, however, warns that a debtor country might repudiate its foreign debt obligations following a radical change in government. *See* Rohatyn, *supra* note 3, at 6 (LDC debt repudiation is possible despite likelihood of alienating capital markets).

84. *See infra* notes 85-88 and accompanying text (describing regulations banking agencies have adopted pursuant to Act).

85. *See* Subpart D—International Lending Supervision, 1 FED. RESERVE REGULATORY SERVICE (FED. RESERVE BOARD) 3-656 to 3-668 (May, 1984) (to be codified at 12 C.F.R. § 211.41-.45) [hereinafter cited as Subpart D]. The Fed issued the new Subpart D under Regulation K which governs international banking operations. *See* 12 C.F.R. § 211 (1965). The new Subpart D provides for the creation of new reserves, the reporting and disclosure of international bank assets, and the adoption of new accounting treatment for fees which banks earn on international loans. Subpart D, *supra*, at 3-656 to 3-668. Subpart D does not treat the capital requirement provision of the Act. *See id.* As of October 1984, however, the FDIC was contemplating gradually raising bank capital requirements to 9% of assets from the current 5.5% level. *FDIC Soft-Pedals Bank-Discipline Plans, Mulls Raising Capital Requirements to 9%,* WALL ST. J., Oct. 2, 1984, at 7, Col. 1. Neither the Fed nor the COC have agreed to the 9% level, but instead have discussed setting a 6% level. *Id.* All three banking agencies must agree on a single capital-to-assets ratio before a new standard will become effective. *Id.*

86. *See* Subpart D, *supra* note 85, at 3-658. The Fed defined "transfer risk" as the risk to a lending institution that a public or private borrower in a foreign country would be unable to service its debt in the currency of payment because of insufficient foreign exchange in the obligor's country. *Id.* at 3-657.2. During a time of fiscal crisis, for example, a foreign government might allocate all available foreign exchange to meet the country's public sector debt, thereby leaving nothing with which private borrowers within the country could pay their foreign debt obligations. *See* Dale, *Country Risk and Bank Regulation,* BANKER, March 1983, at 43 (private sector borrowers in financially troubled countries are likely to be last in queue for scarce foreign exchange, citing recent examples of Mexico and Argentina).

principal amount of each international asset for the initial year and fifteen percent in subsequent years unless the federal banking agencies jointly determine otherwise on a case-by-case basis.[87] Furthermore, the new regulations list the factors that the federal banking agencies will consider in determining the amount of the ATRR required for each international asset.[88] Despite the House Committee's reprimand for the banking agencies' apparent lack of concern about foreign lending practices, the federal banking agencies managed to preserve a great deal of flexibility in regulating international lending practices.[89]

The ultimate value of the Act, beyond that of political expediency in facilitating increased contributions to the IMF,[90] depends in part on the degree to which follow-up regulations and enforcement will prohibit a business-as-usual attitude among bank regulators and bank management.[91] To promote a lasting solution to the international debt crisis, agency regulatory measures adopted under the Act must help reduce the current high level of LDC default exposure of domestic money-center banks and ensure that banks do not exceed prudent levels of foreign default exposure in the future.[92] The regulations, however, must not cause an LDC credit squeeze so severe as to set back indefinitely LDC economic recovery.[93]

Throughout the debate over the need for international lending reform, a dominant legislative concern has been striking an appropriate balance between reducing domestic bank exposure to potential LDC default and avoiding an acute undersupply of credit to LDCs, a situation which could trigger the very risk of LDC default that Congress has sought to protect against.[94] For example, reckless bank lending to debtor nations would cause

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87. *See* Subpart D, *supra* note 85, at 3-659 (specifying reserve amounts banking agencies shall require banks to establish against losses on foreign loans).

88. *Id.* The Fed stated that in determining a foreign loan loss reserve amount, the banking agencies would consider the length of time a bank's foreign assets were impaired, the actions the debtor took to restore debt service, the prospects for restoring asset quality and other factors the banking agencies deem relevant. *Id.*

89. *Cf. supra* text accompanying note 75 (Congress transformed banking agency recommendations in Joint Memorandum into legislation with few changes).

90. *See supra* note 48 and accompanying text (public might view Act as widow-dressing for IMF appropriations bill).

91. *Cf.* Rohatyn, *supra* note 3, at 3 (arguing that Congress should not adopt policy of allowing banks and LDC debtors to muddle through debt crisis, given risk of general financial collapse from such policy).

92. *See infra* note 100 (bank regulations must strike balance between excessive LDC lending and causing LDC credit squeeze).

93. *See infra* note 94 (abrupt credit squeeze could increase liquidity problems for LDC borrowers).

94. *See, e.g., Regulation of Bank Lending, supra* note 7, at 232 (arguing that proposal involving insurance of foreign debt would reduce bank default exposure and help stem reduction of capital available to LDCs); Rohatyn, *supra* note 3, at 7 (expressing concern that dramatic contraction of credit available to LDCs is occurring as money-center banks seek to reduce exposure to LDC default on foreign loans); *Senator John Heinz Discusses the Current World Debt,* TR. & EST., Nov. 1983, at 7 (Senator John Heinz indicates that while volume of bank

further deterioration in the quality of a commercial bank's asset portfolio.[95] A deterioration in a bank's loan portfolio might cause a run on the bank's deposits,[96] or lead to bank insolvency should some of the larger debtor nations default on their massive borrowings.[97] On the other hand, a severe cutback in credit available to debtor nations could cause financial havoc by forcing debtor nations into default on foreign debt.[98] Although providing additional credit to finance LDC trade deficits and interest due on existing debt is not a sound long-term financing arrangement, the continued availability of credit for LDCs in the short-run may be essential to forestall LDC foreign loan defaults.[99] The effectiveness of the Act in promoting greater

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lending to LDCs must decline over time, current danger is that abrupt cutoff of credit to LDCs would exacerbate liquidity crisis among LDCs); *see also* Cline, *The Issue Is Illiquidity, Not Insolvency*, CHALLENGE, July-Aug., 1984, at 12. New bank lending to LDCs dropped from approximately $50 billion in 1981 to $25 billion in 1982 and to slightly less than $25 billion for 1983. *Id.* at 19. Continued lending by private banks is essential in light of projected LDC new capital requirements of between $75 billion and $80 billion through 1986. *Id.*

95. *Cf. supra* note 6 and accompanying text (commercial banks engaged in excessive lending to LDCs face risk of financial collapse should LDCs default on foreign loans).

96. *See Greenspan Warning on Loans*, N.Y. Times, Jan. 3, 1983, at D2, col. 1. Alan Greenspan, member of the Presidential Council of Economic Advisors under the Nixon and Ford administrations, warned that depositor concern over the international debt situation might result in runs on deposits from banks engaged in lending to LDCs. *Id.* The FDIC insures bank depositors for up to $100,000 per depositor. *See* GOLEMBE, *supra* note 14, at 48. Although 95% of the deposit accounts in the United States are fully insured, the FDIC estimated that in 1982 only 20% of the accounts in large money-center banks were fully insured because of the large size of most accounts. *Central Banking Survey*, ECONOMIST, Sept. 22, 1984, at 44. The FDIC insurance scheme, therefore, does not fully protect a large amount of deposits on the books of the principal LDC lenders. *See id.* Depositor uncertainty about the health of a bank's asset portfolio could cause a run on even fully insured deposits given the prospect of delay in FDIC settlement of depositor claims and associated inconvenience in the event of a bank failure. *Id.* at 41.

97. *See Top Banks' Third World Loans Detailed*, N.Y. Times, Mar. 18, 1983, at D3, col. 1. The capital of U.S. multinational banks is not sufficient to cover a write-off of even a portion of their foreign loan exposure. *Id.*; *see supra* note 8 (LDC loans expressed as percentage of bank equity). The Fed is unwilling to promote the notion that the Fed would act as lender of last resort in the event of a banking crisis. *Cf. Central Banking Survey*, ECONOMIST, Sept. 22, 1984, at 32 (central banks reluctant to reassure incompetent bankers). By remaining ambiguous as to its potential role as lender of last resort, the Fed hopes to encourage prudent lending practices among banks. *Id.* As a practical matter, however, the Fed likely would not allow a major bank to fail, given the impact such a failure would have on the entire banking system. *Regulation of Bank Lending*, *supra* note 7, at 224. The response of the banking agencies to the near collapse of the Continental Illinois Bank tends to indicate that they will not allow a major bank to fail. *Cf. Central Banking Survey*, ECONOMIST, Sept. 22, 1984, at 44 (FDIC fully guaranteed all deposits at Continental Illinois and waived FDIC's $100,000 limit in unsuccessful attempt to prevent run on deposits). Critics of the Fed's policy of refusing to publicly declare itself a lender of last resort argue that such a policy injects further uncertainty into the already volatile environment of international lending. *Regulation of Bank Lending*, *supra* note 7, at 223-24.

98. *See supra* note 94 (contraction of credit available to LDCs could cause liquidity problems for LDCs).

99. *See Senator John Heinz Discusses the Current World Debt*, TR. & EST., Nov. 1983,

stability in the world financial system will depend to a large extent on whether the Act and subsequent regulations can protect against the twin perils of LDC credit undersupply and bank overexposure.[100]

The special loan loss reserve requirements under the Act and the ATRR requirements under the regulations provide a significant economic deterrent to continued LDC lending by domestic banks as banks must deduct new reserve amounts from their earnings.[101] Since the passage of the Act, the major domestic banks have raised their loan loss reserves in response to pressure from federal banking agency examiners.[102] Increasing loan loss reserves has reduced earnings for United States based multinational banks.[103] Faced with both the prospect of lower earnings because of strict reserve requirements and the realization that debtor LDCs may remain unable to pay at least some of their foreign debt obligations indefinitely,[104] domestic

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at 7 (Senator John Heinz arguing that abrupt cutback in LDC lending could cause financial turmoil).

100. *See Regulation of Bank Lending, supra* note 7, at 208 (bankers and bank regulators must strike balance between competing goals of bank soundness and continued availability of credit to LDCs); *To Amend the Bretton Woods Agreements Act to Authorize Consent to an Increase in the United States Quota in the International Monetary Fund (H.R. 5970): Hearings Before the Subcommittee on International Trade, Investment and Monetary Policy of the House Committee on Banking ,Finance and Urban Affairs*, 96th Cong., 2d Sess. 394 (1980) (testimony of Henry Wallich, member of Board of Governors of Federal Reserve, indicating that solution to debt situation must neither involve excessive lending nor produce sharp curtailment of lending).

101. *See supra* note 19 and accompanying text (Act requires banks to charge special loan loss reserves against current income). Had the nine largest U.S. money center banks established loan loss reserves representing 10% of the nine banks' loans to the six most indebted LDCs—Mexico, Brazil, Venezuela, Argentina, the Philippines, and Chile—the nine banks would have suffered an average 90% reduction in actual earnings per share for 1983. *See* News Release, The Wachovia Corporation, Oct. 10, 1984, at 2 ("Hypothetical Earnings Reductions from Setting Up Loss Reserves on Loans to Big-6 LDCs").

102. *See Major Banks Avoid Big Loan Write-Offs But Sharply Boost Their Loss Reserves*, Wall St. J., Oct. 18, 1984, at 7, col. 1. According to third quarter earnings reports for 1983, bankers at Security Pacific Corp. increased loan loss reserves by 42%, or $155 million, and bankers at Manufacturers Hanover Corp. and Chase Manhattan Corp. increased loan loss reserves by $30 million and $50 million respectively. *Id.* A banking industry analyst at Smith, Barney, Harris, Upham & Co. attributed the increase in loan loss reserves at the major U.S. banks to the banks' "cushioning" against anticipated problems in the Latin American debt situation. *Id.* The Comptroller of the Currency, however, required First Chicago Corp. to write off $279 million in both foreign and domestic problem loans, a more radical step than requiring an increase in loan loss reserves. *Id.* An anonymous bank officer attributed the tougher regulatory environment to the near collapse of Continental Illinois Corporation earlier in 1983. *Id.*

103. *See Behind the Banking Turmoil*, Bus. Week, Oct. 29, 1984, at 101 (Citicorp reported a 9.5% decline in third quarter earnings instead of flat earnings for that period because bank added $26 million to its loan loss reserves).

104. *Cf. Citicorp Insures Against Losses on Some Loans: Lendings in Five Countries are Protected in a Policy Valued at $900 Million*, Wall St. J., Sept. 7, 1984, at 4, col. 1. Citicorp purchased $900 million in insurance coverage to protect against possible losses on loans to Argentina, Brazil, Mexico, Venezuela, and the Philippines. *Id.* Citicorp had loans totalling

banks will cut back significantly on their foreign lending activity.[105] Although one of the goals of the Act is to safeguard the banking system by curbing aggressive lending to LDCs,[106] the Act may tend to destabilize the world banking system and therefore the soundness of domestic banks by exacerbating the current LDC credit squeeze.[107] The Act is open to criticism on the ground that Congress failed to enact legislation that both promotes sound banking practices and ensures an adequate supply of capital for LDCs.[108]

While the goals of restricting bank exposure to possible LDC default and ensuring an adequate supply of capital to LDCs appear to be in conflict, the legislature and bank regulators could have harmonized these goals by seeking to expand the pool of LDC lenders.[109] Measures encouraging financial institutions not currently involved in lending abroad to enter the international lending market on a modest scale would help ensure the availability of funds that LDCs require to avoid serious liquidity problems.[110] The entrance of new financial institutions into the international lending market also would enable the money center banks to reduce their high levels of foreign exposure without thereby terminating LDC access to American capital markets.[111] Spreading LDC default risk among many financial institutions would reduce the threat of systemic collapse of the world financial system since no major

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roughly $12 billion in the five LDCs as of year-end 1983. *Id.* While Citicorp is the first banking institution to have purchased such an insurance policy, the company's action is indicative of a less optimistic attitude among bankers towards the prospect of repayment of their loans to LDCs. *Id.* Citicorp's action is especially significant given the bank's earlier insistance that the LDC debt situation is a short-term problem. *Id.* It is not yet clear how the federal banking agencies will react to Citibank's insurance scheme.

105. *Cf.* Rohatyn, *supra* note 3, at 7. Even before Congress passed the Act, U.S. banks had cut back the flow of fund to LDCs. *Id.*

106. *See supra* text accompanying note 8 (Congress in enacting foreign lending legislation sought to promote sound banking practices).

107. *See* Rohatyn, *supra* note 3, at 7 (arguing that dramatic contraction of credit available to LDCs is taking place and that LDC credit squeeze poses threat to world financial system).

108. *See infra* notes 109-112 and accompanying text (diversification of lending pool would lower individual bank's exposure to LDC default and provide LDCs with needed funds).

109. *See Regulation of Bank Lending, supra* note 7, at 208 (regulatory policy must seek to harmonize apparently competing goals of limiting bank exposure to LDC default and making capital available to LDCs); *see also id.* at 210-12 (arguing that danger of systemic collapse of financial system would decrease by spreading risk of default through diversification of lenders to LDCs).

110. *See supra* note 94 (contraction of credit available to LDCs could cause liquidity problems for LDCs); *cf.* Bogdanowicz-Bindert, *supra* note 1, at 837 (criticizing proposals for resolving world debt problem which do not provide for new funds for LDCs).

111. *Cf.* Mendez, *supra* note 31, at 183-85. The large money-center banks could achieve actual reductions in their LDC default exposure through syndications and sub-participations of loans to LDCs. *Id.* at 183. In a syndication, a managing bank divides a loan among several participating banks. *Id.* at 184. In a sub-participation, a bank sells part of a loan in its portfolio to one or more other banks in exchange for the right to receive the proceeds from the loan. *Id.* 184. Both of these techniques help banks to diversify their loan portfolios. *Id.* at 184. Congress should take steps to encourage the use of these techniques to involve non-money-center banks in the LDC lending process. *See infra* text accompanying note 115 (discussing way in which Congress could broaden LDC lending pool).

bank or group of banks would face the risk of failure should LDCs default on their debt obligations.[112]

The very factors in the Act which dissuade current international lenders from increasing their foreign exposure also tend to discourage new participants from entering the foreign lending process.[113] While Congress and the regulatory agencies cannot compel financial institutions to participate in lending to LDCs, Congress and the agencies could make lending abroad more attractive to institutions which currently have little or no foreign exposure.[114] A federal program insuring all or part of new foreign loans, for instance, might encourage domestic lending institutions to enter the international lending markets.[115] Banks participating in the insurance program might pay premiums to the government agency administering the program, just as FDIC member banks pay premiums to the FDIC for deposit insurance.[116] In addition, Congress could make insurance of bank LDC lending conditional upon a bank's coordinating its foreign lending activity with the IMF or a similar organization to ensure that banks lacking experience in lending abroad do not lend imprudently.[117]

The International Lending Supervision Act indicates congressional concern for the health of the United States banking system in light of the LDC

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112. *See Regulation of Bank Lending, supra* note 7, at 211-12 (risk of systemic collapse of financial system would decrease if banks would spread LDC default exposure more evenly throughout financial system).

113. *See supra* notes 101-105 and accompanying text (loan loss reserve requirements which banking agencies promulgated pursuant to Act will discourage further lending abroad by U.S. banks). Since the new loan loss reserve requirements apply to all U.S. banks, banks already involved in LDC markets and banks not yet involved in LDC lending will be reluctant to extend credit abroad. *Cf. supra* note 21 and accompanying text (banks are to charge special loan loss reserves for foreign loans against current income).

114. *See Fed Push on Foreign Loans Seen*, N.Y. Times, Jan. 15, 1983, at 29, col. 6 (federal bank regulatory agencies have no legal power to compel banks to lend abroad). Despite the banking agencies' lack of legal authority to compel banks to lend abroad, the agencies have put pressure on banks to extend new credit to LDCs. *Id.*; *cf. Regulation of Bank Lending, supra* note 7, at 209 (President Reagan and Treasury Secretary Regan have urged U.S. banks to continue lending to Brazil).

115. *See Regulation of Bank Lending, supra* note 7, at 228-32 (discussing possible federal default insurance on loans to LDCs).

116. *See id.* at 229-30 (comparing possible federal insurance for LDC lending with FDIC insurance of deposits).

Congress could combine an LDC lending insurance program with country lending limits, as contemplated in the original Senate Bill, to diversify both the asset portfolios of individual banks and the pool of lenders to LDCs. *See supra* notes 58-59 and accompanying text (discussing provision for country lending limits in Senate Bill). *See generally Regulation of Bank Lending, supra* note 7, at 232-33 (discussing effect of adopting country lending limits and program to increase LDC loans).

117. *Cf.* Dale, *Country Risk and Bank Regulation*, BANKER, March 1983, at 48. Richard S. Dale argues that the IMF should make known information on LDC debt levels and propose guidelines for lending to LDCs as the basis for coordinating commercial lending to LDCs. *Id.* Congress and the federal banking regulatory agencies might incorporate IMF coordination of bank lending to LDCs within a possible federal LDC lending insurance program.

debt problem.[118] In the long run, the Act likely will discourage banks from over-lending to LDCs and improve the financial soundness of banks by increasing capital adequacy ratios and foreign loss reserves.[119] Absent companion legislation expanding the pool of LDC lenders and protecting against a sudden contraction of credit available to LDCs, however, the Act may actually destabilize the domestic financial system in the short-run by pushing LDCs closer to default on their foreign borrowings.[120] While the Act has prevented domestic commercial banks and the federal banking regulatory agencies from maintaining a business-as-usual attitude toward LDC lending,[121] the Act may succeed in substituting one source of financial malaise for another.[122] Sound economics require a gradual reduction in total lending to LDCs.[123] The International Lending Supervision Act's weakness is that it does not promote diversification of the pool of lenders to LDCs.[124] Steps toward spreading the risk of LDC default among a greater number of lending institutions would be consistent with a strategy of insulating financial markets from a possible LDC default shock wave.[125]

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118. *See supra* note 8 and accompanying text (Congress intended Act to promote sound banking practices among U.S. banks lending abroad).

119. *See supra* text accompanying notes 11-13 (summarizing provisions of Act).

120. *See supra* note 107 and accompanying text (Act may exacerbate current LDC credit squeeze).

121. *See supra* text accompanying note 105 (Act likely to cause banks to cut back significantly in their foreign lending activity). *See generally supra* note 91 (success of Act depends partly on whether it prohibits business-as-usual attitude toward LDC lending).

122. *See supra* note 107 and accompanying text (while Act will curb aggressive foreign lending by U.S. banks, Act may exacerbate current LDC credit squeeze).

123. *Cf. supra* note 5 and accompanying text (LDCs have contracted enormous debt obligations).

124. *See supra* note 110 and accompanying text (legislation should encourage financial institutions not yet involved in LDC lending to enter LDC lending market).

125. *See supra* note 112 and accompanying text (spreading LDC default risk would help protect world financial markets).