A New Supervisory Approach to Foreign Lending

International lending activities by United States commercial banks have increased greatly in size, complexity, and geographical scope during recent years. International credits now make up a significant portion of major bank loan portfolios and represent an important source of bank earnings. Foreign lending, of course, involves special kinds of risks that are not ordinarily found in domestic lending, although banks' loss experience from foreign loans has in fact been better than from domestic loans in recent years. Nevertheless, the rapid growth of international banking activities has created the need for improved techniques on the part of both banks and bank supervisors for defining, monitoring, and controlling those special risks.

The Federal Reserve System responded by reviewing existing bank examination procedures for foreign credits. It also made a survey in early 1977 of risk management practices by United States banks. Drawing on these reviews, a System Committee on Foreign Lending recommended changes in Federal Reserve procedures to strengthen supervision of international banking. The Federal Reserve Bank of New York has adopted these procedures on a trial basis in its current examinations of international loan portfolios. Systemwide implementation would follow final approval by the Board of Governors

The other Federal bank supervisory agencies—the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC)—were in the meantime studying their respective systems for supervising foreign lending. The three agencies joined together in an effort to develop principles for a common approach to international bank supervision. The aim is an effective supervisory system to ensure that foreign lending does not have adverse effects on the safety and soundness of the United States banking system.

A broad measure of agreement has now been reached on the essentials of a new Federal supervisory approach to foreign lending. An important element is the development of a common reporting form, which measures overall international exposure and its components for each bank. Most banks in this country with international operations have been asked to provide information on their foreign exposure twice a year. That information would enable bank supervisors to evaluate the exposure by country of individual banks and of the United States banking system as a whole.

A further element involves changes in procedures for examination of bank international loan portfolios. The emphasis would be on identifying concentrations of lending that seem large relative to bank capital and country conditions. In addition, examiners would pay particular attention to a bank's own procedures for monitoring and controlling its exposure in each country where it does business.

This article provides some of the details of how the new approach was developed and how it is expected to work.

Defining the special risks of international lending

Much of the risk in foreign lending is no different from that in domestic lending. The present and future standing of individual borrowers must be appraised and monitored in light of changes in economic and financial conditions. Well-managed companies may be adversely affected by a general economic slowdown in a country or by problems in a particular industry. Poorly managed companies may have difficulties even in a strengthening economy. Banks and bank examiners have found it useful to analyze *credit risk* in loan portfolios in terms of traditional risk categories.[1] These same categories are applied to individual international credits as well as to domestic credits.

In addition, international lending involves *country risk*. It is a principal factor that differentiates international lending from domestic lending. Country risk can be and has been defined in various ways. But, broadly speaking, it encompasses the whole spectrum of risks that arise from the economic, social, legal, and political conditions of a foreign country and that may have potential favorable or adverse consequences for loans to borrowers in that country. More concretely, country risk includes the risks of political or social upheaval, nationalization or expropriation, government repudiation of external debts, exchange controls, or foreign exchange shortfalls that might make it impossible for a country to meet external obligations on time. In some cases, payment of interest or principal on loans may be delayed or loan terms may have to be restructured. In rare cases, the result may be actual loan defaults.

Events such as these might materially affect the condition of the United States banks that make loans to a foreign country. Consequently, the potential risks must be carefully considered by banks and bank examiners The examiners are responsible for alerting bank management to those risks that might be difficult for a bank to absorb and might therefore jeopardize the liquidity or soundness of the bank.

The Federal Reserve's review of international lending

In view of the growth of international lending by United States banks and the enlarged role of commercial banks in financing international payments imbalances, the Federal Reserve undertook a comprehensive review of the System's supervisory approach in this area. An *ad hoc* Committee on Foreign Lending was appointed in late 1976 to study procedures and techniques used by member banks in making foreign loans and by Federal Reserve examiners in appraising state-chartered member bank foreign lending.

The committee initially conducted a survey of the existing foreign lending practices of member banks. The survey took the form of detailed discussions with senior bank officers by representatives of Federal Reserve Banks and the staff of the Board of Governors. In addition, an OCC examiner attended each meeting with a national bank. In all, discussions were held with forty-six banks across the country, including the twenty-five largest banks, to obtain a broad cross section by bank size and location.

The discussions were structured around questions concerning a bank's procedures for appraising, monitoring, and controlling foreign credit exposure. Each bank was asked how it defined country exposure, how it distinguished between different types and maturities of credits, and how it treated such factors as guarantees, collateral, and contingencies. The bank was asked whether limits on credits or commitments to a country were established and how they were reviewed as a country's economic and financial conditions changed. Questions were posed on how economic projections for a country were considered in individual lending decisions. Finally, each bank was asked about its policy toward diversification of country credits.

The survey revealed that all banks visited had in place internal systems for monitoring and controlling foreign lending, although practices varied considerably from bank to bank. The range of procedures largely reflected differences in bank size and organization as well as the kinds of international business conducted by individual banks. But they also reflected the relative inexperience of some banks in defining country risk and in measuring exposure to that risk. As a result, the detailed measurement of country exposure differed among banks, both in the types of credits considered subject to country risk and in the methods for consolidating the exposure to a country of different offices of a bank.

Although banks would naturally wish to emphasize particular aspects of their country exposure depending upon their business, the survey suggested that a greater uniformity in measuring exposure would be useful. It would allow bank supervisors to compare banks and let individual banks compare their foreign loan portfolios with averages for others. But, given the diversity of bank size and organization, it would not be desirable to impose a uniform set of procedures for all banks to use in evaluating, monitoring, and controlling foreign lending. Instead, the survey suggested aspects of an effective risk management system could be drawn from the experience at a wide range of banks.

1 Three classifications of loans with above-normal risk are used by examiners substandard, doubtful, and loss In addition, some loans which are superior to those in the substandard class are specially mentioned as warranting more than usual management attention

What a new supervisory approach should include

From this review, it became clear that a restructured supervisory approach to appraising foreign lending should incorporate several features.

It should provide for uniform measurement of a bank's country exposure and a systematic basis for calling bank management's attention to any relatively large exposure which might be potentially troublesome. There is no precise way of measuring country risk, *per se*, or of assigning probabilities to potentially adverse developments in a country. However, a bank's country exposure, the sum of its credits and commitments to a country, can be quantified A consistent measure of exposure would allow examiners to compare portfolio management among different banks and to formulate standards for appropriate diversification within portfolios.

It should ensure that banks themselves have adequate internal systems for appraising, monitoring, and controlling country exposure. A bank supervisor can assess a bank's country exposure only at periodic intervals. But a bank's exposure may change from day to day. An effective internal control system is essential for maintaining continuous management oversight of international lending.

It should keep the appraisal of country exposure separate from the traditional risk classification system used for evaluating individual credits.

It should be capable of uniform application throughout the System. In the past, individual examiners had differing approaches to appraising international loan portfolios, and their individual judgments could vary.

It should provide a mechanism by which Federal Reserve Bank examiners would draw upon the knowledge and expertise of specialists within the System about country conditions to help identify potentially adverse developments in a country.

It should not give credit ratings to countries. Nor should it establish a list of particularly risky countries to which banks would be told not to lend. Bank supervisors are concerned with the condition of individual institutions as the components of a sound banking system. Actions of bank supervisors are not intended to result in the channeling of credit flows toward or away from specific countries or to lead to large disruptions of credit flows. In any case, there is no reason to believe that assessments about countries by bank supervisors would always be better than those of commercial banks.

It should recognize the great uncertainties that exist in any assessment of country risk and should stress that banks are best protected against adverse developments through diversification within their foreign loan portfolios.

Based on those criteria, new examination procedures and techniques were developed that would assist examiners in making more professional evaluations of individual loans and country exposures. They were field tested at state-chartered member banks in the New York, Chicago, and San Francisco Districts in the course of regular examinations. In addition, examination concepts and proposed techniques were discussed with senior officers of several other member banks.

Concurrently, work was in progress by the OCC and the FDIC to review their respective examination procedures for international lending. Discussions among the Federal Reserve and these other agencies suggested that a new Federal supervisory approach would provide the most effective and most equitable basis for examining United States banks' foreign lending portfolios. A broad measure of consensus has been reached on the basic elements of that approach. These are outlined in the following section.

The new supervisory approach

Under the new supervisory approach to international lending, credit risk would continue to be appraised using standard examination procedures and techniques. Individual credits would be reviewed to determine the creditworthiness of the borrowers. Credits identified as having an above-normal credit risk element would be classified by the examiner using the traditional groupings of substandard, doubtful, and loss.

Where the new examination approach would differ from previous procedures is in the treatment of country risk. The new approach would consist of three parts:

(1) *Measurement of exposure* in each country where a bank has a business relationship. In turn, individual bank exposure would be consolidated to show the overall exposure of the United States banking system to each country abroad

(2) *Analysis of exposure levels and concentrations of exposure* in relation to the bank's capital resources and the economic and financial conditions of each country in which the bank has outstanding credits.

(3) *Evaluation of the risk management system* used by the bank in relation to the size and nature of its foreign lending activities.

The end product would be an examination report that reviews internal management systems and identifies certain concentrations of credit within the foreign loan portfolio that warrant management attention

Measurement of exposure

The Federal Reserve survey of United States commercial banks' foreign lending practices showed that there was no standard or uniform banking industry approach to measuring country exposure and no single best method among those used by different banks. Similarly, the Federal supervisory authorities had been defining country exposure differently.

The Federal supervisory authorities have now agreed on a uniform method for measuring exposure. It is based on a common reporting system for international lending information. That system benefited from earlier exercises in collecting international lending data conducted by the major central banks under the auspices of the Bank for International Settlements (BIS). But it goes further by measuring international exposure on a consolidated bank basis. Thus, loans to each foreign country would be included whether made by a bank's head office or by a branch or affiliate abroad. Information about foreign claims is provided by each reporting bank in a semiannual country exposure report, beginning with data for end-December 1977.[2] The report breaks down the bank's claims for each country by type of borrower and by maturity. Loan commitments and other contingencies are also detailed. Activities of a bank's foreign offices with local residents in local currencies are shown separately.

One feature of the country exposure report takes account of an important distinction in international lending. The location of a borrower may not coincide with the location of the ultimate country exposure If, for example, a United States bank has made a loan to a borrower in country X and the loan is guaranteed by another institution in country Y, then the ultimate country exposure is allocated to country Y.

In its country exposure report, a bank is asked to reallocate credits and commitments to the country where the ultimate risk appears to reside. The examiner would then be able to analyze the foreign loan portfolio by this more comprehensive treatment of country exposure, as well as by country of location of borrower. The reallocation of exposure takes into account external guarantees or realizable collateral outside the country of the borrower. In the case of claims on foreign branches of other banks, ultimate exposure is reallocated to the location of those banks' head offices.

By consolidating the data for all reporting banks, the supervisory authorities also get a clearer picture, by location of credit and by country of ultimate risk, of the United States banking system's exposure to each country abroad. These aggregates allow the authorities to compare one bank's foreign loan portfolio with those of other United States banks.

In the examination process, the examiner would use the information from the country exposure report in analyzing a bank's international exposure In particular, the examiner would express the overall measure of exposure for each country where a bank has outstanding credits as a ratio of the bank's capital funds. These ratios would give a picture of the bank's concentrations of lending relative to its own ultimate resources to absorb risk. They would serve also as an indicator to the examiner of which parts of a bank's international portfolio deserve a deeper look.

In summary, the country exposure data would enable the examiner: (1) to evaluate the amounts, location, maturities, and types of claims a bank has abroad, (2) to evaluate the amounts of claims reallocated to country of ultimate risk, and (3) to compare the exposure levels with the bank's capital and to suggest areas for further analysis.

Analysis of exposure levels and concentrations

The second part of the new examination approach would involve analysis of country exposure levels and concentrations of exposure. The objective would be to identify high concentrations of exposure relative to the bank's capital funds and relative to the economic and financial conditions of borrowing countries.

The analysis of country exposure levels would involve three steps:

(1) An evaluation of country conditions by research economists and country specialists. These evaluations would be made available to bank examiners for use as background to their analyses of foreign loan portfolios.

(2) Disaggregation by the examiner of aggregate exposure by referring to a bank's internal records Particular attention would be paid to the types of borrowers and the maturity distribution of the bank's foreign claims.

(3) Examiner comments on the results of the analysis.

Countries that warrant in-depth review would be identified through simple statistical screening techniques. The techniques would be used to pick out countries which have, in relation to other countries, large current account deficits or heavy external debt service or low international reserve positions relative to the size of their own economies and their external trade. The aim is to base a screening mechanism on

[2] The country exposure report is filed by all United States banks and bank holding companies with international activity above a specified level For a description of the report, see box on page 6

objective criteria But the statistical indicators themselves are not designed to be, nor would they be used as, predictors of potential debt repayment difficulties.

For this limited screening purpose, indicators have been computed from reported balance-of-payments statistics and other financial data. One is a measure of short-term current account imbalance, while another is an indicator of medium-term current account imbalance and the rate of external debt accumulation. Other indicators measure countries' debt interest burden in terms of such factors as current receipts (exports of goods and services) and international reserves. The indicators would be regularly computed for the major borrowing countries in which United States banks have exposure.

The screening mechanism is intended to be suggestive only and not exhaustive. But its obvious advantage is its objectivity and relative simplicity. System research economists, moreover, continue assessing available economic statistics which could improve the screening process.

Countries identified through the screening process would be thoroughly reviewed. Comprehensive studies would be prepared for the examiner's use in raising questions with the bank under examination and in appraising country risk in portfolio concentrations. On the economic side, the focus would be on a country's balance of payments and its international reserves, both current and prospective. The review would also include an analysis of the country's domestic economic situation and government policies, foreign exchange rate behavior, and structural trends in the economy. In addition, conditions affecting political and social stability would be noted, especially as they may have a bearing on the overall economic environment.

These reviews of country conditions would provide background for the examiner's analysis of exposure concentrations in a bank's international loan portfolio. All country concentrations which appeared high would be looked at in detail. A bank's outstanding credits in a country would be examined by type of business (loans, acceptances, investments, placements, etc.), by maturity (short term versus long term), and by class of borrower (government, nonbank private sector borrowers, and banks).

Drawing on this analysis of exposure levels and the assessment of country conditions, the examiner would comment on those country exposures which appeared high in relation to the bank's ability to absorb risk and to the country's condition. Certain norms would be established to guide examiners in making critical comments on high concentrations by country. These would not be hard and fast rules. But the approach would ensure a reasonable level of uniformity, while allowing the examiners to exercise judgment and discretion in framing their comments.

Examiner comments might include references to a country's status with the International Monetary Fund or adherence to conditions imposed by the IMF on credit drawings. Comments might also be made where a bank's outstanding loans to a country represent a disproportionate share of the total lending by United States banks to that country, or where information maintained by the bank on a country or group of countries is deemed inadequate.

The objective of any critical commentary would be to encourage appropriate diversification in a bank's international lending portfolio. Diversification remains a bank's best protection against risk in an uncertain world.

Evaluation of risk management systems

The third part of the new examination approach would involve an evaluation of the risk management systems used by banks in appraising and controlling their foreign credit exposure. All banks engaging in international business should have the capability to analyze their customers and risks independently. No bank should lend to a particular borrower, for example, simply because other banks are extending credits to that borrower.

As the Federal Reserve survey of bank foreign lending practices confirmed, banks involved in international business have already set up internal systems for controlling foreign lending. There are notable differences in approach among banks, although these mostly reflect differences in the size and organizational structure of banks as well as the composition of their business.

Whatever the differences of detail, certain general characteristics should be found in all internal control systems. The examiner would need to be satisfied that a bank's risk management system is comprehensive and covers all aspects of the bank's international business. The examiner would evaluate the bank's internal system for measuring exposure to each country where the bank does business. The bank's methods for assessing country conditions would be evaluated to see whether risk assessments are based on reliable and up-to-date information, reviewed with reasonable frequency, and kept separate from marketing considerations. The bank's procedures for monitoring and controlling country exposure would be analyzed. The analysis would consider how the bank limits its lending to individual countries. It would also focus on how and at what stage country risk assessments are considered by bank officers in making lending decisions and in modifying country exposure limits. Any inadequacies found by the examiner in the bank's country risk management system would be brought to management's attention in the examination report.

Concluding remarks

The new approach to appraising international lending outlined in this article has several advantages. It emphasizes diversification of risk in individual bank portfolios. By doing so, it avoids any implications of official credit ratings of foreign countries. It underlines the role of bank managements in seeking diversified portfolios and in maintaining adequate internal mechanisms for monitoring and controlling country exposure. Details of this supervisory approach are still being developed, and discussions among the Federal supervisory agencies are continuing. There is every reason to hope that before long the technical groundwork will be completed and a new approach fully implemented.

Country Exposure Report

A semiannual country exposure report (FR 2036, CC 7610-08, or FDIC 6502/03) is filed by all United States banks and bank holding companies with international activity above a specified level. The report consolidates exposure for all domestic and foreign offices of an institution. Aggregate data from the country exposure report will be made public. The initial report provides data for end-1977. Results of a preliminary survey for June 1977 were released in January 1978.

Country exposure includes both outstanding claims on foreign residents and contingencies. Foreign claims are defined under three categories. (1) *Cross-border claims* are those of bank offices located in one country on residents of other countries. A loan to a company in Britain by a New York bank's head office is a cross-border claim. (2) *Nonlocal currency claims* are those of a bank's foreign offices on local residents denominated in currencies other than the local currency A loan in dollars to a company in Britain by a New York bank's London branch is a nonlocal currency claim. (3) *Local currency claims* are those of a bank's foreign offices on local residents denominated in the local currency. A loan in pounds sterling to a company in Britain by a New York bank's London branch is a local currency claim.

On the report, cross-border and nonlocal currency claims are combined and shown by country of residence of the borrower. The total for each country is broken down by type of borrower: banks, public borrowers, and all other borrowers. The totals are also broken down by estimated time remaining to maturity. Four maturity categories are used: one year and under, one to two years, two to five years, and over five years.

Contingencies are shown separately. They are contractual commitments to extend credit, such as letters of credit and undisbursed portions of loans that are not subject to further bank approval. Contingencies are broken down into two categories (1) public borrowers and (2) banks and other nonpublic borrowers.

Total cross-border and foreign office nonlocal currency claims are adjusted for each country to take account of external guarantees, collateral, and interbank placements that shift the ultimate country risk to another country The reporting bank makes a separate tally by reallocating the claims from the country of the borrower to that of the guarantor A similar reallocation is made for contingencies. The adjusted data show exposure by country of ultimate risk.

Guarantees are narrowly defined to include only formal and legal obligations by residents of countries other than the borrowers'. Claims collateralized by tangible and liquid assets (*e.g.*, cash, certificates of deposit, gold, marketable securities) are reallocated to the country where the pledged assets are held or where their value can be fully realized. In the case of marketable securities, for instance, the exposure would usually be shifted to the country where the security was issued Interbank claims on a branch abroad are shifted to the country in which the head office is located. Claims on subsidiary banks are adjusted to the country of the parent only if formally guaranteed or collateralized in that country.

Local currency claims of a foreign office, the third category of claims noted above, are treated as a country exposure only to the extent that they are not offset by local currency liabilities. To provide a broader picture, local currency assets and liabilities by country are shown separately.

As a final entry, each reporting institution shows for each country in which it has offices the net amount "due to" or "due from" those offices. This reflects the cross-border flows of funds within a banking organization.