U.S. Regulation of Bank Lending to LDCs: Balancing Bank Overexposure and Credit Undersupply

Marc R. Cohen†

Self-discipline is necessary; so, too, is mutual accommodation. . . . Lenders and borrowers must remember that each has an enormous stake in the other’s success.

—President Ronald Reagan, Dec. 1, 1982, Toast to President Joao Baptista Figueiredo of Brazil

The relationship that now exists between commercial banks and less developed countries (LDCs) threatens the stability of the international financial and U.S. banking systems. Many LDCs are experiencing severe problems in servicing their massive debts to the commercial banks, while at the same time the number of banks willing to continue lending to these LDCs and the amount of new credit these banks are willing to extend both are decreasing. In a rare display of unanimity, private and central bankers, government officials from LDCs and developed countries (DCs), multilateral financial institutions, and even the mass media have acknowledged the dangers presented by these mutually reinforcing phenomena. Responsibility for the gravity of the present situation has been attributed to selfish aims on the part of DCs, mismanagement by LDCs, and imprudence on the part of banks. Assigning blame, however, is useful only insofar as it helps avert future crises; the important task today is “to prevent a bad situation from becoming a global disaster.”

After outlining the nature and scope of the present crisis, this Article sets forth the general objectives of U.S. regulation of foreign lending by

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1. 18 WEEKLY COMP. PRES. DOC. 1556-57 (Dec. 13, 1982).
2. The term “LDC” is used in this Article to refer to the underdeveloped countries of the Third World, Eastern Europe, and OPEC which have borrowed extensively from Western commercial banks.
5. Id.
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domestic commercial banks. It then describes the existing regulatory framework and critically analyzes its failure to promote the achievement of these objectives. In conclusion, the Article proposes the establishment of a system of country exposure limits and loan insurance that would better serve U.S. policy goals, while reducing the possibility of a financial catastrophe.6

I. The Crisis in U.S. Commercial Bank Lending to LDCs

The origins of the present crisis can be traced to the massive transfer of financial capital from commercial banks to LDCs that took place throughout the 1970's.7 Because bank lending afforded greater flexibility and political and economic independence, as well as lower costs, the LDCs found borrowing from private banks more appealing than relying on the more conventional public and private sources of foreign capital.8 For their part, the banks, flush with newly created OPEC deposits and faced with stagnant domestic loan demand, were eager to enter the lucrative and then glamorous foreign lending market.9 The upsurge in bank-LDC lending—often called recycling10—that resulted from this confluence of interests initially was dominated by the large

6. Although the present regulatory framework applies equally to lending to LDCs or to other countries, this Article addresses the deficiencies in the framework with respect to lending to LDCs. The reform proposals made herein apply solely to that lending.

The Article focuses on U.S. regulation because of the central role of U.S. banks in LDC lending, and because no international solution to the present financial crisis seems likely. Because the problem has received a great deal of attention in the U.S., it is likely that some reform package will be adopted. In conjunction with the Reagan Administration's request for an increase in the U.S. contribution to the International Monetary Fund, Congress is presently considering a number of initiatives relating to the situation. See infra note 188; see generally No Time for Rancor Against the Banks, N.Y. Times, Apr. 1, 1983, at A26, col. 1 (editorial). If the U.S. successfully can address the problem, other developed countries may choose to adopt similar measures in relation to their banks' international lending.

Although the current recession has exacerbated greatly the debt crisis, even a full worldwide recovery would not obviate the need to address basic problems underlying LDC lending.

7. The LDCs borrowed to sustain development and imports as they experienced balance of payments deficits caused by large increases in petroleum prices, worldwide recessions, and plunging prices for LDC exports. The Debt-Bomb Threat, Time, Jan. 10, 1983, at 42, 45-46.


9. Staff Report, supra note 8, at 43, 46; The Debt-Bomb Threat, supra note 7, at 45; see Egan, supra note 3, at 30.

10. So called because banks circulate OPEC deposits to deficit-plagued LDCs, which in turn return much of the money to the OPEC countries as they pay their petroleum debts.
U.S. "money-center" banks,\textsuperscript{11} but U.S. regional banks, as well as foreign banks, subsequently became more deeply involved.\textsuperscript{12}

The most significant aspect of the banks' novel recycling role is that they have assumed country risk in addition to the normal credit risk which accompanies all loans. Country risk encompasses the economic, social, political, and legal factors that accompany lending to foreign sovereigns or to foreign economic entities whose payment ability may be affected by the actions of foreign states.\textsuperscript{13} It thus includes the risk of "political or social upheaval, nationalization or appropriation, government repudiation of external debts, exchange controls, or foreign exchange shortfalls,"\textsuperscript{14} and has significant influence on the risk of lending to economic entities within a given country.\textsuperscript{15} The assumption of country risk in loans to LDC borrowers, whether sovereign or private entities, has added a new and potentially dangerous dimension to the banks' exposure.

As U.S. bank lending to LDCs has increased, banks' exposure to LDCs in relation to their capital\textsuperscript{16} has generated substantial concern.\textsuperscript{17}

\textit{The Debt-Bomb Threat, supra} note 7, at 45; Egan, \textit{supra} note 3, at 30; \textit{Staff Report, supra} note 8, at 43, 46.
\textsuperscript{11} \textit{Staff Report, supra} note 8, at 9; \textit{The Debt-Bomb Threat, supra} note 7, at 45-46; Egan, \textit{supra} note 3, at 30.
\textsuperscript{12} \textit{The Debt-Bomb Threat, supra} note 7, at 45-46; Egan, \textit{supra} note 3, at 30.
\textsuperscript{14} \textit{Id.}
\textsuperscript{15} Eichler, \textit{Country Risk Analysis and Bank Lending to Eastern Europe}, in \textit{Eastern European Economic Assessment, Part 2: Regional Assessments: A Compendium of Papers Submitted to the Joint Economic Comm., 97th Cong., 1st Sess. 761} (Comm. Print 1981). The same commentator noted that country risk "is concerned with the willingness and the ability of the central bank to furnish a borrower with convertible currency." \textit{Id.}

A useful distinction between country risk and credit risk is that the latter is the particular financial risk inherent in each economic entity within an LDC, while the former represents the general possibility of a breakdown in a country's finances of sufficient magnitude to threaten repayment of the loans of all entities located in the country.

A small proportion of bank loans to LDCs are guaranteed by governments or entities outside the LDC. In these cases, the country risk borne by the bank is that of the guarantor country. \textit{A New Supervisory Approach to Foreign Lending, supra} note 13, at 6.

\textsuperscript{16} The ratio of outstanding loans to capital is a crucial measure of bank exposure, because capital is depleted when loans are written off as losses, with the result that the lending bank becomes less solvent. \textit{See Top Banks' Third World Loans Detailed}, N.Y. Times, Mar. 18, 1983, at D3, col. 1. For purposes of analyzing loan exposure, a bank's capital usually is taken to be shareholders' equity plus retained earnings and loss reserves. \textit{A Roundup of Fourth Quarter Bank Results}, N.Y. Times, Jan. 15, 1983, at D1, col. 3. The Comptroller of the Currency regulations which limit U.S. bank lending to individual foreign public sector borrowers to a percentage of capital, \textit{see infra} text accompanying notes 114-19, define capital as shareholders' equity plus "unimpaired surplus," which includes surplus and undistributed profits, capital reserves, 50% of loss reserves, and certain subordinated instruments. 12 C.F.R. § 7.1100 (1982). The loss reserve component of capital under these regulations will be increased to 100%, effective April, 1983. \textit{See 47 Fed. Reg. 56,863 (1982).}
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The combined capital of the 159 largest internationally-active U.S. banks, which do the vast majority of U.S. lending to LDCs, is $63.7 billion, which amounts to only about 40% of their LDC exposure.\textsuperscript{18} Moreover, the situation is exacerbated by the concentration of LDC loans within a relatively few countries.\textsuperscript{19} Capital exposure to these LDCs has risen significantly over the past three years, and most of the

\textsuperscript{17} G. JOHNSON, ASPECTS OF THE INTERNATIONAL SAFETY NET 9-12 (IMF Occasional Paper No. 17, 1983); Pressure on Bank Regulators, N.Y. Times, Nov. 11, 1982, at D1, col. 3.
\textsuperscript{18} See G. JOHNSON, supra note 17, at 11 (table); see also Table 1, infra note 19.
\textsuperscript{19} Table 1 sets forth the exposure of different groups of U.S. banks to non-OPEC LDCs (NOLDCs) and Eastern European countries expressed as a percentage of each group's aggregate capital.

Table 1
LDC Exposure as Percentage of Aggregate Capital for Largest U.S. Banks Required to File Country Exposure Lending Survey

<table>
<thead>
<tr>
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<tbody>
<tr>
<td></td>
<td>128 Largest Banks</td>
<td>9 Largest Banks</td>
</tr>
<tr>
<td>NOLDCs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>Brazil</td>
<td>28</td>
<td>39</td>
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<tr>
<td>Mexico</td>
<td>21</td>
<td>27</td>
</tr>
<tr>
<td>Philippines</td>
<td>6</td>
<td>10</td>
</tr>
<tr>
<td>South Korea</td>
<td>11</td>
<td>17</td>
</tr>
<tr>
<td>Taiwan</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>SUBTOTAL</td>
<td>80</td>
<td>113</td>
</tr>
<tr>
<td>ALL NOLDCs</td>
<td>112</td>
<td>161</td>
</tr>
<tr>
<td>EASTERN EUROPEAN COUNTRIES</td>
<td>15</td>
<td>21</td>
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<tr>
<td>TOTAL EXPOSURE</td>
<td>127</td>
<td>182</td>
</tr>
</tbody>
</table>

increase has been borne by the larger banks.20 As a result of these conditions, the U.S. banks have become vulnerable to any disruption of the recycling system.

The three largest LDC borrowers, Mexico, Brazil, and Argentina, are experiencing severe problems in servicing their debts to private banks and have declared temporary moratoriums on repayment.21 Many smaller debtor countries are experiencing debt service problems similar to those of the bigger borrowers,22 and the Federal Reserve Board's

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20. G. JOHNSON, supra note 17, at 4-5; Dizard, supra note 3, at 61.
Table 2 illustrates the current exposure to Mexico of the largest U.S. banks.

Table 2

<table>
<thead>
<tr>
<th>Bank</th>
<th>Exposure to Mexico (percentage of aggregate capital)</th>
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<tbody>
<tr>
<td>Chemical Bank</td>
<td>91</td>
</tr>
<tr>
<td>Bank of America</td>
<td>83</td>
</tr>
<tr>
<td>Manufacturers’ Hanover</td>
<td>77</td>
</tr>
<tr>
<td>Bankers’ Trust</td>
<td>75</td>
</tr>
<tr>
<td>Citibank</td>
<td>69</td>
</tr>
<tr>
<td>First Chicago</td>
<td>69</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>63</td>
</tr>
<tr>
<td>Morgan Guaranty</td>
<td>62</td>
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<tr>
<td>Mellon</td>
<td>61</td>
</tr>
<tr>
<td>Chase Manhattan</td>
<td>59</td>
</tr>
<tr>
<td>Crocker</td>
<td>55</td>
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<tr>
<td>First Interstate</td>
<td>53</td>
</tr>
<tr>
<td>Security Pacific</td>
<td>45</td>
</tr>
<tr>
<td>Marine Midland</td>
<td>43</td>
</tr>
<tr>
<td>Continental Illinois</td>
<td>37</td>
</tr>
</tbody>
</table>

Capital exposure ratios in this table were calculated by dividing bank loan exposure by bank capital, each expressed as a percentage of assets. See Loans to Argentina and Mexico Hurt Banks, N.Y. Times, Dec. 2, 1982, at D1, col. 4, D13, col. 2 (lending levels); A Roundup of Fourth Quarter Bank Results, supra note 16, at D1, col. 4 (bank capital). The exposure of U.S. banks to Brazil is 80% of that to Mexico; exposure to Argentina is 40% percent of that to Mexico. See G. JOHNSON, supra note 17, at 11. Exposure to Brazil and Argentina is more concentrated in the money center banks than that to Mexico. Ipsen, After Mexico the Regionals Are in Retreat, EUROMONEY, Jan. 1983, at 58, 63.

21. After an infusion of huge credits from central banks of developed countries, from the U.S. government, and from the International Monetary Fund (IMF), see How Mexico Lined Up Credits, N.Y. Times, Aug. 31, 1982, at D1, col. 3, Mexico in August 1982 declared a limited moratorium on repayment of the principal of its private and public sector foreign loans, see Bankers Tentatively Agree to Let Mexico Delay Repayment of Some Debt Principal, Wall St. J., Aug. 23, 1982, at 2, col. 3.


22. See The Debt-Bomb Threat, supra note 7, at 42-57 (Poland, Yugoslavia, Costa Rica, Zaire, South Korea & Venezuela); Dizard, supra note 3, at 60-78 (Nigeria & Chile); Pressure on Bank Regulators, supra note 17, at D1, col. 3 (Sudan); Kuczynski, Latin American Debt, 61 FOREIGN AFF. 344, 347 (1982-83) (Philippines); The Rumanian Debt Accord, N.Y. Times, Dec. 8, 1982, at D9, col. 1 (Rumania); Bolivia Seeks Help on Debt, N.Y. Times,
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"vulnerability indicators" for most LDCs are at record high levels. It has been forecast that unless global economic conditions improve within one year, many LDCs will be unable to meet interest payments, much less repay loan principal. Moreover, as defaults caused by financial conditions become more likely, the risk of defaults arising out of political hostility also seems greater.

The repayment problems of the LDCs have been aggravated by a sharp contraction in bank lending which itself is a reaction to the difficulties being experienced by the borrowers. Many lenders, and especially the U.S. regional banks, have drastically reduced their total exposure to LDCs. Smaller lenders, including the U.S. regional banks, are both less committed to LDC lending and more cautious than their money-center counterparts. As international conditions have worsened, these smaller lenders have reduced their foreign lending sharply, while the money-center banks have been unable to withdraw from the market for fear of causing its collapse. As lending is curtailed, countries previously in sound financial condition are forced into...
payment problems as their financial base is depleted.\(^{31}\)

Unless corrective measures are taken, the convergence of LDC repayment difficulties and the contraction in lending will lead banks and LDCs to experience mutually reinforcing illiquidity and insolvency\(^{32}\) which could trigger systemic financial crisis. If a number of LDC loans were to go into default and be written off as bad debt, many banks would become insolvent.\(^{33}\) If the public were to lose confidence in other banks and a deposit run occur, widespread bank failure and

\(^{31}\) Gasser & Roberts, supra note 23, at 29.

For example, Brazil's repayment problems have been worsened by this reduction in lending. IMF Plans Pressure on Banks to Help Brazil, supra note 21, at D1, col. 1. These problems have been said to be the result of Brazil's lenders' "trying to get out." Id.

\(^{32}\) Although the practical difference between illiquidity and insolvency is not always clear, there is a useful conceptual distinction between liquidity problems, which involve short-term cash shortages in otherwise sound entities, and insolvency, which implies a structural, long-term excess of liabilities over assets. G. Johnson, supra note 17, at 18, 31-32; Dizard, supra note 3, at 78.

In a bank, liquidity problems could arise from an overall lending contraction or from a short-term run on deposits, either of which would deplete the sources from which banks meet their current obligations and fund new loans. G. Johnson, supra note 17, at 31-32; Dizard, supra note 3, at 78. Liquidity problems could be countered with cash loaned by the Federal Reserve or other sources. G. Johnson, supra note 17, at 18, 31. Bank insolvency, the excess of depositors' claims (liabilities) over outstanding loans expected to be repaid (assets), would occur if many loans had to be written off as losses, and the long-term survival of the bank were called into question—a far more serious and difficult situation than a liquidity "squeeze." See Grant, Can the Cooke Committee Stand the Heat, Euromoney, Oct. 1982, at 39; Challenge for Central Banks, N.Y. Times, Nov. 7, 1982, at D1, col. 3, D13, col. 1.

LDCs' financial problems also can be characterized in terms of illiquidity and insolvency. Illiquidity connotes a temporary—albeit serious—shortfall of cash needed to fund deficits and repayments. Pressure on Bank Regulators, supra note 17, at D1, col. 3. Solvent countries experiencing liquidity problems are able to borrow through the liquidity crisis and generate funds to repay their debt. Wriston, Banking Against Disaster, N.Y. Times, Sept. 14, 1982, at A27, col. 1. Conversely, insolvent countries have little hope of generating sufficient funds to repay lenders and will not be extended either long- or short-term credit. Silk, Less Jittery Financiers, N.Y. Times, Sept. 15, 1982, at D2, col. 1.

Walter Wriston, a prominent banker, has characterized the present financial situation as a liquidity problem caused by LDCs' temporary cash-flow difficulties. Wriston, supra, at A27, col. 1. A former Treasury Department official described Wriston's assessments as "soporific" and "just plain cotton candy." Silk, supra, at D2, col. 1 (quoting Robert Roosa, former Under-Secretary of the Treasury). A spokesman for the Comptroller of the Currency has described the liquidity crisis as one "the likes of which we've never experienced." Loans to Argentina and Mexico Hurt Banks, supra note 20, at D13, col. 2. Felix Leutwiler, the chairman of the Bank for International Settlements, the clearing bank for the world's central banks, has stated that "if out of the liquidity problem there comes a solvency problem, I am not sure we can handle it." Dizard, supra note 3, at 75.

\(^{33}\) If U.S. banks were to have to write off even a fraction of their LDC exposure, their capital would be eliminated and the banking system would be rendered virtually bankrupt. Top Banks' Third World Loans Detailed, supra note 16, at D3, col. 1; see supra notes 16-20 and accompanying text. Many officials and commentators believe that a fiscal crisis in one or more of the large debtor LDCs easily could jeopardize U.S. banks and endanger the global financial system. See, e.g., U.S.-Mexico Talks Are Inconclusive, N.Y. Times, Apr. 20, 1983, at A5, col. 1 (comments of Sec. of Treasury Donald Regan); House Panel Criticizes Plan to Raise I.M.F. Aid, N.Y. Times, Dec. 22, 1982, at D1, col. 1 (same); Lever, Interna-
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financial collapse could result.34 Conversely, if in a period of crisis, banks’ short-term cash positions were to become inadequate and new credit to LDCs were restricted, LDC borrowers might collapse for lack of funds, which in turn could cause the failure of major international banks.35 Such apocalyptic scenarios may not occur, but this would not necessarily mean that the crisis had been resolved. The present situation may simply produce an accelerating deterioration of the world economy marked by smaller, recurrent financial crises from which recovery would be nearly impossible.

Although the present crisis is a product of unfavorable international economic conditions, it strongly demonstrates a fundamental failure of the U.S. bank regulatory system. U.S. policy currently emphasizes the provision of stop-gap loans to LDCs and attempts—both ironic and of doubtful success—to pressure banks to increase their LDC lending.36 The fundamental failures of the regulatory process that allowed the crisis to develop are not being addressed. A new approach is needed37 that would both mitigate the dangers posed by bank overexposure to LDCs and forestall contraction of lending by spreading more evenly among lenders and governments the risks and costs of LDC lending.38

II. Regulatory Objectives: Dilemma and Solution

A. The Dilemma of Bank Overexposure and Credit Undersupply

Two superficially competing concerns—the preservation of the safety

34. G. JOHNSON, supra note 17, at 12, 31-32; Dizard, supra note 3, at 75. A senior economic advisor has stated that such a deposit run would foster a crisis environment that “could lead to a depression.” Greenspan Warning on Loans, N.Y. Times, Jan. 3, 1983, at D2, col. 1 (quoting comments of Alan Greenspan).
35. G. JOHNSON, supra note 17, at 12, 31-32. According to U.S. Treasury Secretary Regan, if international capital flows are not increased, LDCs will “go by the boards” and the current recession could become a worldwide depression. House Panel Criticizes Plan to Raise I.M.F. Aid, supra note 33, at D1, col. 1 (testimony in favor of increased U.S. support for the IMF).
36. IMF Plans Pressure On Banks to Help Brazil, supra note 21, at D1, col. 1.
37. Felix Rohatyn, a prominent financier, states that “it is undeniable that both the known facts and the potential problems argue against a policy of hoping to muddle through with a little bit of luck. The risk of inaction is simply too great.” Rohatyn, supra note 25, at 3. See also Lever, supra note 33, at A27, cols. 2-5.
38. No Time for Rancor Against the Banks, supra note 6, at A26, col. 1.
of the U.S. banking system and the maintenance of the world financial system—motivate the federal interest in regulating bank lending to LDCs. Regulators and bankers have recognized an apparent tension between the prudential regulatory concern for bank soundness and the need for the continuation of capital flows to LDCs to maintain the stability of the international political and economic order. Effective regulatory policy must seek to harmonize these two goals.

The broad goals of U.S. banking regulation and supervision historically have been to ensure the stability of the banking system, to protect individual depositors, and to foster competition among banks. Regulators maintain that the system is not intended to protect individual banks; the policy assumption has been that banks and their stockholders and large depositors should be relatively free to assume risks, restrained only by fear of losses and free of regulatory guarantees and strictures. Nevertheless, most regulators would concede that they probably would not allow a large bank to fail, for fear of the likely consequences to the system. In fact, the regulatory system operates at the individual bank level, despite its ostensible systemic emphasis.

This prudential goal—the maintenance of the stability of the U.S. banking system—underlies the federal regulation of international banking activity. Many banking officials see the LDC exposure of

39. International Debt: Hearings Before the Subcomm. on International Finance of the Senate Comm. on Banking, Housing, and Urban Affairs, 95th Cong., 1st Sess. 86 (1977) (testimony of Henry Wallich, Member, Board of Governors, Federal Reserve) [hereinafter International Debt]. Wallich later expanded on this theme: "A high level of lending . . . could lead to excessive risk concentration . . . while . . . a low level . . . may make it difficult for these countries to finance their anticipated current-account deficits . . . ." Quota Hearings, supra note 19, at 394. See also Roll, supra note 35, at 121.

40. Wallich's solution is to "avoid excessive lending" but to "avoid a sharp curtailment" of lending. Quota Hearings, supra note 19, at 394. See also Cooke, Supervising Multinational Banking Organizations: Evolving Techniques for Cooperation Among Supervisory Authorities, 3 J. COMP. CORP. L. & SEC. REG. 244, 254 (1981).

41. MINORITY STAFF OF HOUSE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 96TH CONG., 1ST SESS., THE OPERATIONS OF U.S. BANKS IN THE INTERNATIONAL CAPITAL MARKETS 25 (Comm. Print 1979) [hereinafter MINORITY STAFF REPORT].

42. Challenge for Central Banks, supra note 29, at D1, col. 5, D13, col. 1.

43. Confidential interview with federal bank regulator (Sept. 24, 1982).

44. Confidential interview with federal bank regulator (Sept. 24, 1982); Challenge for Central Banks, supra note 29, at D1, col. 5, D13, col. 1; G. JOHNSON, supra note 17, at 34; see infra text accompanying notes 145-47.

45. In monitoring foreign lending, "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." A New Supervisory Approach to Foreign Lending, supra note 13, at 2 (emphasis added).

46. When one important element of the current regulatory scheme was announced, it was asserted that "[t]he 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." Id. at 1.
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U.S. banks as a serious threat to the domestic financial system, and hope that such exposure will be greatly reduced.\footnote{47} In apparent contrast to this emphasis on reduced exposure, highly placed U.S. policymakers have stressed the need to maintain international capital flows to LDCs.\footnote{48} For example, during their trip to Brazil in December 1982, both President Reagan and Treasury Secretary Regan exhorted U.S. banks to lend more to that country.\footnote{49} Paul Volcker, Chairman of the Board of Governors of the Federal Reserve, also has stated that there is "clearly a transitional need" for LDC lending to continue,\footnote{50} and that banks would "protect their interests" by meeting that need.\footnote{51} Stressing that at this time regulatory concerns should not interfere with LDC lending, Volcker further declared that "new credits should not be subject to supervisory criticism."\footnote{52}

The recent emphasis on the need to maintain the flow of capital is a result of the perception that the crisis has dangerous potential consequences for the United States. Obviously, collapse of the international financial system would be catastrophic from the U.S. perspective, but other, less dramatic dangers are present as well. Federal Reserve economists predict that reductions in bank lending to LDCs could cause

\footnote{47} Regulators feel that banks should not "continue to carry this burden over the long term." \textit{Quota Hearings}, supra note 19, at 477 (testimony of Lewis Odom, First Deputy Comptroller of the Currency). Congressional sentiment motivated by the current situation also favors more "disciplined" (that is, less) lending to LDCs. \textit{See Banks' Bid for Aid Stirs Old, Deep Resentments}, N.Y. Times, Feb. 10, 1983, at D1, col. 4; \textit{House Unit Spars With Bankers}, N.Y. Times, Feb. 9, 1983, at D7, col. 4; \textit{House Panel Criticizes Plan to Raise I.M.F. Aid}, supra note 33, at D1, col. 1.

\footnote{48} This attitude also contrasts with years of high-level indifference to LDC lending. \textit{See Quota Hearings}, supra note 19, at 474, 477 (1980 testimony of Lewis Odom that U.S. bank regulators "neither encourage nor discourage" international lending); \textit{id}. at 398 (1980 testimony of Henry Wallich that "[b]ank lending to [LDCs] . . . is not directly constrained by regulatory policy"). Before the onset of the present crisis, official concern was limited to determinations by middle-level regulators that banks had the resources necessary to conduct international lending. \textit{Id.}

\footnote{49} \textit{Reagan Promises to Provide Brazil a $1.2 Billion Loan}, supra note 21, at A1, col. 6. Secretary Regan is known to favor continued private lending to LDCs. Confidential interview with federal bank regulator (Sept. 24, 1982). Senior policymakers also are trying to coerce banks into maintaining and increasing their lending to Mexico, although they have no legal power to compel them to do so. \textit{Fed Push on Foreign Loans Seen}, N.Y. Times, Jan. 15, 1983, at 29, col. 6, 35, cols. 4-6. However, regulators still are basically unwilling to tell banks specifically in which countries to lend and how to limit their LDC exposure. \textit{See Pressure on Bank Regulators}, supra note 17, at D1, col. 3.

\footnote{50} \textit{Brazil Requests a Further Loan of $1.5 Billion}, N.Y. Times, Dec. 14, 1982, at A1, col. 1, D6, col. 6.

\footnote{51} \textit{Worries on Lending Abroad}, N.Y. Times, supra note 29, at D1, col. 3.

\footnote{52} \textit{Brazil Requests A Further Loan of $1.5 Billion}, supra note 50, at A1, col. 1, D6, col. 6. Volcker specifically proposed that regulators would not necessarily "classify" new loans that were made to replace already classified loans—loans previously found problematic by federal examiners. \textit{IMF Plans Pressure on Banks to Help Brazil}, supra note 21, at D1, col. 1, D3, col. 1; \textit{see generally infra} text accompanying notes 89-92 (loan classification procedures).
significant reductions in the imports and gross national products of the
countries most dependent on bank financing.53 Such economic deterio-
ration would greatly affect the United States, which sends more than
one-third of its exports to the LDCs.54 It has been forecast that without
increased lending to LDCs, the U.S. growth rate would decline by 1%,
the trade deficit would increase by $14 billion, and the U.S. industries
already most seriously damaged by the recession would endure further
hardship.55

Under the present circumstances, the goals of domestic safety and of
international stability are not only compatible but indeed insepara-
ble.56 Continued foreign lending is required to avert defaults by
financially strapped borrowers, for such defaults would have a harmful
impact on the U.S. banking system, as well as on the general economy.
At the same time, however, the safety of the domestic banking system
must be enhanced if it is to continue to support the international econ-
omy by maintaining and increasing the supply of capital. The central
regulatory objective, then, is to develop a strategy that fosters the si-
multaneous maximization of domestic safety and continued LDC
lending.

B. Diversification: The Path to Solution

Federal regulation of LDC lending must be reformed by the imple-
mention of a strategy that will foster diversification both of the loan
portfolios of the individual banks and of the pool of institutions en-
gaged in the LDC lending process.57

The goal of diversification of banks’ portfolios recognizes that if
many of a bank’s loans are concentrated in single countries, it becomes
dangerously exposed to country risk that would threaten the ability of
all borrowers, public or private, within those countries to repay their
loans.58 Except in the seemingly unlikely case of the simultaneous col-

54. GENERAL ACCOUNTING OFFICE, BANK EXAMINATION FOR COUNTRY RISK AND IN-
TERNATIONAL LENDING ii (GAO/ID-82-52, 1982) [hereinafter GAO REPORT]; Lever, supra
note 33, at A27, col. 2.
55. Dizard, supra note 3, at 78. This prediction is based on the assumption that levels of
new lending remain constant; in fact, they are declining.

The LDC exposure of U.S. banks already may be affecting the U.S. financial system and
economy by slowing the decline of consumer lending rates. See Challenge for Central Banks,
supra note 29, at D1, col. 3.
56. Roll, supra note 35, at 121.
57. Quota Hearings, supra note 19, at 394 (testimony of Henry Wallich).
58. See supra text accompanying notes 13-15.
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lapse of many LDC borrowers,\(^{59}\) banks' vulnerability to the effects of dramatic changes in countries' economic and political situations can be significantly reduced by the maintenance of loan portfolios that are not weighted heavily with loans to a small number of countries or to countries with similar characteristics.\(^{60}\)

Diversification of individual banks' portfolios will not suffice, however, if only the present small number of banks remains involved in the LDC lending process. Because LDCs' debts now have assumed huge proportions, sizeable levels of country risk are forced on even the most diversified lenders if only a few lenders are willing to extend credit. The risk of bank failure currently is centered on the large "money-center" banks, which are involved in most LDC lending. Because the basic safety of the entire U.S. banking system relies on those banks, the entire system remains in jeopardy.\(^{61}\)

Diversification of the pool of lenders is especially attractive because the present exposure of the U.S. banking system as a whole to LDCs, either individually or collectively, is not excessive.\(^{62}\) The more critical problem is that the exposure is too heavily concentrated in a small number of money-center banks;\(^{63}\) if it were spread more evenly through the system, the systemic danger created by the failure of a single borrower would be mitigated greatly.\(^{64}\)

Under the present regulatory scheme, no measures are in place that effectively promote diversification of the portfolios of individual banks.\(^{65}\) At the same time, systemic diversification actually is decreas-

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59. *International Debt*, supra note 39, at 86 (testimony of Henry Wallich). Indeed, diversification helps to reduce the possibility of such a widespread financial collapse.

60. *Quota Hearings*, supra note 19, at 454 (testimony of Lewis Odom). See also *A New Supervisory Approach to Foreign Lending*, supra note 13, at 5.

61. E.g., G. JOHNSON, supra note 17, at 32.

62. The aggregate capital of all U.S. commercial banks in 1980 was $115 billion. See 1980 FDIC ANNUAL REPORT 243, 245. This figure represents almost twice the 1981 capital of the U.S. banks most heavily involved in LDC lending, see G. JOHNSON, supra note 17, at 11. Were LDC lending distributed evenly throughout the commercial banking system, the ameliorative effect on loan concentration would be dramatic. For example, exposure to Mexico, the LDC to which U.S. banks are most exposed, see supra note 19, would fall from 34% of capital to under 20%, a significant reduction of risk.

63. Although the combined exposure of the banks which lend to LDCs is high, this exposure is small when compared with that of the largest individual banks. See G. JOHNSON, supra note 17; see also supra notes 19, 20 and accompanying text. Leaving aside the increased involvement of other U.S. commercial banks, the even distribution of the exposure among the 159 banks already deeply involved in LDC lending also would improve the situation greatly.

64. Systemic diversification is yet more important if LDC lending is increased. See infra note 68.

65. The present regulatory structure does seek to limit bank overexposure, but relies largely on an ineffective lending limit and country risk assessment process to do so. See
ing as the smaller U.S. lenders, although often better capitalized than their money-center counterparts, and in fact well-positioned to enter the market, nonetheless are retrenching their participation in the lending process. The bank regulatory system thus must encourage portfolio diversification to reduce the loan concentrations of the overexposed banks, while at the same time diversifying and expanding the pool of lenders which participate in LDC lending.

III. Present Regulatory Framework: Description and Critique

A unified system of federal regulation of LDC lending has not developed; the present regulatory structure best can be described as a group of weakly coordinated and disparate elements. One element is a uniform approach to the examination of foreign lending which has been implemented by the federal bodies directly involved in the bank examination process. Other elements include statutory lending limits for national banks supervised by the Office of the Comptroller of the Currency (COC), disclosure requirements for bank holding companies promulgated by the Securities and Exchange Commission (SEC), and the unclear potential role of "lender of last resort" played by the Federal Reserve Board (FRB).

It is clear that these elements, considered individually, or collectively and artificially as a regulatory system, are not achieving the promotion of diversification that should be the object of federal regulation of overseas lending. The uniform approach, as presently implemented, is deeply flawed by its over-reliance on country risk assessment and by the ineffectiveness and inflexibility of its enforcement apparatus, while the statutory lending limits are not responsive to bank overexposure to country risk. The SEC's disclosure requirements are at once incom-

infra text accompanying notes 69-126. Regulatory policy explicitly must require diversification of banks' portfolios.


67. The need to encourage greater participation by the regional banks often has been recognized by federal regulators, who even have suggested that pension funds, insurance companies, and other financial institutions become involved. See Quota Hearings, supra note 19, at 397-99, 467, 474 (testimony of Henry Wallich and Lewis Odom); Wallich, The Future Role of the Commercial Banks, reprinted in id. at 421, 428. In spite of this recognition, current regulatory policies simply are not achieving this result.

68. Given a static demand for LDC loans and a sufficient supply of willing lenders, portfolio diversification, which would ensure that banks not be overexposed to a few large borrowers, would also ensure diversification of the lending pool—that each country's loans would be spread among a number of lenders. However, since the level of lending must be dramatically increased, and since many banks are unwilling to expand or even maintain their present levels of exposure, portfolio diversification must be accompanied by a policy which will expand and diversify the lending pool available to LDCs.
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plete and counterproductive, and the ambiguity surrounding the role of the FRB in the event of crisis is having negative effects both on the supply of capital available to LDCs and on the stability of the banking system. Many of the critical risks now faced by the international financial system are directly attributable to these failures of the present scheme of bank regulation.

A. The Uniform Approach to Bank Examination

The adoption of a uniform approach to the examination of overseas lending marked the first coordinated federal attempt to monitor foreign lending.69 This first supervision of international activity came about in response to the growth in U.S. foreign lending during the 1970's, basically as an extension of existing domestic regulatory principles.70 The uniform approach is coordinated by the Interagency Country Exposure Review Committee, an informal nine-member working group in which the FRB, the FDIC, and the COC are represented equally.71 In supervising the foreign loan examination process, the committee determines country risk exposure levels that warrant comment by bank examiners, reviews bank assessments of country risk, classifies countries according to their estimated financial strength, estimates the likelihood of repayment of loans that have experienced payment interruptions, and requires partial or total write-offs of some of those loans.72

69. Its adoption was announced in November 1978, after several years of separate and independent review of the issue by the three interested federal bodies. Agencies Set Int'l Risk Exam Procedure, Am. Banker, Nov. 9, 1978, at 1, col. 3; see MINORITY STAFF REPORT, supra note 41, at 29.

The supervision and examination of U.S. banks' foreign and domestic activities is divided among three regulatory bodies: the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (COC), and the Federal Deposit Insurance Corporation (FDIC). The FRB is responsible for foreign activities of state member banks, bank holding companies, and Edge Act subsidiaries of all member banks; the FDIC is responsible for insured state nonmember banks, and the COC supervises national banks. MINORITY STAFF REPORT, supra note 41, at 28; Corse & Nichols, United States Government Regulation of International Lending by American Banks, in INTERNATIONAL FINANCIAL LAW 105 (R. Rendell ed. 1980). The vast majority of international lending is undertaken by national banks. Id.

In the bank examination process, federal authorities attempt to identify potential problems through the periodic inspection of bank records and procedures. It is a principal tool in all federal regulation of U.S. banking activity, foreign and domestic. Although the uniform approach is applicable to the examination of all overseas loans, it is treated here with particular attention to its role in LDC lending. See supra note 6.

70. STAFF REPORT, supra note 8, at 23-26; Cooke, supra note 40, at 248; Corse & Nichols, supra note 69, at 105. The examination of a bank's foreign loans occurs as part of the general bank examination process. GAO REPORT, supra note 54, at 1.

71. GAO REPORT, supra note 54, at 1, 3; MINORITY STAFF REPORT, supra note 41, at 28. The Committee meets three times each year. GAO REPORT, supra note 54, at 3.

72. MINORITY STAFF REPORT, supra note 41, at 29-30. The Federal Reserve Bank of New York supplies the Interagency Committee with the economic and political data necessary to perform these tasks. GAO REPORT, supra note 54, at 4.
The data evaluated under the uniform approach are generated through confidential reporting required of U.S. banks having foreign branches or certain banking subsidiaries and total foreign exposure of $20 million or more. Each such bank must file semi-annually a Country Exposure Report, which provides a comprehensive consolidated account of the bank's international activity. The report breaks down foreign loan exposure by country debtor or guarantor, type of credit, type of borrower, and maturity. The data from the reports are aggregated in the Country Exposure Lending Survey, which facilitates interbank comparisons and systemic analysis useful in the examination and regulatory process.

The bank examination process uses these comparative data to promote diversification and safety by drawing the attention of bank management to excessive or overly risky foreign exposure. Examiners analyze exposure to a given country as a percentage of the bank's capital and comment on high exposure in light of the country's condition and the bank's capacity to absorb loss. Examiners also comment on the bank's total foreign exposure and on individual country exposure that appears unusual by comparison to averages for the entire system. Examiners' comments are not a "directive to refrain" from lending, but


74. See Minority Staff Report, supra note 41, at 30; A New Supervisory Approach to Foreign Lending, supra note 13, at 6. The COC, FRB, and FDIC use the same Country Exposure Report form. Id; see FDIC Staff Memorandum, FDIC Supervision of Foreign Lending by Insured State Nonmember Banks, att. I, reprinted in Quota Hearings, supra note 19, at 518, 537. Further description of the Country Exposure Reports and their compilation in the Country Exposure Lending Survey is set forth id at 518-36.

75. A New Supervisory Approach to Foreign Lending, supra note 13, at 4, 6.


77. A New Supervisory Approach to Foreign Lending, supra note 13, at 1.

78. Id. at 3; GAO Report, supra note 54, at 3.

79. A New Supervisory Approach to Foreign Lending, supra note 13, at 5. The comment process is linked to the categorization of countries' financial strength made by the Interagency Committee. See infra text accompanying notes 82-85. "Special comments" are to be made if a bank's exposure to a "moderately strong" or "weak" country exceeds 15% or 10%, respectively. GAO Report, supra note 54, at 5. At the examiner's discretion, a comment may be made if exposure to a "moderately strong" country falls between 10% and 15% of capital, or if exposure to a "weak" country falls between 5% and 10%. Id. Examiners list "concentrations of country exposures" exceeding 25%, 10%, and 5% of capital to strong, moderately strong, and weak countries, respectively. Id. Examiners also retain discretion as to the degree to which a comment will be "highlighted" in the examination report. Id. at 16.

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only advise bank management of levels of exposure “worthy of review.”

Under the uniform approach, the staff of the Federal Reserve Bank of New York also conducts its own country risk analysis by assessing the “relative strength of different countries” as it may have impact on the U.S. banking system. The staff has developed a screening mechanism based on balance of payments indicators to flag countries for in-depth analysis in which economists and country specialists probe the LDC’s debt structure, debt maturity profile, and other measures of economic and political well-being. The results of its analysis are passed on to the Interagency Committee, which uses them to categorize countries according to their financial strength. The goal of this process is to convey an independent appraisal that banks might compare with their own assessments.

The uniform approach also requires that federal examiners evaluate the country risk methodology used by individual banks. Examiners verify that the banks are using reliable and timely information, and that the information is reviewed frequently. In order to ensure that country risk analysis is conducted without bias, the examiners also insist that the bank demonstrate the organizational separation of the country risk analysis unit from the loan marketing process.

The sole direct sanction available under the uniform approach is

81. *Quota Hearings,* supra note 19, at 398 (testimony of Henry Wallich); see also GAO REPORT, supra note 54, at 1.
82. *A New Supervisory Approach to Foreign Lending,* supra note 13, at 4-5. There is a tension between this analysis and the traditional reluctance of U.S. bank regulators to rate the creditworthiness of LDC borrowers, which inevitably would influence the allocation of credit among particular countries. *Id.* at 3; *Quota Hearings,* supra note 19, at 398-99 (testimony of Henry Wallich); *Pressure on Bank Regulators,* supra note 17, at D3, cols. 4-5.
83. *A New Supervisory Approach to Foreign Lending,* supra note 13, at 4-5; GAO REPORT, supra note 54, at 4-5. More qualitative “country studies” also are prepared. *Id.* at 4-5.
84. GAO REPORT, supra note 54, at 3. The four categories are “strong,” “moderately strong,” “weak,” and “classified.” *Id.*
85. *Quota Hearings,* supra note 19, at 445 (testimony of Lewis Odom). The FRB economists who perform these analyses consider their assessments potentially inferior to those of the banks, because they feel the banks have greater experience, closer contacts with the LDCs, and the incentives of the profit motive. Confidential interview with federal bank regulator (Sept. 24, 1982); see also *A New Supervisory Approach to Foreign Lending,* supra note 13, at 3. They believe, however, that this difference in quality is growing smaller. Confidential interview with federal bank regulator (Sept. 24, 1982).
86. *A New Supervisory Approach to Foreign Lending,* supra note 13, at 3; GAO REPORT, supra note 54, at 5-6.
87. *Id.* at 5.
88. *Id.*
89. The bank regulatory system can impose indirect sanctions and incentives by linking banks’ cooperation with the regulatory system to its cooperation or resistance on unrelated issues. Confidential interviews with U.S. bank executives (Sept. 19, 26, Dec. 29, 1980, Feb. 13, 1981). Thus, for example, banks which would not respond to governmental pressure to
the power of the Interagency Committee to “classify” any or all of a country’s loans if payments from the country on one or more loans are interrupted for reasons considered to be connected with country risk.\textsuperscript{90} The committee may classify loans into one of three categories: “substandard” (or “non-performing”), “doubtful,” or “loss,” each of which results in a reduction of the bank’s earnings.\textsuperscript{91} Loans may not be “declassified” until the debtor country is judged to have rectified completely its payment situation.\textsuperscript{92}

Classification can be a two-step process involving administrative discretion at both levels. On the basis of its assessment of the likelihood of repayment, the Interagency Committee can classify some or all loans made to a given country and can assign loans to different classifications according to the type of borrower or maturity schedule.\textsuperscript{93} If the Interagency Committee has classified some loans as “doubtful,” the second step of the classification process is called into play; bank examiners must decide after negotiating with the banks what percentage of a doubtful loan to write off. Although discretion is broad in the classification process itself, the Interagency Committee does not begin the process until a payment interruption believed to involve country risk has occurred or is judged to be “imminent.”\textsuperscript{94}

In appraising the uniform approach, perhaps its gravest defect is that it overemphasizes the value of country risk assessment as a regulatory tool. The Interagency Committee, by categorizing countries on the basis of country risk analysis as well as by instructing bank examiners to monitor the country risk methodology used by individual banks, relies too heavily on this type of analysis. It appears to give its imprimatur to the soundness of the technique as a device to limit bank overexposure. This reliance is unfounded, however, for country risk analysis, whether conducted by government regulators or by banks themselves, is of

\textsuperscript{90} GAO \textit{REPORT}, \textit{supra} note 54, at 3-5; \textit{Quota Hearings}, \textit{supra} note 19, at 398-99 (testimony of Henry Wallich).

\textsuperscript{91} The extent of the reduction depends on the classification. Classification of the loan as “substandard” has the consequence that interest on the loan cannot be accrued on the bank’s books. Classification as “doubtful” requires that some percentage of the loan to be negotiated between the bank and government examiners must be counted against the bank’s general loan loss provisions. Classification as a “loss,” the most severe sanction, causes a special 100% write-off of the loan. Confidential interview with federal bank regulator (Apr. 20, 1983).

\textsuperscript{92} \textit{Id.} (Sept. 24, 1982).

\textsuperscript{93} \textit{See GAO REPORT, supra} note 54, at 3 & n.3.

\textsuperscript{94} \textit{Quota Hearings, supra} note 19, at 398-99 (testimony of Henry Wallich).
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doubtful utility.\textsuperscript{95} Political risk, which is crucial to the evaluation of country risk, has proven virtually impossible to predict and evaluate.\textsuperscript{96} Interest rates and commodity prices, also central to country risk analysis, are equally difficult to forecast.\textsuperscript{97} Furthermore, payment difficulties experienced by one country may undermine bank confidence in otherwise sound debtor countries, thereby creating further payment difficulties unlikely to have been anticipated by country risk assessment models.\textsuperscript{98} In sum, the relevant variables are so unpredictable as to render problematic even the most elaborate and careful country risk analysis.\textsuperscript{99}

Even when country risk is forecast correctly, banks may fail to heed the danger signals.\textsuperscript{100} This phenomenon is probably explained by two factors. Bank lending officers, who tend to deprecate country risk analysis, often prevail over skeptical bank economists, probably for reasons of the bank's interest in growth, short-term profit, and the maintenance

\textsuperscript{95} This is not to suggest that risk assessment is not of entrepreneurial value to banks, but rather that because country risk assessment is problematic, and because it might require the allocation of credit among borrowers, it should not be relied upon by the bank regulatory system as a means of protecting against overexposure to risk.

\textsuperscript{96} The Iranian revolution and the Falklands war demonstrated the impracticability of forecasting major political change, which can drastically alter a nation's country risk situation. Anderson, \textit{More Models than Vogue Magazine}, EUROMONEY, Nov. 1982, at 41, 43. Political developments need not be so dramatic as revolution or war to affect country risk significantly. For example, in lending to Eastern Bloc countries, the banks appear mistakenly to have relied on the "umbrella theory," which held that the Soviet Union would in effect guarantee the loans of its satellites. \textit{Id.} at 43, 45.

\textsuperscript{97} \textit{Id.} at 44. The precipitous fall in oil prices that helped cause the Mexican payment crisis was foreseen neither by Mexico nor by its lenders. \textit{Taming Mexico's Passion for More}, N.Y. Times, Sept. 12, 1982, § 3, at 1, col. 2.

\textsuperscript{98} For example, Brazil experienced precisely this problem in the aftermath of the repayment difficulties of Mexico and Argentina. \textit{See Brazil Requests a Further Loan of $1.5 Billion}, \textit{supra} note 50.

\textsuperscript{99} Federal regulators are aware of this weakness. \textit{A New Supervisory Approach to Foreign Lending}, \textit{supra} note 13, at 3 ("great uncertainties . . . exist in any assessment of country risk"). Nonetheless, the uniform approach remains heavily dependent on country risk analysis.

\textsuperscript{100} For example, lending to both Mexico and Argentina continued at high volume until the time payments were interrupted. Gasser & Roberts, \textit{supra} note 23, at 27; \textit{see also} Eichler, \textit{supra} note 15, at 773. These situations appear to have been exceptional, for banks historically have slowed lending to LDCs one or more years before the onset of repayment problems. Gasser & Roberts, \textit{supra} note 23, at 27. The Mexican and Argentine "exceptions" are quite troubling, however, in view of the importance of both countries and the magnitude of their debts. Ironically, awareness of political risk may have exacerbated this tendency by permitting acceptable levels of such risk to justify continued lending and divert attention from economic factors which argued for the suspension of credit. Anderson, \textit{supra} note 96, at 42.
of customer relationships.\textsuperscript{101} Also, continued lending may appear to offer the only protection for a bank’s outstanding medium or long-term debt to the LDC.

In short, attention to country risk analysis is inadequate to serve as a guiding regulatory principle for the effective management of bank exposure to country risk. It seems to be reliable only in predicting near-term or very long-term conditions,\textsuperscript{102} while the stable, efficient lending time frame is of medium term.\textsuperscript{103} This asymmetry causes country risk analysis to have a distorting effect on lending decisions. Country risk analysis fosters a misleading impression of accuracy, which has led to extensive loan concentration in a group of countries which appeared to have low country risk, but which currently are experiencing severe repayment difficulties. When country risk analysis counsels caution, large, money-center banks with a stake in continued lending are likely to disregard it.\textsuperscript{104} At the same time, the regulatory emphasis on country risk analysis may deter participation in the lending process by regional banks, for their lack of independent country risk analysis capability may make them reluctant or unable to lend.\textsuperscript{105} In this way, country risk analysis may exacerbate the lack of diversification in the pool of LDC lenders.\textsuperscript{106} While banks undoubtedly will continue to make use of country risk analysis, it is vulnerable to serious criticism, and the emphasis given it by the uniform approach is fundamentally misguided.

A second failing of the uniform approach is that the comment procedures of the examination process have been largely ineffective in influencing bank behavior.\textsuperscript{107} Moreover, the discretion afforded regulators in both the comment and the classification processes has precluded the emergence of clear standards,\textsuperscript{108} and the comments that are made are

\textsuperscript{101} Anderson, \textit{supra} note 96, at 43; \textit{Quota Hearings}, \textit{supra} note 19, at 443 (testimony of Lewis Odom).
\textsuperscript{102} These forecasts might be expressed in terms of months or decades. Anderson, \textit{supra} note 96, at 43.
\textsuperscript{103} P. \textsc{Wellons}, \textit{supra} note 8, at 25.
\textsuperscript{104} Ipsen, \textit{supra} note 20, at 65.
\textsuperscript{105} \textit{Id}. at 58-62, 65; \textit{Small Bank in the South Comes to Regret Entry into Foreign Lending}, \textit{supra} note 28, at 1, col. 6; Riley, \textit{supra} note 28, at 34, 39-40; Dizard, \textit{The Revolution in Assessing Country Risk}, \textsc{Institutional Investor}, Oct. 1978, at 65, 75.
\textsuperscript{106} Ironically, it has been maintained that the policy of the federal bank authorities has been to rely on diversification to control overexposure because of the difficulty of assessing country risk. FDIC Staff Memorandum, \textit{supra} note 74, at 520.
\textsuperscript{107} A recent General Accounting Office report found that comments on LDC exposure made during the examination process had “little impact” on bank lending. \textit{GAO Report}, \textit{supra} note 54, at 20-21. “A large majority” of the special comments made on LDC loans in 1979 had to be reiterated in 1980. \textit{Id}. at 20.
\textsuperscript{108} \textit{Id}. at 6-7, 13-16.
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rarely strong enough.\textsuperscript{109}

The one regulatory sanction available to the bank examiners, loan classification and the accompanying reduction of earnings, is difficult to impose in its present form without causing more harm than good. At present, classification does not occur before the interruption of payments; thus, problem loans rescheduled without interruption cannot be classified.\textsuperscript{110} Should an interruption actually occur, immediate write-offs could complicate an already difficult situation, and even provoke systemic crisis. The relative harshness of the sanctions that follow a “loss” or “doubtful” classification has made regulators reluctant to impose them; instead, they often choose to classify loans as “non-performing,” which reduces the impact on earnings substantially.\textsuperscript{111} In sum, under the uniform approach the Interagency Committee is able to monitor bank lending to LDCs, but the banks, under no obligation to follow its recommendations and generally unaffected by its one sanction,\textsuperscript{112} largely have remained free to pursue their own course.\textsuperscript{113}

B. \textit{Statutory Lending Limits}

The second element of the federal regulatory scheme is the system of statutory lending limits administered by the Office of the Comptroller of the Currency. In 1979, under the authority of federal statutory language that limited to ten percent of capital the exposure of a national bank to any borrower,\textsuperscript{114} the COC promulgated regulations which applied this lending limit to any public sector borrower in a foreign country.\textsuperscript{115} The intent of the new regulations was to diversify banks’ international portfolios and thus to reduce the concentration of bank

\textsuperscript{109} Id. at 6-7. The entire comment process, based as it is on moral suasion, seems unlikely to be effective in the U.S. The problem may lie in the difficulty of coordinating on an individual basis policies applicable to such a large number of banks. See \textit{id.} at 13-16.

\textsuperscript{110} Confidential interview with federal bank regulator (Sept. 24, 1982).

\textsuperscript{111} Mayer, \textit{supra} note 3, at 48.

\textsuperscript{112} Bank supervisors recently urged banks to provide special reserves for troubled international loans, but the banks successfully lobbied against the measures on the ground that the establishment of such reserves would reduce earnings. \textit{Pressure on Bank Regulators}, \textit{supra} note 17, at D3, col. 1.

\textsuperscript{113} \textit{Pressure on Bank Regulators}, \textit{supra} note 17, at D3, cols. 1-6.


\textsuperscript{115} Loans to foreign governments, their agencies and instrumentalities, 44 Fed. Reg. 22,714 (1979) (codified at 12 C.F.R. § 7.1330 (1982)). These regulations were reaffirmed officially in 1983. 48 Fed. Reg. 15,844-54 (1983) (to be codified at 12 C.F.R. § 32.5(d)).
lending in particular countries or areas.\textsuperscript{116}

To prevent the circumvention of the lending limit by the extension of loans to multiple state entities not truly separate from one another, the regulations require that each public sector borrower pass a two-pronged "means and purposes" test.\textsuperscript{117} In order to satisfy the means test, the borrower must demonstrate that its own sources of revenue are sufficient to service its debt.\textsuperscript{118} The purposes test is met if the loan is to be used for a purpose consistent with the borrower's general business.\textsuperscript{119}

Although bank regulators maintain that the present lending limit is effective in aiding diversification,\textsuperscript{120} this confidence appears to be misplaced. Because it enforces no limit on total lending to individual countries,\textsuperscript{121} it fails to confront the crucial effect of the LDC's overall political and economic situation on the ability of borrowers to repay their external debt. The economic health and domestic cash position of individual borrowers in an LDC become quite irrelevant in times of national economic difficulty. This interdependence requires that loans to all economic entities within an LDC be considered effectively to have been made to a single borrower.\textsuperscript{122} Because the means and purposes test is met easily by most LDCs' public sector borrowers and does not apply to the private sector borrowers which hold a substantial portion of the foreign debt in the larger LDC borrowers,\textsuperscript{123} overall bank exposure to LDCs has come to exceed by many times the public sector borrower exposure limit.\textsuperscript{124} Moreover, even if the regulations were ef-

\textsuperscript{116} MINORITY STAFF REPORT, \textit{supra} note 41, at 31.
\textsuperscript{117} 12 C.F.R. § 7.1330 (1982).
\textsuperscript{118} 12 C.F.R. § 7.1330(a)(1) (1982). The bank's assessment of the borrower's means must be set forth. 12 C.F.R. § 7.1330(b)(4) (1982). Although a presumption of dependence is created if more than 50% of its operating revenue is provided by the central government, a central government guarantee of the borrower's debts is not necessarily inconsistent with the requirements of the means test. \textit{Id.}
\textsuperscript{119} 12 C.F.R. § 7.1330(a)(2) (1982). A written representation is sufficient to satisfy the purposes test, unless the bank has reason to know that the loan will be used for a different purpose. 12 C.F.R. § 7.1330(b)(5) (1982).
\textsuperscript{120} Quota Hearings, \textit{supra} note 19, at 442 (testimony of Lewis Odom).
\textsuperscript{121} Bank regulators are cognizant of this fact, but maintain that the limit fosters diversification. \textit{Id.}
\textsuperscript{122} GAO REPORT, \textit{supra} note 54, at 12. In time of crisis, LDCs' central banks and exchange control authorities play a pivotal role in authorizing and providing hard currency for the repayment of external debt. The little foreign exchange that may be available often arbitrarily is allocated to repay government debt. \textit{See Loans to Argentina and Mexico Hurt Banks, supra} note 20, at D1, col. 4, D13, col. 1.
\textsuperscript{123} \textit{See id.} at D1, col. 4.
\textsuperscript{124} \textit{See supra} notes 19-20.
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effective as drafted, it appears that some banks have been permitted to disregard the limits in lending to certain LDCs.125

The present statutory lending limit has been grossly ineffective in either containing foreign exposure or promoting diversification.126 This failure, combined with the ineffectiveness of the uniform approach, has produced chronic, acute, and perilous bank overexposure to individual LDCs.

C. The Securities and Exchange Commission and Public Disclosure of Lending Activity

The Securities and Exchange Commission (SEC), in the exercise of its power to require public disclosure of information material to investors in publicly traded companies, recently initiated a program to require bank holding companies to disclose certain data about the foreign loans of their bank subsidiaries.127 In announcing this program, it declared that the “unusual risk and uncertainties” associated with country repayment problems constituted material information within the scope of its regulatory authority.128 It further asserted that greater than normal credit risks are present in LDC lending in general and that bank disclosure practices in recent SEC filings had varied widely.129

125. Pressure on Bank Regulators, supra note 17, at D3, col. 4.
126. Although bank regulators are cognizant of the importance of diversification, particularly in light of the difficulty of country risk assessment, Quota Hearings, supra note 19, at 452-53 (testimony of Lewis Odom), and also realize that country risk is implicated in all external currency loans to foreign countries, whether to public or private borrowers, id., they concede nevertheless that the present lending limits “are not directly related to country exposure,” id. An FRB official candidly admits that the exposure of the banks heavily involved in LDC lending is larger than it should be, Pressure on Bank Regulators, supra note 17, at D3, col. 1, while a recent General Accounting Office report “criticized regulators for ineffectively restraining bank exposure to foreign countries,” id.
127. SEC Staff Accounting Bull. No. 49, Disclosures by Bank Holding Companies About Certain Foreign Loans, 47 Fed. Reg. 49,627-28 (1982) (to be compiled at 17 C.F.R., pt. 211) [hereinafter SAB-49]. Staff Accounting Bulletins are issued by the staff of the SEC to resolve urgent questions of accounting policy. SEC Orders Loan Data on Poor Nations, supra note 28, at 3, col. 1, 14, col. 1. Although they are not the result of official action by the Commission, and therefore lack binding force, they are treated by the investment community with the same deference as SEC regulations. Id.

The SEC took this action in response to a decision by bank regulators to relax proposed disclosure requirements relating to past due loans. See Loan Rules Clarified, N.Y. Times, Oct. 27, 1982, at D20, col. 5.
128. SAB-49, supra note 127, at 49,627.

These disclosure requirements were augmented by Staff Accounting Bull. No. 49A, which requires the disclosure of debt renegotiations between banks and LDCs. 48 Fed. Reg. 3585 (1983) (to be compiled at 17 C.F.R., pt. 211) [hereinafter SAB-49A].
129. SAB-49, supra note 127, at 49,627.

The SEC disclosure scheme was endorsed by both the Chairman of the FDIC and the Comptroller of the Currency for the reason that it would lead to greater prudence on the part of the banks. Bennett, Pushing Banks Into the Open, N.Y. Times, Oct. 27, 1982, at D2,
Banks are given two options for compliance under this disclosure scheme. Under the first, the bank must disclose its total exposure to countries which are experiencing debt service problems and to which more than one percent of the bank's total outstanding loans have been lent. Exposure to individual countries may be aggregated unless there exist "heavy concentrations in any country." The bank also must describe the potential impact of problem loans on its financial condition. Under the second option, the bank discloses separately the magnitude of its exposure to each country in which it has lent more than one percent of outstanding loans, regardless of the borrower's payments situation. As under the first option, specific disclosure of any "material adverse impact" on the bank's financial condition is required. These requirements represent a significant departure from previous bank disclosure procedures under which banks could aggregate their foreign exposure into regional blocs from which individual countries and problem loans could not be isolated.

Despite the endorsement they have received from different bank regulators, the recently promulgated SEC disclosure requirements have created as many problems as they have solved. First, there is a fundamental tension between public disclosure and the basic assumptions of bank regulation, which stress the importance of maintaining public confidence through discreet governmental supervision. These data could lead insured depositors to withdraw funds from particular banks.


Bank regulators traditionally have relied on confidential suasion to accomplish their goals; until quite recently, public disclosure of an individual bank's position was anathema. Bennett, supra, at D2, col. 1; confidential interview with federal bank regulator (Sept. 24, 1982). It is often argued that the public would overreact to disclosure of a troubled bank's situation and cause a fatal deposit run on a bank that otherwise would be saved. Bennett, supra, at D2, cols. 1-2. In any case, it is argued, public disclosure would not benefit the depositors, because they already are protected by FDIC insurance. Bennett, supra, at D2, col. 1. Since bank supervisors' deep-seated antagonism to public disclosure persists, confidential interview with federal bank regulator (Sept. 24, 1982), it seems that their approval of the SEC's disclosure directives is indicative of the growing sense of urgency with which they view the need to control lending risk.

130. SAB-49, supra note 127, at 49,628.
131. Id.
132. Id.
133. The bank must provide an "indication as to the effect" on its financial condition of loans to "countries that are currently experiencing liquidity problems." Id.
134. Id.
135. Id.
136. Kinkead, supra note 28, at 75.
137. Bennett, supra note 129, at D2, col. 1. Bank executives maintain that the information made public under the disclosure standards is subject to misinterpretation. Kinkead, supra note 28, at 75.
or from the system as a whole, either of which could cause potentially severe liquidity problems. It remains unclear whether the public will be able to evaluate LDC creditworthiness from the disclosed data. Indeed, disclosure may exacerbate the market contraction caused by the retreat of regional banks from the LDC lending market, with the resulting dangerous consequences for the U.S. banking and international financial systems.

Second, if effective disclosure of high levels of country exposure were to be deemed desirable, the SEC requirements are plainly inadequate. Several lending exposures of just less than one percent of total outstanding loans could exceed a bank's capital and pose significant undisclosed risk. Moreover, the regulations still permit the aggregation of loan balances under some circumstances. The disclosure of loans made to the offshore subsidiaries of a problem country's banks also is not required, although the risk associated with that country may have profound effects on the loans' repayment prospects. Finally, banks are left with substantial discretion to determine whether a given LDC merits "problem" status for disclosure purposes.

D. The Role of the Federal Reserve Board

The final element of federal involvement in the regulation of LDC lending is the indirect influence on international banking exerted by two distinct Federal Reserve Board (FRB) policies.

The FRB's major indirect influence on LDC lending is exerted not by regulation, but rather by the hidden effect that the FRB inevitably has on bank behavior by virtue of its potential role as "lender of last resort." Were the FRB to play such a role, in the event of a financial crisis it would assist otherwise solvent banks experiencing temporary cash shortages by providing collateralized short-term injections of funds. Although the official position of the FRB is that it would not rescue an insolvent bank that had written off much of its loan portfo-

138. See Bennett, supra note 129, at D2, col. 1.
139. Kinkead, supra note 28, at 75.
140. This would occur because of pressure to withdraw from LDC lending from unduly alarmed bank stockholders and boards of directors. See Ipsen, supra note 20, at 65; Kinkead, supra note 28, at 75; SEC Orders Loan Data on Poor Nations, supra note 28, at 14, cols. 1-4.
141. See infra text accompanying notes 182-84.
142. Kinkead, supra note 28, at 75.
143. Id.
144. Id.; SEC Orders Loan Data on Poor Nations, supra note 28, at 14, cols. 1-4; see supra notes 131-34 and accompanying text.
145. See MINORITY STAFF REPORT, supra note 41, at 40; G. JOHNSON, supra note 17, at 18.
lito, it is widely believed that the FRB, out of fear of the likely systemic consequences, would not allow a major bank to fail.

The "safety-net" role of the FRB as a lender of last resort thus remains fundamentally ambiguous, a condition which exacerbates present uncertainty. There should exist some central bank facility to protect banks against solvency shocks caused by nonperforming LDC assets, for the social costs of bank failures far exceed their private costs. The FRB seems to maintain that it will not function as such a lender of last resort for insolvent banks, but its pronouncements are so delphic that its eventual behavior cannot be predicted. The FRB's stance, far from advancing its goal of promoting prudence, may only inhibit the regional banks' participation in LDC lending, while the money-center banks continue to lend, perhaps mistakenly confident that the FRB would intervene, were the situation to become desperate. This ambiguity thus exacerbates the lack of diversification that federal policy instead should be rectifying.

The second indirect influence of the FRB on LDC lending results from the effect on interest rates of its control of U.S. monetary policy. It has been speculated that a primary purpose behind the recent drop in U.S. interest rates brought about by the FRB was to strengthen the banking system weakened by its LDC exposure.

146. Challenge for Central Banks, supra note 29, at D1, col. 5, D13, col. 1.
147. Id. The smaller depositors of any major bank are protected by the FDIC, but there is no protection from country risk for the bank itself and its stockholders. International Debt, supra note 39, at 87 (testimony of Henry Wallich).
148. G. JOHNSON, supra note 17, at 18. The problem of providing a lender of last resort confronts the central banks of all developed countries. The "Group of Ten" developed countries, which includes the U.S., in September 1974 issued a mutual statement outlining the role and capacity of central banks in this context. It declared that "[w]hile it is not practical to lay down in advance detailed rules and procedures for the temporary support to banks experiencing liquidity difficulties, the means are available for that purpose and will be used if and when necessary." Grant, supra note 29, at 39 (quoting joint statement of Group of Ten). A central banker has described this statement as "deliberately delphic" in order "to encourage prudence and market discipline." Interpretations of its effect are varied: it may protect the entire system, or only large banks; it may provide protection for solvency shocks arising from total losses on loans, or it may only cover short-term liquidity problems. Id.; Challenge for Central Banks, supra note 29, at D1, col. 5, D13, col. 1.
149. G. JOHNSON, supra note 17, at 34.
150. Id.
151. Id. at 33-34.
153. Dizard, supra note 3, at 60; Silk, Behind Fed's Move on Rates, N.Y. Times, Aug. 27, 1982, at D2, col. 1. The timing of the FRB's intervention into the market seems to confirm this hypothesis. The FRB's downward push on interest rates began within days of Mexico's first payment interruption. N.Y. Times, Aug. 17, 1982, at D1, col. 1. It seems plausible that
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The drop in interest rates has increased bank profitability,\textsuperscript{154} which has allowed the banks to bolster their capital base,\textsuperscript{155} has made less onerous any write-offs that might occur on LDC loan defaults,\textsuperscript{156} and also may make possible increased LDC lending.\textsuperscript{157} At the same time, declining interest rates also improved the payments position of the LDCs by reducing the floating interest on their debt.\textsuperscript{158} Thus, in spite of the widespread public opposition to any “bail-out” of overextended banks,\textsuperscript{159} the lowering of interest rates has aided the banks significantly, without requiring them to bear any of the burden, and without significant public scrutiny.

IV. A New Regulatory Structure for LDC Lending

The twin objectives of U.S. regulation of overseas lending, the protection of the U.S. banking system and the stabilization of the international financial regime, have not been achieved by the present regulatory framework. Bank overexposure to LDCs has reached levels far beyond any standard of prudence, while a contraction of lending threatens to drive many LDCs into default. A different structure is needed which will not only diversify the loan portfolios of banks which lend to LDCs but also diversify and enlarge the pool of funds available to the LDC lending market. It is imperative that broader participation in LDC lending be encouraged, in order both to diversify lenders’ portfolios and to expand the flow of capital to LDCs.

These objectives should be achieved by the establishment of a country exposure limit in conjunction with an optional, government-backed insurance plan. The former would limit the concentration of individual LDCs’ loans in banks’ holdings, while the latter would encourage smaller banks as well as non-bank institutions to enter the lending market and permit banks to expand their LDC lending activities without increasing exposure to country risk. As part of the insurance system, the Federal Reserve Board would refuse definitely any role as lender of last resort with respect to banks endangered by LDC lending, and banks would be permitted to decline insurance upon disclosure of their uninsured exposure. Under this regulatory system, the objective of di-

\textsuperscript{154} Id.; Mayer, \textit{supra} note 3, at 47-48.
\textsuperscript{155} Kinkead, \textit{supra} note 28, at 75.
\textsuperscript{156} Mayer, \textit{supra} note 3, at 47-48.
\textsuperscript{157} Id.
\textsuperscript{158} The Debt-Bomb Threat, \textit{supra} note 7, at 51.
\textsuperscript{159} See infra note 166.
versification of portfolios and lenders would be achieved, and many unnecessary and ineffectual elements of the present system would be eliminated.

A. The Country Exposure Limit

A limit on banks' total lending in individual countries should be enacted to reduce individual banks' exposures to country risk and to increase the diversification of their loan holdings. This country exposure limit would set a ceiling, stated as a percentage of a bank's capital, on aggregate loan exposure to sovereign and private entities located in a given country.\footnote{Aggregate bank loan exposure to individual countries already is used for examination purposes by the Interagency Committee. See supra notes 78-79 and accompanying text. Disclosure of such exposure already is required of bank holding companies by the SEC. See supra notes 130-34 and accompanying text.}

The country exposure limit should be uniform for total lending in each country because of the practical difficulties in differentiating the risks posed by different borrower countries and because of the risk of political interference in the capital allocation process.\footnote{Uniform country exposure limits have been opposed on the ground that they would be too rigid given differences in borrowers' capacity to absorb debt. Volcker Statement, supra, at 6. This focus on the borrowers' capacity to absorb debt is misplaced, given the difficulties of country risk analysis. Regulatory policy instead must focus on reducing the dangerous exposure of the banking system. A limit of the kind suggested here would reduce this exposure, but would be high enough to provide the banks extensive flexibility in the allocation of their funds.} The country limit should be at the level above which a bank's solvency\footnote{See supra note 32.} would be threatened if the debtor country were to experience severe payment difficulties, but should be set as high as possible so as to minimize its restrictive effect on lending.

160. Aggregate bank loan exposure to individual countries already is used for examination purposes by the Interagency Committee. See supra notes 78-79 and accompanying text. Disclosure of such exposure already is required of bank holding companies by the SEC. See supra notes 130-34 and accompanying text.

161. See Federal Reserve Board Press Release 6 (Apr. 11, 1983) (statement of Paul Volcker before the Senate Committee on Banking, Housing and Urban Affairs) [hereinafter Volcker Statement]; Proposal to Set Country Lending Limits on International Loans Finds No Favor Outside of Congress and Regulatory Agencies, WASH. FIN. REP. (BNA), No. 40, at 664-65 (Mar. 28, 1983) [hereinafter Proposal to Set Country Lending Limits]; Pressure on Bank Regulators, supra note 17, at D3, col. 4. Uniform country exposure limits have been opposed on the ground that they would be too rigid given differences in borrowers' capacity to absorb debt. Volcker Statement, supra, at 6. This focus on the borrowers' capacity to absorb debt is misplaced, given the difficulties of country risk analysis. Regulatory policy instead must focus on reducing the dangerous exposure of the banking system. A limit of the kind suggested here would reduce this exposure, but would be high enough to provide the banks extensive flexibility in the allocation of their funds.

162. See supra note 32.
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Current estimates suggest that most U.S. banks could endure an aggregate loss of approximately sixty percent of capital.\textsuperscript{163} It would be imprudent to set the limit so high, however. The fact that loans to foreign countries rarely become total losses\textsuperscript{164} should be counterbalanced by the possibility that a substantial number of unrelated domestic and foreign loans might fail at the same time as those in a troubled country. Therefore, the country exposure limit should be set below sixty percent, perhaps in the range between thirty and fifty percent of capital.\textsuperscript{165}

The country exposure limit should be implemented in phases so as to allow banks over the country exposure limit gradually to divest their excess loans. This would allow more heavily exposed money-center banks time to market their excess LDC loans and would foster the orderly diversification of the lending pool to include banks, as well as institutions such as pension funds and insurance companies, which have excess country lending capacity.\textsuperscript{166} During the phase-in period, it

\begin{itemize}
\item \textsuperscript{163} Confidential interview with federal bank regulator (Jan. 20, 1981).
\item \textsuperscript{164} This is the case even over the short run. Top Banks' Third World Loans Detailed, supra note 16, at D3, col. 1.
\item \textsuperscript{165} One financier has proposed a country exposure limit set between 10% and 20% of capital. Rohatyn, supra note 25, at 7. This range approximates the current lending levels of the 159 largest U.S. lenders taken as a whole, although it is lower than present levels of exposure to Brazil and Mexico. It is much lower than the present exposure of the money-center banks. See supra notes 19-20. This limit may be overly restrictive, for it would constrain the increased LDC lending necessary for the stability of the international financial system. See supra text accompanying notes 48-55.
\item Congress currently is considering a bill authorizing the FRB to impose differing country exposure limits on LDCs. This proposal has been opposed by bankers and regulators alike. Proposal to Set Country Lending Limits, supra note 161, at 664-65. It would create foreign policy difficulties and by itself would lead to a liquidity crisis that could threaten the banking system. Id. The Comptroller of the Currency has stated that the imposition of country exposure limits may be considered, Country Loan Limits May Be Put on Banks, Conover Warns, supra note 129, at 2, col. 1, but no action has been taken, Bank Regulators Agree to Restrict Foreign Lending, Wall St. J., Apr. 8, 1983, at 4, col. 1. At least one bank supervisor believes that the imposition of statutory exposure limits might be advisable. Confidential interview with federal bank regulator (Sept. 24, 1982).
\item \textsuperscript{166} Wallich, The Future Role of the Commercial Banks, reprinted in Quota Hearings, supra note 19, at 429-30; Wallich, American Banks Abroad in 1985, reprinted in Quota Hearings, supra note 19, at 439-40; Quota Hearings, supra note 19, at 467 (testimony of Lewis Odom).
\end{itemize}
seems likely that competitive forces would compel banks which must dispose of part of their LDC portfolios to maintain their overall LDC exposure by making or acquiring loans to countries for which they have not met the limit. By the end of the phase-in period, the aggregate exposure of the banking system to LDCs probably will have remained constant, or even grown, but diversification both of individual banks' portfolios and of the lending pool will have reduced significantly the systemic risk of that exposure.

The present aggregate exposure of the U.S. banking system is not excessive. By providing a limit for individual banks' exposure and an incentive for smaller banks to participate in LDC lending, an effective country exposure limit would spread this exposure more evenly through the system, while interfering with the lending market only as much as is necessary to ensure safety from collapse.

B. Insurance of Country Risk in LDC Lending

In conjunction with the uniform country exposure limit, the federal bank regulatory authorities should establish a plan for the optional insurance of country risk in LDC lending and require disclosure of loans which are not insured. Country risk insurance is vital to facilitate the diversification of lenders accomplished by the country exposure limit and the expansion of the capital flows available for LDC lending. Because of the probability that the imposition of a country exposure limit, without more, would lead to a reduction in overall U.S. lending to LDCs, other affirmative measures must be implemented in order to ensure both a supply of lenders able to assume loans divested by overexposed banks and a supply of capital for new loans.

By permitting banks to assume country risk in lending at a predict-
able cost, country risk insurance would encourage the entry into the LDC market of banks which previously have considered LDC lending too risky, and would permit banks already in the market to increase their LDC lending activity without increasing their exposure to risk. Country risk insurance thus also would help ensure that if reductions in lending were caused by the country exposure limit, they would be counterbalanced by the entry of new lenders. Moreover, by spreading the risk of default across a large pool of lenders, country risk insurance would reduce the risk of bank insolvency arising from country default, would minimize greatly the possibility of a cataclysmic chain of bank failures and country defaults, and would help to increase depositor confidence in the banking system.

Insurance should be available only to cover country risk in lending to public and private entities within LDCs; losses due to factors of normal credit risk should continue to be borne by banks and reflected in the interest margins they demand. Insurance would be available for any or all of a bank’s LDC loans, and claims would be honored for full or partial nonpayment of either interest or principal.

Premiums should be assessed at a uniform rate on the principal of the loans insured. A uniform rate is appropriate because of the difficulty of evaluating country risk and the need to insulate the credit allocation process from political interference. In this way the plan is

Banks to Help Brazil, supra note 21, at D1, col. 1; Fed Push on Foreign Loans Seen, supra note 49, at 29, col. 6. They are undesirable by comparison to a comprehensive solution.

173. For the most part, these are the regional banks and non-bank institutions which do not have sufficient access to LDC country information to lend confidently. See supra text accompanying note 28. Regional banks may be able to obtain better data through information-sharing consortia. See Banks Plan Effort for Poor Lands, N.Y. Times, Oct. 28, 1982, at D3, col. 1; Worldwide Debt Data for Banks, N.Y. Times, Jan. 12, 1983, at D1, col. 6. The mere access to such information is unlikely to generate sufficient participation by the regional banks, given their lack of experience and commitment to LDC lending. See supra note 28 and accompanying text.

174. Of course, these banks could expand their lending in individual countries only up to the country exposure limits described above. See supra text accompanying notes 160-70.

175. In order to protect more fully against the risk of concurrent LDC defaults, insurance could be made mandatory for an individual bank’s aggregate LDC exposure in excess of a fixed percentage of bank capital in the range of 100% to 200%.

176. The maintenance of depositor confidence in banks is as important as the reassurance of hesitant regional banks, for it is necessary that banks which lend to LDCs have access to sufficient funds to continue present levels of lending. See G. JOHNSON, supra note 17, at 34. The development of depositor confidence was the primary goal in the establishment of the FDIC. See Scott & Mayer, Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform, 23 STAN. L. REV. 857, 858-60 (1971).

177. The insurance of rescheduled loans would be at a higher premium. See infra note 181.

178. No Time for Rancor Against the Banks, supra note 6, at A26, col. 1; Proposal to Set Country Lending Limits, supra note 161, at 665. Arguments supporting a uniform premium rate are analogous to those made in favor of a uniform country lending limit. See supra note
modeled after the FDIC, which is backed by the U.S. government and funded at a uniform rate by the insuror banks.\textsuperscript{179}

Country risk insurance should protect banks—and the banking system—only from system-threatening failures caused by non-performing LDC loans—not from the risk of loss that accompanies all lending. While providing effective insulation from bank failures arising out of country risk, the insurance system nonetheless should impose on individual banks the costs of imprudent or negligent lending practices. Therefore, only a fixed percentage of each loan would be insurable and losses would not be recoverable until loan payments had been interrupted for a number of months. These provisions not only would encourage prudent lending, but also would give lenders an incentive to reschedule or refinance the debt of fundamentally creditworthy borrowers.\textsuperscript{180} Losses which occur within one year of the making of the loan also would not be recoverable, so as to require banks to bear lending risks which they should be able to assess adequately.\textsuperscript{181} To protect against the related possibility of the insurance of loans which have become problematic, banks would be permitted to insure loans only at the time of their making. Finally, in order to discourage LDC defaults, the U.S. government would be subrogated to banks' rights of collection against a defaulting LDC.

Insurance should not be mandatory; banks should be permitted to self-insure, but should they do so, they also should be required to disclose their risk-taking to their shareholders and the banking public.\textsuperscript{182}

\textsuperscript{161} and accompanying text. It might be possible to differentiate premiums on the basis of a very limited number of broad country risk categories, such as those currently used by the Interagency Committee. See supra notes 82-84 and accompanying text. An attempt to create a refined set of categories, however, would invite precisely the same difficulties involved in the assessment of country risk. See supra notes 95-99 and accompanying text.

\textsuperscript{179} See Scott & Mayer, supra note 176, at 866-74.

\textsuperscript{180} Some administrative determination of the actual interruption of payments would be necessary, but this could be minimized if the burden of proof were placed on the claimant.

\textsuperscript{181} A lower percentage of coverage at a higher rate might be available during this period so that banks could choose more fully to insulate themselves from risk.

A related problem exists as to the insurance of rescheduled or "rolled-over" loans. It would be important in the implementation of the insurance plan not to discourage loan rescheduling, which plays an essential role in the maintenance of international capital flows. Because rescheduled loans probably are most vulnerable to the continued threat of payment interruption, the demand to insure them probably would be high. Application of the one-year holding period for new loans to rescheduled ones might overly impede rescheduling. Instead, insurance should be available for rescheduled loans, but at a higher premium rate reflecting their greater risk. This higher premium reflects the operation of the market, for banks currently are able to obtain increased interest margins and fees on rescheduled loans. Bank Regulators Agree to Restrict Foreign Lending, supra note 165, at 4, col. 2.

\textsuperscript{182} The money-center banks are likely to oppose any insurance scheme as superfluous and costly, and as overly favorable to smaller banks—the same arguments they made in opposition to the establishment of the FDIC. These banks would be permitted to attempt to
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Banks would face no disclosure requirements as to insured loans. Disclosure of non-insurance of LDC loans should be required because non-insurance would represent an exposure to risk which would be important to large depositors and material to bank stockholders. Banks would disclose their uninsured loan exposure to each foreign country, together with that created by loans to branches and subsidiaries of each country's banks, and would explain the potential impact of that exposure on earnings and solvency.

In this connection, the FRB affirmatively would declare that it would not act as lender of last resort for banks jeopardized by uninsured LDC loans. Such a clarification of the FRB's role would add to market stability without discouraging responsible behavior on the part of banks. Uninsured LDC loans would be subject to loss reserve and loan write-off requirements similar to those currently in place, but imposed more flexibly and over longer periods in order to prevent destabilization of the system. Bank regulators would have the power to mandate loss reserve accumulation and loan write-offs both before the economist by comparison to the insurance pool, but would be required to disclose the magnitude and country recipient of uninsured loans.

183. Banks probably need not be required to disclose uninsured amounts within the insurance plan, i.e., the percentage of each loan which cannot be covered, see supra text accompanying note 180, and loans within the one-year holding period, see supra text accompanying note 181. Uninsured amounts probably would be so small by comparison to the amounts within the plan that disclosure would be unwarranted; the country exposure limit should ensure safety. An alternative approach might require the aggregated disclosure of uninsured amounts.

184. Disclosure would promote prudence on the part of the banks by exposing their uninsured LDC lending to the scrutiny of their stockholders, uninsured large depositors, and even small insured depositors who might withdraw their funds from banks engaged in such lending at excessive levels of risk. The potential pressure from disclosure would likely provide an incentive to achieve safety through participation in the insurance plan.

Banks and bank regulators traditionally have considered disclosure of loan information to be anathema. Disclosure heretofore has been resisted on three grounds: first, it is unnecessary to protect small depositors, who are insured under the FDIC; second, confidentiality is essential to the conduct of lending; and third, bank shareholders and large depositors in any event are offered significant protection by the examination process and other federal bank regulations. The plan recommended here would not force the banks to disclose individual loans, credit risk assessments, or other information that should be confidential. The existence of the present crisis suggests that it would be unwise to continue to rely on the present regulatory framework to ensure safety.

185. Banks have sought clarification of the FRB's role as a lender of last resort. Grant, supra note 29, at 39. Congressional sentiment seems to require that the banks submit to greater regulation if they are to receive assurances of support from the central banks. See Challenge for Central Banks, supra note 29, at D13, col. 2. In order to ensure maximum confidence on the part of depositors, it is important that the FRB's policy on assistance of last resort be clear and explicit. See id. This also would alleviate smaller banks' uncertainty over whether they would be included in a federal bank rescue if collapse were to occur. See G. JOHNSON, supra note 17, at 34.

186. See supra text accompanying notes 89-94.
occurrence of payment interruptions and at the time of reschedulings. These provisions, in conjunction with relatively strict disclosure requirements, probably would provide strong incentives for loan insurance.

The most significant near-term risk to the international financial system is the possibility of a contraction of the flow of capital to LDCs. Such a lending contraction would impair further both their economic development and their ability to service their loans and thus would jeopardize their bank creditors. The country risk insurance system proposed here would encourage smaller lenders to re-enter the LDC lending market and would allow some banks to increase their LDC lending without exposing themselves to greater country risk. The system thus would diversify and enlarge the pool of capital available for LDC lending.

C. The Case for Fundamental Reform

The system of country exposure limits and country risk insurance proposed here has several advantages by comparison to the present regulatory framework. Most important, the proposed plan would reduce significantly the risk of financial calamity currently posed by bank overexposure and the reduction of capital flows to LDCs. Country lending limits would diversify the loan portfolios of the banks which lend to LDCs and enlarge the pool of lenders in the LDC capital mar-

187. The regulatory supervision of these loans would not be particularly costly, for it is likely that only an uninsured default by a large LDC borrower would require such gradual write-offs.

188. A number of other banking reform proposals have been made. In response to Congressional criticism, the three federal bank regulatory bodies have suggested improving the present supervisory system by strengthening the examination process and write-off provisions, adding new disclosure requirements, and changing accounting rules which tend to exaggerate short-term profits reported in LDC lending. See Volcker Statement, supra note 161, at 6-7; Bank Regulators Agree to Restrict Foreign Lending, supra note 165, at 4, col. 2. These incremental measures do not represent a departure from the current approach and are subject to its flaws. See supra notes 69-159 and accompanying text. They seem unlikely to promote the goals of domestic safety, international stability, and diversification.

Another proposal advocates requiring maintenance of non-interest-bearing reserves amounting to a fixed percentage of international loans outstanding in order to increase interest rates and thus reduce borrowing. House Panel Criticizes Plan to Raise I.M.F. Aid, supra note 33, at D1, col. 1, D3, col. 1. Because it only safeguards existing loans and contains no incentives for diversification and continued lending, this proposal would cause a sharp restriction in the international flow of capital, with its attendant dangers. See supra text accompanying notes 27-35.

It has also been proposed that the government provide banks capital in exchange for preferred stock or the assumption of troubled loans below market value. Rohatyn, supra note 25, at 6. This proposal would impose a heavy burden on the taxpayers and lead to excessive government involvement in the private capital market, which could impede future LDC lending.
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et, while a government-operated insurance plan would help to reverse the contraction in available capital caused by the reduced participation of the regional banks in LDC lending. The availability of country risk insurance for LDC loans would reduce much of the regional banks' uncertainty about LDC lending, while the divestiture at discount of money-center banks' LDC loans over the country exposure limit would provide a profitable opportunity for them to return to the market. Once regional banks again participate in LDC lending, the existence of country risk insurance would encourage them not to restrict their lending at first signs of payment difficulty.

Many negative aspects of the present regulatory structure would be eliminated by the proposed plan, and some of its components would be made more effective. The regulatory system proposed would eliminate reliance on country risk assessment to regulate LDC exposure. Most of the present examination and enforcement procedures for LDC lending would be replaced by the more easily administered lending limit and insurance and disclosure system. Although data collection and risk assessment would continue to be useful functions of both the banking authorities and the banks' internal credit evaluation processes, the administration of lending limits would not require the close analysis of bank risk profiles which has been demanded by the present comment system. Close analysis of banks' internal risk assessment procedures also would be made unnecessary. The regulatory burden imposed by the current program of disclosure would be eliminated for all banks except those which choose to self-insure.

The plan also has the benefit of limiting the role of the U.S. government in the allocation of private capital to LDCs, while permitting the maintenance of the significant bank financing of LDCs which is in the U.S. interest. Government policy should and does abjure regulatory involvement in the credit allocation process; political action on the government's part should not be permitted to interfere with the international flow of private capital. The proposed plan also would alleviate the compromise of U.S. monetary policy caused by the indirect prevention of LDC default through lower interest rates.

This plan provides an equitable distribution of its costs among LDCs, banks, and the U.S. government. Although overexposed banks

189. Pressure on Bank Regulators, supra note 17, at D1, col. 3, D3, col. 3; No Time for Rancor Against the Banks, supra note 6, at A26, col. 2.

190. Although there always would remain the possibility of government intervention on grounds of national security, as in the U.S. interventions during the Iranian crisis.

191. See supra text accompanying notes 152-59.
would incur losses as they disposed of their excess LDC loans, it is not unfair that they suffer reduced earnings as part of the price of restructuring the massive debt they accumulated, for high interest rates have compensated them for the risk of some losses. The cost of the debt restructuring and country risk insurance would be passed on to the LDCs in the form of higher interest margins,\(^9\) which, unfortunately, would further slow their development.\(^9\) At the same time, it does not seem unreasonable that the U.S. government provide a level of institutional support for a scheme which will help perpetuate the "public" role of the banks,\(^1\) especially since the governments of the developed countries largely have abdicated their traditional role as financiers of LDC deficits and have endorsed its assumption by the commercial banks.\(^5\) These costs certainly are far less than those all parties would bear in the event of a financial collapse.

V. Conclusion

The U.S. and global financial systems are threatened gravely by present levels and concentrations of commercial bank lending to LDCs. While the concentration of LDC loans among the largest U.S. banks endangers the stability of the U.S. banking system, any reduction in the flow of bank lending to LDCs could precipitate financial catastrophe or prolonged depression. U.S. policymakers therefore must balance two superficially contending objectives, which in fact are mutually reinforcing: the maintenance of the safety of the domestic banking system, which is promoted by the reduction of bank overexposure to LDCs, and the stability of the international financial system, which must be bolstered by increasing the level of capital flows to LDCs. The combined diversification of the pool of U.S. institutions involved in LDC

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192. It seems likely that the actual rates charged LDC borrowers would not change greatly, for the cost of the insurance premium which would be passed through to them would be substituted for the risk component of the interest rates they currently pay. It is possible, however, that the poorer LDCs would enjoy slightly lower effective interest rates, which would be compensated by higher rates for wealthier ones, for the insurance scheme would tend to pool the risk premiums which the market would demand of them.

193. This unfortunate result is far preferable to the effects on LDCs' economies of the systemic shock or prolonged economic stagnation that would accompany a significant contraction in LDC lending.

194. Many feel that the role of the commercial banks in LDC lending can continue to be constructive. See, e.g., Wallich, *The Future Role of the Commercial Banks*, supra note 67, at 429. Furthermore, the economic vigor of the LDCs continues to be of great importance to economic conditions in the developed countries. See *supra* notes 48-55 and accompanying text.

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lending and of the loan portfolios of those institutions already heavily involved will harmonize and achieve these objectives.

Current U.S. regulation of commercial bank lending to LDCs is not promoting this diversification. The regulatory system is comprised of a group of uncoordinated and disparate elements including ineffective bank examination and statutory lending limits, disclosure requirements which are simultaneously counterproductive and incomplete, and the uncertain role of the Federal Reserve Board as a lender of last resort. Furthermore, much of the system is permeated by faulty assumptions about the usefulness of country risk analysis. The ineffectiveness of the regulatory system continues to exacerbate the domestic and international crisis, in spite of some regulators’ recognition that diversification is essential to the achievement of systemic stability.

Most of the current reform proposals either fail to escape the flaws of the present system or promise to reduce the flow of capital to LDCs to a level that will invite disaster. The reforms proposed by this Article—enactment of a uniform country exposure limit in conjunction with a plan offering banks a choice between insurance of their country risk exposure or disclosure of their LDC lending—will enhance portfolio and lender diversification without limiting capital flows to LDCs. Its costs will be shared efficiently among banks and governments without hampering market independence, injecting political considerations into capital allocation, or constraining the policy judgments of the LDCs. The dangers posed by the perpetuation of the present situation compel consideration of fundamental regulatory reforms of the kind proposed here.