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Recent Development: New Limits on Banks Lending to Foreign Nations

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RECENT DEVELOPMENT

NEW LIMITS ON BANKS LENDING TO FOREIGN NATIONS

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I. INTRODUCTION

On November 30, 1983, Congress enacted legislation to increase the United States contribution to the International Monetary Fund[1] (IMF) by 8.4 billion dollars.[2] The legislation was the culmi-

1. The International Monetary Fund (IMF), created at the Bretton Woods Conference in 1944, was designed to aid member countries in financing payment deficits and to supervise their exchange rates and policies. There are now 146 members of the IMF. The IMF plays the role of both borrower and lender by borrowing money from countries able to lend and using this money to make loans to needier countries. Whether the IMF makes a loan depends on the borrowing country's compliance with fund policy—a practice that has been criticized as being too political and has engendered great resentment in many of the borrowing countries. Nevertheless, a borrowing country's compliance with IMF conditions plays a role in the new lending scheme set up by the International Lending Supervision Act of 1983. *See infra* note 8. For further discussion of the IMF, see K. DAM, THE RULES OF THE GAME: REFORM AND EVOLUTION IN THE INTERNATIONAL MONETARY SYSTEM (1982); Allen, *The Recent Shift in United States Policies Toward the International Monetary Fund and the World Bank,*

nation of several months of heated debate and represented a dramatic policy reversal toward the IMF by the Reagan Administration.[3] Prior to 1983, the President had opposed increased funding for the IMF in order to compel borrowing countries to reduce their reliance on the Fund by undertaking domestic austerity programs.[4] The President feared that borrowing countries otherwise would not attempt to reduce their outstanding debt if continued financing and refinancing from the IMF remained readily available.[5]

The Administration's sudden change of policy is one factor that led opponents of the IMF funding legislation to criticize the bill as a measure designed merely to "bail out" large, private United States banks from precarious financial standing caused by their imprudent loans to high-risk countries.[6] The IMF funding legisla-

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16 VAND. J. TRANSNAT'L L. 1 (1983); Gold, *Law and Reform of the International Monetary System,* 10 J. INT'L L. & ECON. 371 (1975); Gold, *A Report on Certain Recent Legal Developments in the International Monetary Fund,* 9 VAND. J. TRANSNAT'L L. 223 (1976); Southard, Jr., *The Evolution of the International Monetary Fund,* 5 N.C.J. INT'L L. & COM. REG. 425 (1980). The Articles of Agreement of the International Monetary Fund can be found in 60 Stat. 1401, T.I.A.S. No. 1501, 2 U.N.T.S. 39, *as amended* July 28, 1969, 20 U.S.T. 2775, T.I.A.S. No. 6748, 726 U.N.T.S. 266.

2. Supplemental Appropriations Act, 1984, Pub. L. No. 98-181, § 1101, 1983 U.S. CODE CONG. & AD. NEWS (97 Stat.) 1153, 1287 (codified at 22 U.S.C.A. § 286e-2 (West Supp. 1984)) (amending the Bretton Woods Agreements Act, the current revision of which may be found at 22 U.S.C.A. §§ 286-286gg (West 1979 & Supp. 1984)) [§§ 801-813, 1101-1102 hereinafter cited as IMF Funding Legislation]. The legislation consists of eleven titles that regulate housing assistance programs, rural housing, the Export-Import Bank Amendment Act, Home Mortgage Disclosure Act Amendments, international lending supervision, and multilateral development banks. The polyglot bill was the result of political hostage holding when Congress would not increase the appropriation for the IMF until the Reagan Administration supported a Democratic housing subsidy bill. *Strange Bedfellows: Increased Aid to IMF Becomes Political Issue Crossing Party Lines,* Wall St. J., Sept. 26, 1983, at 1, col. 1 [hereinafter cited as *Strange Bedfellows*]. The legislation also increased congressional control over funds disbursed to the IMF and instructed the United States representative to the IMF to oppose specific lending activities by the Fund. IMF Funding Legislation, *supra,* §§ 801-813, 1983 U.S. CODE CONG. & AD. NEWS (97 Stat.) at 1267-78 (codified in scattered sections of the Bretton Woods Agreements Act, *supra*).

3. *See* Allen, *supra* note 1, at 2.

4. *See id.*

5. *See id.*

6. *See Strange Bedfellows, supra* note 2, at 1, col. 1; *see also* Note, *U.S. Regulation of Bank Lending to LDCs: Balancing Bank Overexposure and*

tion reflects congressional sensitivity to this charge:

> The Secretary of the Treasury shall instruct the United States Executive Director of the Fund — (1) to oppose and vote against any Fund drawing by a member country where, in his judgment, the Fund resources would be drawn principally for the purpose of repaying loans which have been imprudently made by banking institutions to the member country . . . .[7]

Congress, however, seemed to be reacting even more dramatically to charges of a bailout when in the same Appropriations Act it enacted the International Lending Supervision Act of 1983[8] (Act or ILSA). The stated purpose of the Act is to "encourage prudent private [lending to foreign parties]"[9] in order to protect "the economic health and stability of the United States."[10] To achieve this goal, Congress authorized increased regulation of private banks in the United States by the three major banking regulatory agencies—the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Comptroller of the Currency.[11] Thus, it may be merely coincidental that Congress simultaneously passed a measure criticized as an escape hatch for big banks and legislation subjecting private banks yearning for deregulation to greater federal control.[12] On the other hand, Congress may have enacted only superficial regulatory controls to avert criticism of

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Credit Undersupply, 8 YALE J. WORLD PUB. ORD. 200, 208 (1982) (noting that the Government cannot allow a large bank to fail because of the possible consequences to the banking system); Needham, *Banks Must Acquire Equity in Debtor Countries*, Wall St. J., Sept. 30, 1983, at 31, col. 3.

7. IMF Funding Legislation, *supra* note 2, § 807, 1983 U.S. CODE CONG. & AD. NEWS (97 Stat.) at 1273.

8. Pub. L. No. 98-181, §§ 901-913, 1983 U.S. CODE CONG. & AD. NEWS (97 Stat.) 1153, 1278-84 (codified at 12 U.S.C.A. §§ 3901-3912 (West Supp. 1984)).

9. 12 U.S.C.A. § 3901(a)(2).

10. *Id.* § 3901(a)(1).

11. *Id.* §§ 3904-3908.

12. *See Proposals for Legislation to Increase the Resources of the International Monetary Fund: Hearings Before the Subcomm. on International Finance and Monetary Policy of the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. 198, 274 (1983) (statements of George J. Clark, Executive Vice President, Citibank, New York, and Paul A. Volcker, Chairman, Board of Governors, Federal Reserve System) [hereinafter cited as *Senate Hearings on International Debt*]. Both Mr. Clark and Mr. Volcker, while noting problems, cautioned that Congress should not overreact and that specific types of controls such as special reserves were unnecessary. *Id.*; *see also id.* at 241 (statement of Mr. Volcker).

its funding legislation.[13]

Whatever its original purpose, the Act now may need to be reevaluated in light of several recent developments. For example, less than six months after the Act took effect, the United States Government loaned three hundred million dollars to Argentina as part of a multinational financial rescue package.[14] The loan agreement was instrumental in enabling Argentina to meet its installment payments on previous outstanding loans, thus avoiding the financial reverses that an Argentine default might have created for creditor lending institutions in the United States.[15] Several lending institutions, however, considered voluntarily reclassifying their loans to Argentina to nonaccrual status in order to reflect Argentina's inability to pay without United States intervention.[16]

The alleged "bailout" not only caused problems for United States bankers, but it also created a risk that political unrest would erupt in Argentina if the additional collateral given to the United States by the Argentine Government were to be disclosed.[17] Furthermore, the IMF demand that many Latin American countries impose strict austerity measures as a condition[18] for granting new loans has often had severe political repercussions. For example, debate over the IMF demand caused Peru's Prime Minister to resign[19] and incited potential labor unrest in Bolivia.[20] The problems in Bolivia are indicative of the difficulties encountered by several other governments when attempting to imple-

13. *See Strange Bedfellows*, *supra* note 2, at 21, col. 1 (arguing that the proposed Lending Supervision Act is a mere "wrist-slapping" for banks enacted as a "tradeoff" for support of increased IMF funding); *cf. Senate Hearings on International Debt*, *supra* note 12, at 154 (statement of Martin Mayer, author of several major banking books, arguing that country lending limits, which are not incorporated into the ILSA, are "essential" to a successful regulatory scheme).

14. *See Argentine Debt Pact Avoids Trouble Now May Cause Pain Later*, Wall St. J., Apr. 2, 1984, at 1, col. 1 (Midwest ed.) [hereinafter cited as *Argentine Debt Plan*].

15. *See id.*

16. *See Banks May Downgrade Argentine Debt Status*, N.Y. Times, Apr. 4, 1984, at D4, col. 1 (national ed.).

17. *Questions Arise Over Argentine Bailout Package*, Wall St. J., Apr. 12, 1984, at 35, col. 1 (Midwest ed.).

18. *See supra* note 1.

19. *See Peruvian Government Slips Into Crisis Over Adoption of IMF Austerity Program*, Wall St. J., Apr. 12, 1984, at 35, col. 2 (Midwest ed.).

20. *See Bolivia Unveils Harsh Economic Austerity Plans*, Wall St. J., Apr. 16, 1984, at 33, col. 1 (Midwest ed.).

ment austerity programs.[21]

Although not directly tied to the foreign debt problem, the recent loss of congressional confidence in United States bank regulatory agencies caused by the failure of the Continental Illinois Bank may also compel reevaluation of the Act. The purported failure of the regulators to discover the extent of Continental Illinois' imprudent loans has led several legislators and regulators to call for greater supervision of lending institutions.[22]

This Recent Development will briefly examine the International Lending Supervision Act of 1983, including the regulatory scheme that predated the Act and the restrictions the Act places on the private banking industry in the United States. It then will comment on the Act's major drafting infirmities and the need for additional regulatory requirements not included in the Act.

II. THE HISTORY OF THE INTERNATIONAL LENDING SUPERVISION ACT OF 1983

A. Development of the Problem

In recent years private United States financial institutions have increased their lending to foreign countries, foreign individuals, and foreign business enterprises at an exponential rate.[23] Authorities generally concede that loans or other investments from the United States are necessary to foster economic growth in develop-

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21. *See, e.g., Brazilian Decree Draws Protest Miring Debt Plan,* Wall St. J., Oct. 21, 1983, at 28, col. 3 (Midwest ed.) (describing difficulties in Brazil caused by proposed limits on wage increases); *Argentina Cancels IMF Agreement Due to Expire in April,* Wall St. J., Mar. 7, 1984, at 20, col. 4 (Midwest ed.) (describing Argentina's unwillingness to comply with IMF austerity measures). These problems illustrate the possible complications that will arise under the ILSA, which orders bank regulators to evaluate the status of loans to debtor countries in part by measuring the countries' compliance with IMF austerity measures. *See supra* note 1 and accompanying text.

22. *See, e.g., Senate Banking Subcomm. Hearings, supra* note 12, at 3 (statement of Sen. Heinz).

23. *See, e.g., International Bank Lending: Hearings Before the Subcomm. on Financial Institutions Supervision Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs,* 98th Cong., 1st Sess. 15 (1983) (statement of Charles A. Bowsher, Comptroller General, General Accounting Office) [hereinafter cited as *House Hearings on International Bank Lending*]; H.R. REP. No. 175, 98th Cong., 1st Sess. 31, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 1898, 1914 (citing a 700% increase in United States bank loans to non-OPEC developing countries).

ing countries, which in turn provide a growing market for United States exports.[24] Intensified lending activity, however, has rapidly increased the exposure of United States banks to the risk of default by foreign entities.[25] Consequently, Congress has become more aware that sudden adverse political, social, or economic changes within a foreign country—a form of "country risk"[26]—can prevent the country from making its scheduled payments or repaying its debt at all.[27] A prime example is Poland, a

24. *See* COUNCIL ON ECONOMIC ADVISORS, ECONOMIC REPORT OF THE PRESIDENT, 174, 184-89 (1982); *see also* Allen, *supra* note 1, at 27; *House Hearings on International Bank Lending, supra* note 23, at 15 (statement of Charles A. Bowsher).

25. *E.g., House Hearings on International Bank Lending, supra* note 23, at 16 (statement of Charles A. Bowsher); H.R. REP. No. 175, *supra* note 25, at 32, *reprinted* at 1915; Note, *supra* note 6, at 200.

26. All international loans are evaluated in terms of "country risk." The term has various meanings and is discussed fully in Walter, *Country Risk and International Bank Lending,* 1982 U. ILL. L. REV. 71. Mr. Walter describes the role of country risk as follows:

> International bank lending involves several sources of risk that differ from purely domestic lending. One source of risk is that the foreign borrower resides in a politically sovereign national state different from that of the lender. Even though the creditworthiness of a particular foreign borrower may have been established to the bank's satisfaction, events may occur that could prevent the borrower from meeting its obligations under the terms of the loan. For example, the economy of the country in which the borrower is located may take a sudden turn for the worse, seriously threatening the borrower's ability to service its debt. The borrower's country may experience a balance of payments emergency and impose exchange controls that, in turn, would prevent a financially healthy borrower from meeting foreign debt obligations. The lender also risks violent political upheavals that could close or destroy a borrower's factories. By making such a loan, therefore, the lender takes on two kinds of risk: *credit risk* associated with the borrower itself, and *country risk* associated with conditions in the nation where the borrower resides. If, on the other hand, a bank lends directly to a foreign government, or to a non-governmental borrower under unconditional government guarantee, the bank incurs no credit risk because the government has unlimited power to create money to service the debt. The bank still carries country risk, however, because the government may be unable or unwilling to service the external debt, which usually is denominated and payable in currencies other than its own.

Id. at 71-72 (footnotes omitted).

27. *Id.* The situation in several countries exemplifies how unpredictable social events may affect the international lending market. For instance, the president of Argentina's central bank, Julio Gonzalez del Solar, recently was arrested

country that cannot even meet the interest payments on its twenty-seven billion dollar debt to the West.[28] By late 1982, the Polish balance-of-payment problem had reached a point at which Poland effectively had the bargaining power to negotiate new trade credits before agreeing to pay the interest then due on its loans.[29] Western banks not able to afford a default were forced to grant trade credits to Poland in order to reschedule the 1982 interest payments in the hope of receiving payments on the loans coming due in 1983 and 1984.[30]

More recently, Western banks and governments have entered into loan negotiations with France to reschedule its fifty billion dollar debt,[31] with the Philippines to renegotiate its eighteen billion dollar debt,[32] with Argentina to renegotiate its seven billion dollar debt[33] and with Poland to renegotiate both its 1981 and 1982 debts.[34] By August 1982, neither Mexico nor Brazil could

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after his return from an IMF meeting in Washington, D.C., where he was attempting to reschedule payment of his country's seven billion dollar foreign debt. The Argentine judge explained that the arrest took place because Gonzalez del Solar had prejudiced his nation's interest in rescheduling the debt. *Argentina's Central Banker is Arrested for Allegedly Being Remiss in Debt Talks,* Wall St. J., Oct. 4, 1983, at 36, col. 1 (Midwest ed.) [hereinafter cited as *Argentina's Central Banker*]. In Mexico, bankers have alleged that private Mexican industrial debtors have formed a cartel to negotiate a favorable rescheduling of debt agreements. *Mexican Firms Resist New Loan Terms; Bankers See Monetary Debtors' Cartel,* Wall St. J., Oct. 4, 1983, at 37, col. 2 (Midwest ed.). In Brazil, the Brazilian Congress recently defeated a law limiting wage increases. The limitations had been demanded by the IMF as a condition of continued funding. The defeat of the legislation may terminate further IMF funding to Brazil, and thus increases the risks to United States banks with loans to that country. *Brazilian Decree Draws Protests, Miring Debt Plan,* Wall St. J., Oct. 21, 1983, at 28, col. 3 (Midwest ed.).

28. Current Development, *Rescheduling of Polish Debt for 1982 to Western Banks,* 21 COLUM. J. TRANSNAT'L L. 389, 389 (1983). Poland's interest payments totalled 1.1 billion dollars in 1982.

29. *Id.; see also* Roberts, *The Banks' Friends Have Put Them Over a Barrel,* Wall St. J., Oct. 14, 1983, at 32, col. 3 (Midwest ed.) (noting that country debt may increase bargaining power).

30. Current Development, *supra* note 28, at 391.

31. *See Banks Urge Paris to Refinance Debt,* N.Y. Times, Jan. 30, 1984, at 29, col. 1 (national ed.).

32. *See Philippines May Ask Its Creditors Today to Reschedule $18 Billion Foreign Debt,* Wall St. J., Oct. 14, 1983, at 3, col. 2 (Midwest ed.).

33. *See Argentina's Central Banker, supra* note 27, at 36, col. 1.

34. *See U.S. Seen Agreeing to Seek New Plan on Poland's '82 Debt,* Wall St. J., Nov. 1, 1983, at 10, col. 3 (Midwest ed.).

make payments on their external debts of eighty-one billion and seventy-nine billion dollars, respectively.[35] These and other similar situations[36] led the Comptroller General of the United States to conclude in 1983 that "[i]n recent years the country risk has increased as a widening number of countries have developed balance-of-payment difficulties, including countries where U.S. bank exposure is very large."[37]

Even after the passage of the ILSA, United States lending institutions continued to make large loans to foreign countries, particularly the Eastern European countries.[38] In April 1984 the Organization for Economic Cooperation and Development (OECD) reported that the debt of developing countries had risen 9.8 percent in 1983. OECD projected that the foreign debt problem will continue for several more years and will require continued efforts to negotiate temporary payment plans.[39]

Congress recognized the foreign debt problem as early as 1974 when the House Banking and Government Operations Committee studied the role of unwise foreign investments in the failures of the United States National Bank of San Diego and the Franklin National Bank.[40] More recently, Congress observed that United States bank loans comprised nearly one-third of the debt of the non-OPEC developing nations.[41] The failures of large banks and the mounting debt of high-risk countries raised questions concerning the adequacy of federal supervisory practices.[42] Nonetheless, the lending trend continued, and by mid-1977 private United States loans to non-OPEC developing countries were increasing at an annual rate of 43.6 percent.[43] By 1982 the nine largest United States banks had made loans to Argentina, Brazil, and Mexico

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35. H.R. REP. No. 175, *supra* note 25, at 34-35, *reprinted* at 1917-18.

36. *See, e.g., Peru to Ask Bankers to Ease Credit Terms on $4 Billion of Debt*, Wall St. J., Feb. 6, 1984, at 24, col. 3 (Midwest ed.).

37. *House Hearings on International Bank Lending*, *supra* note 23, at 15 (statement of Charles A. Bowsher).

38. *See U.S. Banks Looking to Lend Again in Financially Sounder East Europe*, Wall St. J., Mar. 1, 1984, at 26, col. 1 (Midwest ed.).

39. *See OECD Sees Debt Ills of the Third World Continuing to Grow*, Wall St. J., Apr. 11, 1984, at 36, col. 4 (Midwest ed.).

40. *See* H.R. REP. No. 175, *supra* note 23, at 31-32, *reprinted* at 1914-15.

41. *Id.* at 31, *reprinted* at 1914.

42. *Id.* at 30-32, *reprinted* at 1913-15 (quoting William Isaac, Chairman of the FDIC, and Fernand St. Germain, Chairman of the House Financial Institutions Subcommittee).

43. *Id.* at 33, *reprinted* at 1916.

that totaled over 30 billion dollars and amounted to nearly 140 percent of their capital.[44] At that time, the same nine banks had loaned developing and Communist bloc countries over 81 billion dollars.[45] By the end of November 1983, United States commercial banks had made foreign loans totalling nearly 400 billion dollars.[46] The enormity of the debt owed to United States private banks and the difficulties they had encountered in collecting timely installments on the loans led the House Committee on Banking, Finance and Urban Affairs to conclude that "over the past decade . . . the Federal banking agencies [have failed] to effectively monitor and prevent the unsound operating and lending practices of U.S. banks."[47]

Lending institutions have responded to the charge by claiming that the improper use of statistics has painted an unduly bleak picture of the United States foreign debt situation. Banks argue that the international lending market is quite lucrative.[48] They point out that during the mid-1970s, banks located in the major financial centers of the United States received almost fifty percent of their earnings from foreign operations, with some major banks earning more than seventy percent of their income from investments abroad.[49] Bankers also contend that much of the concern over the balance-of-payment problem is unfounded. They generally point to five factors that alleviate some of the risks of making foreign loans: (1) the use of a procedure that accurately determines lending risk by considering the degree of danger when setting a loan's amount, maturity date, and interest rate; (2) the diversification of portfolios to include different types of loans made in different areas; (3) the practice of granting over seventy-five percent of foreign loans to countries with rapid rates of growth and excellent export performance; (4) the substantial number of foreign loans that are guaranteed by entities outside the borrowing country; and (5) the success that banks have had

44. *Id.* at 35, *reprinted* at 1918.

45. *Id.* at 36, table 1, *reprinted* at 1919.

46. 69 FED. RESERVE BULL. A59, table 3.18 (Nov. 1983).

47. H.R. REP. No. 175, *supra* note 23, at 30, *reprinted* at 1913.

48. *See* Reisner, *Default By Foreign Sovereign Debtors: An Introductory Perspective*, 1982 U. ILL. L. REV. 1, 4.

49. *See id.* (citing STAFF OF SENATE SUBCOMM. ON FOREIGN ECONOMIC POLICY OF THE COMM. ON FOREIGN RELATIONS, 95TH CONG. 1ST SESS., INTERNATIONAL DEBT, THE BANKS, AND U.S. FOREIGN POLICY 9 (Comm. Print 1977)).

when rescheduling the debts of foreign countries.[50] In addition, executive officers of the three largest United States banks assured a congressional committee in 1977 that the larger banks, which held most of the foreign loans, had both expertise in international lending affairs and the financial resources to protect adequately against any potential loss.[51]

B. The Prior Regulatory Scheme

Apparently, Congress has remained unpersuaded by the arguments of the private banking industry. The history of the ILSA contains several statements explicitly condemning both the lack of prudent lending policies by the major banks and the absence of proper supervision by federal regulatory agencies.[52] In fact, the Act was not the first attempt by Congress or the federal regulatory agencies to control private international lending. Before 1977 Congress had left the supervision of country risk[53] largely to the federal banking agencies, whose approaches to this task differed significantly.[54] In 1965 the Comptroller of the Currency began examining the foreign branches of national banks; it opened a London office in 1972 to observe the foreign lending activities of United States banks.[55] By 1973 the Comptroller had instituted a program requiring national banks to report their country risk exposure level on a worldwide basis.[56]

Prompted by a number of bank failures, Congress created the Federal Financial Institutions Examination Council (FFIEC) in 1978[57] to bring uniformity to all bank examination standards, in-

50. *See* Reisner, *supra* note 48, at 4 n.19.

51. H.R. Rep. No. 175, *supra* note 23, at 34, *reprinted* at 1917 (citing statements before the House Financial Institutions Subcommittee).

52. *See, e.g., id.* at 30-31, 33, *reprinted* at 1913-14, 1916. The House Committee concluded that the majority of banks followed a small group of leading banks without deciding for themselves the wisdom of the lending practices. According to the House report, banking activity in the early and mid-1970s "revealed early on a tendency of banks to behave in an almost herd-like fashion much of the time." *Id.* at 31, *reprinted* at 1914.

53. For a discussion of "country risk," see *supra* note 26.

54. *House Hearings in International Bank Lending, supra* note 23, at 332 (statement of J. Charles Partee, Member, Board of Governors of the Federal Reserve System).

55. *Senate Hearings on International Debt, supra* note 12, at 351 (statement of C. T. Conover, Comptroller of the Currency).

56. *Id.*

57. 12 U.S.C. §§ 3301-3308 (1982). The FFIEC consists of the Chairman of

cluding those standards "classifying loans subject to country risk."[58] The FFIEC's role, however, is limited to establishing uniform standards and making recommendations concerning the supervision of financial institutions.[59] In 1979 the Interagency Country Exposure Review Committee (ICERC) was created to implement Congress' statutory directive to evaluate country risk.[60] ICERC is comprised primarily of senior field bank examiners and has three major functions: (1) to guarantee uniform evaluation of country risk regarding comments on concentrations of country exposure, (2) to determine when credits warrant classification due to country risk, and (3) to decide in which of three categories the borrowing country should be placed.[61] The third

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the Board of Directors of the FDIC, a Governor of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Chairman of the Federal Home Loan Bank Board, and the Chairman of the National Credit Union Administration Board. *Id.* § 3303(a). It would be misleading to imply that international balance-of-payment problems played more than a minor role in the enactment of the legislation creating the Federal Financial Institutions Examination Council. Its creation followed the exposure of problems associated with self-dealing by bank insiders as in the Bert Lance affair. *See* H.R. REP. No. 1383, 95th Cong., 2nd Sess. 200-01, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 9331-32 (additional views of Rep. St. Germain).

58. 12 U.S.C. § 3305(b)(1).

59. *Id.* § 3305.

60. The ICERC was not created statutorily, but as an informal subcommittee of the FFIEC, and consists of representatives of the Office of the Comptroller, the FDIC, and the Federal Reserve. *House Hearings on International Bank Lending, supra* note 23, at 18 (statement of Charles A. Bowsher, Comptroller General, General Accounting Office). The ICERC was designed to measure country risk and to aid bank examiners in evaluating the quality of loans to these countries. For a description of the ICERC's operation *see infra* note 63.

61. *House Hearings on International Bank Lending, supra* note 23, at 333 (statement of J. Charles Partee). Mr. Partee continued:

> In making determinations about the level of transfer risk in lending to various countries, ICERC has available a considerable amount of information. To provide a starting point for ICERC's analysis of country conditions, comparable quantitative information was developed for about seventy countries. In addition to compiling this information, economists at the Federal Reserve Bank of New York and the [Federal Reserve] Board provide ICERC with current studies covering specific countries—studies that include available information from the IMF. ICERC also receives oral briefings from U.S. Treasury staff on conditions in the countries under review. Finally, prior to each meeting examiners visit a number of banks to obtain their views on the countries and the banks' current and future lending plans.

Id. at 333-34.

function is tied to whether the bank's exposure to an individual country is significant enough to require mandatory comment by ICERC.[62] Congress intended that ICERC's comments on bank examination reports be used to force regulatory agencies to take into account the risk created by certain types of foreign loans when evaluating the condition of a bank.[63] The procedures were intended to ensure that the leadership of private financial institutions would fully consider all risks associated with making loans to foreign countries.[64]

Critics of the system have usually observed that all United States "banks"[65] are regulated by one or more of the three super-

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62. *Id.* at 333.

63. *Id.*; *see also id.* at 34-35 (statement of Marc E. Leland, Assistant Secretary of the Treasury for International Affairs). Mr. Leland described some of the procedures and roles of ICERC as follows:

> [T]he Interagency Country Exposure Review Committee . . . was formed in 1979 and is composed of representatives of the OCC [Comptroller of the Currency], the Fed and the FDIC. It meets three times a year and considers about 20 countries at each meeting, evaluating their current economic situation and future economic prospects. Judgments made by the Committee are disseminated to bank examiners for use in evaluating loan portfolios of individual commercial banking institutions. In this way, a uniformity and consistency of approach is ensured, both geographically and across regulatory agencies. Aside from the work of the OCC itself, the main element in the Treasury's participation in the [ICERC's] work is a set of oral presentations made at the start of the Committee's meetings by the Treasury economists responsible for each country in the Office of the Assistant Secretary for International Affairs. These presentations, which take approximately 30 minutes for each country, usually cover two full days and involve roughly a dozen Treasury staff. A typical presentation includes a review of the country's recent economic trends, current economic policies, and projections of the future direction of the economy, as well as any important structural factors, such as the quality of natural resources, that should be brought to the Committee's attention. The focus in these presentations is on the country's current and prospective ability to service its external debt. Where appropriate, the Treasury desk officers discuss the status of IMF programs, the prospects for World Bank loans on other official bank financing, the level of bilateral and multilateral development aid, and the rescheduling of official debt.

Id.

64. *Id.* at 34-36.

65. The question of what is or is not a bank has become quite complex, and has resulted in a great deal of confusion in the implementation of regulatory schemes. *See, e.g.*, St. Louis County Nat'l Bank v. Mercantile Trust Co., 548 F.2d 716 (8th Cir. 1976); Einhorn, *National Banks' Discount Brokerage Services are Permissible Under Glass-Steagall Act, But an Office at Which Such Ser-*

visory agencies—the FDIC, the Federal Reserve, and the Comptroller.[66] Many believe that the division of responsibility duplicates effort and creates inconsistent methods of handling a problem.[67] Congress relied on this criticism as implied justification for passing the Act when it placed responsibility for many of the perceived balance-of-payment problems between foreign debtors and private United States banks with the Federal Reserve, the Comptroller, and the FDIC, and not with in the FFIEC or ICERC.[68] The members of the committee on Banking, Finance and Urban Affairs believed that the crisis was precipitated by the neglect or disinclination of the three major regulatory agencies to follow up on the guidelines set by the Council.[69] The Committee Report on the ILSA chastized the agencies: "If the U.S. cannot resolve the substantial differences of opinion regarding international bank supervision within its own regulatory structure, its ability to provide the required leadership in international regulatory cooperation will be impaired."[70] Whether or not the reproach was justified, by early 1983 the growing concern over the balance-of-payment problem and the allegations of improper lending activities by private financial institutions caused congressional leaders,[71] the Chairman of the FDIC,[72] the Comptroller of the Currency,[73] the Chairman of the Federal Reserve System's Board of Governors,[74] and various economists[75] to call for some measure of

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vices are Offered Constitutes a Branch, 101 BANKING L.J. 349 (1984).

66. *See* Englert, *Bank Supervision in Historical Perspective,* 34 BUS. LAW. 1659, 1672 (1979). For a more detailed, but somewhat outdated overview of the regulatory system, see Hackley, *Our Baffling Banking System,* 52 VA. L. REV. 593 (1966).

67. *See, e.g.,* Englert, *supra* note 66, at 1673.

68. *See* H.R. REP. No. 175, *supra* note 23, at 39, *reprinted* at 1922.

69. *See id.* This conclusion is questionable. Given the composition of the Federal Financial Institutions Examination Council, it is difficult to divorce it from the regulatory agencies. *See supra* note 57.

70. H.R. REP. No. 175, *supra* note 23, at 39, *reprinted* at 1922.

71. *See House Hearings on International Bank Lending, supra* note 23, at 1, 2 (opening remarks of Chairman St. Germain).

72. *See id.* at 209-12, 216-18 (statements of FDIC Chairman William Isaac).

73. *See Proposed Solutions to International Debt Problems: Hearing on S. 502 Before the Senate Comm. on Banking, Housing, and Urban Affairs,* 98th Cong., 1st Sess. 57-61 (1983) [hereinafter cited as *Senate Hearing on Proposed Solutions*] (statement of C. T. Conover, Comptroller of the Currency).

74. *See Hearings Before the House Comm. on Banking, Finance and Urban Affairs,* 98th Cong., 1st Sess. (1983), *reprinted in* 69 FED. RESERVE BULL. 80, 81-82 (1983) (statement of Paul A. Volcker, Chairman, Board of Governors, Federal

reform. Congress, the agencies, and the private parties, however, arrived at different conclusions as to the proper solution. The heads of the regulatory agencies argued that new legislation was not necessary because the requisite changes could be worked out through the existing scheme of regulation.[76] They proposed instead that the following five-point plan be implemented through appropriate regulations: (1) a strengthened program of country risk examinations and evaluation; (2) increased disclosure of banks' country exposures; (3) a system of special reserves; (4) supervisory rules for accounting for fees; and (5) strengthened international cooperation with foreign banking regulators through the International Monetary Fund.[77]

The agencies' plan was intended to establish additional limits on lending and to encourage prudent private lending without creating arbitrary barriers to capital movement.[78] For example, proponents of the bill refused to include country lending limits in the scheme in order to avoid obstructing the use of incentive in foreign lending.[79] The three regulatory agencies and many critics

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Reserve System). In his testimony, Mr. Volcker both defended the existing regulatory scheme and discussed the worsening balance-of-payment problem. Mr. Volcker, however, also hinted that change of some type was necessary:

> Between mid-1980 and mid-1982, the claims on Mexico of the nine largest U.S. banks grew from 32 to 50 percent of capital funds, with lending terms tightening only toward the end of that period. Less dramatic but significant increases in these banks' exposures to Argentina and Brazil also occurred. The comments made in examination reports during this period did reflect growing supervisory concerns about the situation in these countries and the potential for payment difficulties. However, questions naturally arise as to whether those comments were stated forcefully or early enough, whether they were considered carefully enough by the banks—or, indeed, whether that kind of approach to the problem, involving the most difficult kind of judgment by banks and supervisors alike, needs to be supplemented by other techniques.

Id., *reprinted* at 85.

75. *See, e.g.*, Roberts, *supra* note 29, at 32, col. 3.

76. As Chairman Volcker stated, "[W]e believe the bank regulatory agencies can use, and would plan to use, existing authority to define and prevent unsafe and unsound banking practices [in the international lending area]." *Senate Hearing on Proposed Solutions*, *supra* note 73, at 18.

77. *Id.* at 24 (*Joint Memorandum on Program for Improved Supervision and Regulation of International Lending*).

78. *Id.*

79. *Id.* at 32.

from the private sector[80] opposed any new legislation in part because they believed that the banking industry had learned to evaluate country risk properly when making foreign loans.[81] In fact, the heads of the several large United States banks that would be most directly affected by the proposed ILSA stated that any improper lending practices of the past have been corrected and that additional regulation or legislation would serve only to stymie profitable investment opportunities.[82] Other critics argued that the legislation was a mere "wrist-slap" for the banks, enacted only to appease those who objected violently to the enactment of increased funding for the IMF.[83] The accuracy of these objections can be determined only through an examination of the provisions of the ILSA and the early regulations promulgated by the banking agencies as authorized by the Act.

III. Overview of the ILSA Lending Provisions

A. Introduction

Before discussing the particular provisions of the Act it is useful to note two introductory points. First, the Act maintains the existing division of responsibility over financial institutions by the Federal Reserve Board, the FDIC and the Comptroller of the Currency.[84] Second, the Act applies to "any agency or branch of a foreign bank, and any commercial lending company owned or

80. *See* H.R. Rep. No. 175, *supra* note 23, at 38, *reprinted* at 1921; *see also supra* note 14 and accompanying text.

81. *See Western Banks to Lend Soviets $150 Million,* Wall St. J., Feb. 6, 1984, at 28, col. 1 (Midwest ed.) ("Following the economic crises and debt reschedulings of Poland, Romania, and Yugoslavia, Western bankers have clamped down on lending to East Europe."); *see also U.S. Seen Agreeing to Seek New Plan on Poland's '82 Debt,* Wall St. J., Nov. 1, 1983, at 10, col. 3 (Midwest ed.) ("Rescheduling of Poland's debt to the West wouldn't be likely to make commercial banks any more willing to resume private lending to Poland.").

82. *See, e.g., Senate Hearings on International Debt, supra* note 12, at 230 (letter from William J. McDonough, Executive Vice President and Chief Financial Officer, First National Bank of Chicago, to Senator Heinz in which Mr. McDonough states that increased federal regulation "could put American banks at a competitive disadvantage and curtail the availability of finance to support U.S. exports").

83. *See Strange Bedfellows, supra* note 2, at 1, col. 1.

84. *See* 12 U.S.C.A. § 3902(1) (West Supp. 1984).

controlled by . . . foreign banks or companies."[85] This section will analyze the five major substantive provisions of the Act that will affect private lending institutions and explain the possible changes made by these provisions.

B. The Substantive Provisions

The first major provision, which directs "[e]ach appropriate Federal banking agency" to require banking institutions to create special reserves when repayment of their foreign loans becomes questionable,[86] will probably produce the most dramatic change in bank lending practices. The Act envisions that reserves would be needed when a foreign borrower has exhibited an inability to make payments on its indebtedness over an extended period of time.[87] A potential default may be evidenced in some circumstances by the debtor's failure to make interest payments, its failure to comply with the terms of rescheduled loans, or its failure to comply with IMF economic programs.[88] The Act also compels a lender to create a special reserve in a cryptically defined situation when "no definite prospects exist for the orderly restoration of debt service."[89] The reserves, when considered in conjunction with the bank's capital, must be sufficient to protect against potential loss.[90] They must also be deducted from current income and cannot be included in capital and surplus considerations.[91]

Although the Act is subject to differences of interpretation, recent rules issued by the Federal Reserve Board, the FDIC, and the Comptroller have supplemented its provisions.[92] The regulations order the establishment of an Allocated Transfer Risk Reserve (ATRR) whenever the statutory prerequisites are met;[93]

85. *Id.* § 3902(2)(B).
86. *Id.* § 3904(a)(1); *see also infra* note 98 and accompanying text.
87. 12 U.S.C.A. § 3904(a)(1).
88. *Id.* § 3904(a)(1)(A)(i)-(iii).
89. *Id.* § 3904(a)(1)(B).
90. *Id.* § 3904(b).
91. *Id.* § 3904(a)(2)(B).
92. *See* 49 Fed. Reg. 5590 (1984) (to be codified at 12 C.F.R. pt. 20); 49 Fed. Reg. 5591 (1984) (to be codified at 12 C.F.R. pt. 211); 49 Fed. Reg. 5593 (1984) (to be codified at 12 C.F.R. pt. 351).
93. *See supra* note 92. The regulations contain the same standards set forth in the statute for determining whether a loan has been impaired. The regulations, however, give additional evaluative criteria. *See infra* note 97. An Allocated Transfer Risk Reserve is required in order to protect against the "risks

each year the federal agencies shall jointly determine the international assets that require an ATRR, the amount of the ATRR, and the date of its creation.[94] Although the amount of the reserve will depend on the particular circumstances,[95] the regulations state that the amount must be at least ten percent of the loan in the first year and at least fifteen percent in subsequent years unless otherwise determined.[96] The regulations also provide guidelines to help determine whether the creation of an ATRR is required. For example, the length of time the asset has been impaired, the success of attempted debt rescheduling efforts, and future restoration prospects would all be relevant considerations.[97]

The new regulations regarding ATRRs may have a significant effect on foreign lending practices if the ten percent and fifteen percent reserve levels are enforced consistently. Testimony by the heads of the federal banking agencies before the Senate Subcommittee on International Finance and Monetary Policy indicated that the agencies intend to enforce the special reserve requirements rigorously.[98] The agency heads expressed concern that a

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presented in certain international assets when the Federal banking agencies . . . determine that such reserves are necessary. In particular, they are intended to require banking institutions to recognize uniformly the transfer risk and diminished value of international assets which have not been serviced over a protracted period of time." 49 Fed. Reg. 5587-88 (1984) (joint notice of final rules by the Federal Reserve Board, the FDIC, and the Comptroller).

94. 49 Fed. Reg. 5590, 5591, 5593 (1984) (to be codified at 12 C.F.R. pts. 20, 211, 351).

95. The regulations promulgated under section 3904(a) of the International Lending Supervision Act list four factors, in addition to those specifically listed in the statute, *see supra* notes 86-91 and accompanying text, which the appropriate agency shall evaluate when deciding the amount of the required reserves: "(1) The length of time the quality of the asset has been impaired; (2) Recent actions taken to restore debt service capability; (3) Prospects for restored asset quality; and (4) Such other factors as the Federal banking agencies may consider relevant." 49 Fed. Reg. 5591, 5592, 5593 (1983) (to be codified at 12 C.F.R. §§ 20.8, 211.43, 351.1).

96. *Id.*

97. *See supra* note 95. In addition, the regulations provide that the ATRR is to be charged to current income and may not be included in the bank's capital or surplus. 49 Fed. Reg. 5591, 5592, 5593. These provisions, however, add little if anything to the statutory language. *See supra* note 91 and accompanying text.

98. C. Todd Conover, Comptroller of the Currency, noted that "[s]ome U.S. Banks are not realistically recognizing the value of foreign loans with protracted repayment difficulties. We believe banks should adjust the value of the assets,

number of banks were not creating reserves when prudent lenders would do so and implied that special reserves will be ordered for a significant number of the major banks making international loans.[99] Moreover, the testimony of federal banking regulators and the regulations indicate that the reserve requirement will affect the amount of the banks' capital as well as the distribution of dividends.[100] Thus, this provision of the Act and the regulations promulgated under it demonstrate that the Act should have a marked impact on the lending policies of several major United States banks.

The second major substantive provision of the Act provides that "[e]ach appropriate Federal banking agency shall promulgate" regulations designed to control the practice of placing excessive debt service fees on rescheduled loans.[101] The Act makes it clear that banks may impose rescheduling fees only if the fees are amortized over the life of the loan.[102] The provision grew from the concern of banking regulators that "front-end" fees,[103] which are not amortized, may increase a bank's incentive to lend by cre-

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rather than carrying them on their books at full value." *Senate Hearings on International Debt, supra* note 12, at 356-57. William Isaac, Chairman of the FDIC, also testified that, "[m]any banks have acted responsibly and provided specific reserves to reflect foreign loans at a realistic carrying value. Others have not. We believe that when severe and protracted problems warrant, banks should specifically reserve against certain loans." *Id.* at 388. Mr. Isaac also testified that requiring these reserves will cause "earnings statements . . . capital accounts . . . and dividend policies" of major banks to be more "realistic." *Id.* Paul Volcker, Chairman of the Federal Reserve, agreed with his colleagues, maintaining that special reserves will indirectly cause greater loan diversification. *Senate Hearing on Proposed Solutions, supra* note 73, at 29 (joint statement of Paul A. Volcker, William M. Isaac, and C. T. Conover).

99. *Senate Hearing on Proposed Solutions, supra* note 73, at 29 (joint statement).

100.

> Such provisions [for the requirement of special reserves] would be deducted from current earnings and, to the extent required by regulation, would not be included in capital for regulatory and accounting purposes. The prospective requirement for reserving, with its attendant bottom-line earnings impact, should act as a cautionary element when the initial decision to lend is being made.

Id.; *see supra* note 97.

101. 12 U.S.C.A. § 3905 (West Supp. 1984).

102. *See id.* § 3905(a)(1).

103. *Senate Hearing on Proposed Solutions, supra* note 73, at 30 (joint statement of Paul A. Volcker, William M. Isaac, and C. T. Conover).

ating a deceptive short-term appearance of increased income when the entire fee is added to the bank's current income.[104] Many argue, however, that front-end fees usually represent both a reimbursement for arranging or rescheduling the loan and an adjustment to the interest yield.[105] Nevertheless, applying the fee to current income creates a distorted picture of the health of the financial institution.

Regulations promulgated under this provision distinguish the different types of fees charged by banks when a loan is originated or rescheduled.[106] Although the regulations recognize that the distinction is difficult to draw, the rules have attempted to provide guidelines by dividing the fees into three categories: (1) fees representing a reimbursement of direct processing costs, (2) fees representing remuneration from services in making commitments (such as assumption of the risk of adverse changes in market interest rates over the commitment period), and (3) fees representing a yield adjustment.[107] Under the new guidelines the fees that represent a yield adjustment must be amortized over the life of the loan and cannot be added to current income. Prior to this legislation "neither generally accepted accounting principles nor regulatory policy definitively specif[ied] the manner in which fee income to the bank [was] . . . recognized."[108] Thus, the new

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104. *See id.*; *see also id.* at 60 (statement of C. T. Conover, Comptroller of the Currency); H.R. REP. No. 175, *supra* note 23, at 42, *reprinted* at 1924. Chairman Isaac expressed his concern before the Senate Committee on Banking, Housing and Urban Affairs:

> [Front-end] fees are often taken into income in the period a loan is made, providing a boost to current earnings. A more realistic approach, particularly for rescheduled debt, would have that portion of the fee used to increase the yield on the loan taken into income over the life of the loan.

Senate Hearing on Proposed Solutions, supra note 73, at 65 (statement of William M. Isaac, Chairman, FDIC); *see also id.* at 30 (joint statement of Paul A. Volcker, William M. Isaac, and C. T. Conover).

105. *See Senate Hearing on Proposed Solutions, supra* note 73, at 60 (statement of C. T. Conover, Comptroller of the Currency).

106. 49 Fed. Reg. 5594, 5596-99 (1984) (Accounting of International Loan Fees) (to be codified at 12 C.F.R. §§ 20.7, 20.9, 211.42, 211.45, 351.2) (proposed Feb. 13, 1984).

107. *See Senate Hearing on Proposed Solutions, supra* note 73, at 50 (appendix D to joint statement of William M. Isaac, C. T. Conover, and Paul A. Volcker); 49 Fed. Reg. 5594, 5595.

108. *Senate Hearing on Proposed Solutions, supra* note 73, at 46 (appendix D to joint statement of William M. Isaac, C. T. Conover, and Paul A. Volcker). The explanation of the regulations proposed by the agencies states as follows:

method of accounting for rescheduling fees represents another major change that may have a substantial impact on the manner in which banks determine their current income.

The third major substantive provision of the Act calls for increased disclosure of international lending data.[109] It requires "each banking institution with foreign country exposure risk to submit" information at least quarterly about the exposure to the appropriate regulatory agency.[110] Furthermore, banks now are required to make public the figures concerning foreign country exposure in relation to the bank's assets.[111] The purported purpose of disclosure is to control foreign lending through "marketplace discipline."[112] The chairmen of the federal banking agencies have stated that public disclosure will allow bank depositors and investors to scrutinize foreign loans more closely.[113] Public disclosure will have two major effects. First, it will cause banks to make more prudent loans by forcing them to disclose their loans more frequently. Second, depositors and investors will require adequate reserves and greater risk diversification in return for continued and increased investment with the banks.[114]

The new requirement of quarterly reports and public disclosure of country risk exposure will alter the frequency, promptness, and amount of information previously required from banks. Because the previous practice of publicly disclosing information regarding country exposure was not uniformly followed by all banks,[115] the provision will impose definite new reporting requirements on banks that have not previously disclosed this information. The provision doubles the number of reports previously required by

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"No banking institution shall charge any fee in connection with the restructuring of an existing international obligation of the borrower unless all fees exceeding the banking institution's administrative costs of the restructuring are deferred and recognized over the term of the loan as an interest yield adjustment." 49 Fed. Reg. at 5595. To account for the allowed fees, the regulations provide that "[t]he interest method should be used during the loan period to recognize the deferred fee revenue in relation to the outstanding loan balance." *Id.* at 5897-98.

109. 12 U.S.C.A. § 3906 (West Supp. 1984).

110. *Id.* § 3906(a).

111. *Id.* § 3906(b).

112. *Senate Hearing on Proposed Solutions, supra* note 73, at 28 (joint statement of William M. Isaac, C. T. Conover, and Paul A. Volcker).

113. *See id.*

114. *Id.*

115. *Id.*

the regulatory agencies[116] and reduces the filing time for the reports from sixty to forty-five days after the filing date.[117] The most dramatic change, however, is the new Country Exposure Information Report that the FFIEC will begin requiring banks to file as an attachment to the current Country Exposure Report. The new report, which will be made public on request, requires banks to provide detailed information on all foreign country exposure that exceeds one percent of the bank's assets. Less detailed information is required on country exposure that is above 0.75 percent of the bank's assets but is below 1 percent. In addition, the current Country Exposure Report was amended to require reporting banks to state the amount of their exposure for each country that is protected by the guarantee of the United States Government or its agencies.[118] The new method of reporting banks' exposure to foreign risks will facilitate the ability of both the public and the regulatory agencies to judge the stability of financial institutions engaged in foreign investing.

The fourth major provision of the Act instructs the federal regulatory agencies to set minimum levels of capital that the banks must maintain in order to guard against foreign country risk "in light of the particular circumstances" of the institution.[119] The levels of capital may vary according to the stability and diversity of the various institutions' loan portfolios.[120] The Act also authorizes the regulatory agencies to ensure that financial institutions reach and maintain the specified levels of capital through the issuance of specific directives to individual banks.[121] Pursuant to section 8 of the Federal Deposit Insurance Act,[122] the regulatory agencies may also declare any bank's failure to maintain adequate capital levels to be an "unsafe and unsound" banking practice.[123] Furthermore, a bank's degree of adherence to any directive to achieve a specific capital level will be considered by bank regula-

116. *Id.* at 28-29.

117. Quarterly Report of Country Exposure by U.S. Banking Organizations, 48 Fed. Reg. 56,848, 56,849 (1983) (proposed Dec. 23, 1983). For a discussion of these FFIEC regulations, see 49 Fed. Reg. 5586 (1984).

118. *See* 49 Fed. Reg. at 5586.

119. 12 U.S.C.A. § 3907(a) (West Supp. 1984).

120. *See* H.R. REP. No. 175, *supra* note 23, at 39-40, *reprinted* at 1922-23; *see also* 12 U.S.C.A. § 3907(a).

121. 12 U.S.C.A. § 3907(b)(2)(A)-(B).

122. 12 U.S.C. § 1818 (1982).

123. 12 U.S.C.A. § 3907(b)(1) (West Supp. 1984).

tors when determining whether to approve the bank's proposal to take action that in any manner may hinder the establishment of the specified capital level.[124]

This section of the Act may have a marked impact on both the capital structure and lending practices of larger banks. For example, under the present scheme banks that have less than one billion dollars in assets must maintain a capital to asset ratio of at least six percent,[125] while banks with assets exceeding one billion dollars may maintain a ratio as low as five percent.[126] The minimum ratios, however, do not apply to approximately seventeen of the largest United States banks, designated as "multinational banks," whose capital levels are set on a case-by-case basis.[127] The language of the Act retains this case-by-case determination.[128] The agencies, however, now take the position that "specific minimum" ratios for all types of banks should be instituted.[129] Thus, pursuant to authorization provided by the Act, the agencies may issue regulations that would alter by several billion dollars the capital structure of several of the large banks. The mandatory ratios may have the corresponding effect of limiting the amount of money available for international lending. Congress, however, has justified this potential consequence by noting that the need for equity and increased bank stability outweighs the potential harm to the financial market.[130] In taking its position, Congress rejected the idea that larger banks should be treated differently in the international lending market because they possess greater ability to protect themselves through loan diversification.[131] Congress believed that their ability to diversify may have contributed to the present problem.[132] Thus, if federal banking regulators set strict

124. *Id.* § 3907(b)(3)(A).

125. H.R. REP. No. 175, *supra* note 23, at 45, *reprinted* at 1928.

126. *Id.*

127. *Id.*

128. 12 U.S.C.A. § 3907(a) (West Supp. 1984); *see supra* notes 119-20 and accompanying text.

129. *See, e.g.,* H.R. REP. No. 175, *supra* note 23, at 46, *reprinted* at 1929 (citing a letter from Paul A. Volcker to Banking, Finance, and Urban Affairs Committee Chairman St. Germain).

130. *See id.* at 46, *reprinted* at 1929; *see also Senate Hearings on International Debt, supra* note 12, at 241 (statement of Paul A. Volcker cautioning against drastic, inflexible legislation because of the possible adverse effect on the international financial scene).

131. H.R. REP. No. 175, *supra* note 23, at 46, *reprinted* at 1929.

132. *Id.; see also Senate Hearings on International Debt, supra* note 12, at

capital requirements on United States banks, the largest banks in the international lending market will be the ones most affected.

The fifth major substantive provision[133] is the most detailed, but is the most limited in its application. This section of the Act basically requires that whenever a bank makes loans in excess of twenty million dollars to fund specific types of projects a "senior official" must approve a written feasibility study of the project.[134] The study must explore the project's potential for profit, its impact on world markets, its benefit to the foreign country's economy, and the possibility that the project will create enough revenue to pay for itself apart from the subsidies or guarantees of any country.[135] In addition, federal bank examiners shall consider these completed studies whenever they review the conduct of a bank.[136]

In drafting this section of the Act, Congress was attempting to alleviate two problems. First, banks had not been adequately reviewing the viability of their foreign loans.[137] Second, when evaluating a bank's condition, bank examiners had not been taking proper account of the feasibility of certain projects.[138] It is interesting to note, however, that the types of loans that will be most closely monitored under this provision—loans for mining projects, metal processing operations, and fabricating facilities[139]—will finance projects in smokestack industries that the United States no longer dominates. In addition, the loans finance competition for

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147 (statement of noted author Martin P. Mayer, describing the operations of United States private financial institutions). Mr. Mayer gave a telling example, showing why diversification is not a complete solution in the international market:

> One of our more eminent international bankers, holding one of those more-than-vice-president posts at Citibank, used to brag that he had no worry about his bank's portfolio in Mexico, because there were 7,000 different borrowers.
>
> He was soundly diversified. When push came to shove, it turned out all these borrowers were dependent on a single source of dollars to meet their . . . payments.

Id. at 147.

133. 12 U.S.C.A. § 3908 (West Supp. 1984).

134. *Id.* § 3908(a)(1).

135. *Id.* § 3908(a)(2).

136. *Id.* § 3908(b).

137. H.R. REP. No. 175, *supra* note 23, at 44-45, *reprinted* at 1927-28.

138. *Id.*

139. 12 U.S.C.A. § 3908(a)(1).

United States industries in which labor unions are very strong. Congress, therefore, may have drafted this provision as a protectionist measure because its practical effect is to complicate foreign lending only for projects that will compete with troubled United States industries. The record does not indicate any motive for drafting the provision.[140] The lack of an articulated motive suggests that Congress considered domestic industrial interests when it chose to require feasibility studies in a single group of foreign development projects.

IV. COMMENTARY

At first glance, the International Lending Supervision Act appears to have a broad impact and to herald startling restrictions on the banking industry's foreign lending practices. A closer analysis of the language Congress chose to include and to omit from the Act, however, as well as the initial regulations promulgated under its authority, reveals that although the restrictions imposed by the Act represent more than a "wrist slap," they may not solve the perceived problem. Specifically, congressional drafting in four major areas seems to limit the apparent goals of the Act's revisions.

First, the policy of continued extensive cooperation between federal banking agencies and the IMF[141] may reduce the practical effect of the program. The Act provides that the regulatory agencies shall require banks to maintain special reserves whenever a foreign debtor country fails to comply with the economic policies set by the IMF.[142] An early interagency policy statement called for even greater cooperation between the regulatory agencies and the IMF and allowed banks to advance additional loan credit to countries implementing IMF-sanctioned economic measures.[143] The policy directive justified the additional credit by explaining that it "may strengthen the functioning of the adjustment process, help to improve the quality of outstanding credit, and thus may be consistent with the objectives of the program of improved

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140. *See* H.R. REP. No. 175, *supra* note 23, at 44-45, *reprinted* at 1927-28.

141. 12 U.S.C.A. § 3904(a)(1)(a)(iii).

142. *Id.* § 3904(a).

143. *See* Emergency Statement on Examination Treatment of International Loans, 1 FED. BANKING L. REP. (CCH) ¶ 2075, at 1971 (Dec. 15, 1983). For a practical discussion of the problems with conditioning future loans on compliance with IMF policies, see BUS. WEEK, Feb. 6, 1984, at 60.

supervision."[144] Requiring special reserves supports the Comptroller's policy by basing the determination of whether a bank has impaired its assets to a degree necessitating the establishment of special reserves in part on the foreign country's compliance with IMF economic recovery programs.[145]

Ideally, supporting IMF programs benefits the United States.[146] A regulatory scheme that stresses compliance with IMF programs as a factor in determining whether loans made to foreign countries require special reserves, however, functions on the assumption that IMF austerity programs are, in the majority of cases, an assurance of repayment. If this assumption proves to be incorrect in a significant number of cases, the regulations might allow the external debt of foreign countries to increase without any assurance of repayment.[147]

Second, the continued independence of the three primary regu-

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144. Emergency Statement on Examination Treatment of International Loans, *supra* note 143, at 1971-72.

145. *See supra* note 88 and accompanying text.

146. *See, e.g., Senate Hearings on International Debt, supra* note 12, at 308 (statement of Paul A. Volcker). Mr. Volcker stated:

> To be sure, some of the IMF advances to borrowing countries, whether or not the United States is the immediate source of the funds, are likely, directly or indirectly, to be spent on U.S. exports. Some of the funds may promptly find their way back into the U.S. banking system or credit markets.
>
> But those technical comparisons should not obscure the basic point of the IMF commitment. The strengthening of the IMF is an integral part of the overall effort to defend the stability of the international financial system. The success of that effort will not be measured by the amount of dollars drawn, but by its contribution to confidence that governments can and will work together to assure that the financial system can and will withstand strains and pressures, continuing to function effectively in the interest of every country.
>
> That concern is not abstract or altruistic. The international financial system is not separable from our domestic banking and credit system. The same institutions are involved in both markets. A shock to one would be a shock to the other. In that very real sense, we are not considering esoteric matters of international finance, or primarily what is in the interest of heavily indebted developing countries, although that is involved. We are talking about dealing with a threat to the recovery, the jobs, and the prosperity of our own country, a threat essentially without parallel in the postwar period.

Id. See generally Allen, *supra* note 1.

147. *Cf.* BUS. WEEK, Feb. 6, 1984, at 60 (discussing the reaction in Argentina to IMF-imposed domestic austerity problems).

latory agencies limits the impact of the Act. An early version of the Act would have given the FFIEC authority to implement the Act by allowing it to regulate the level of reserves,[148] to direct the frequency and content of disclosures of foreign lending exposure,[149] and to establish capital adequacy standards for the varying degrees of country exposure.[150] In the final version of the Act, however, Congress chose to substitute all references to the FFIEC with the phrase "[e]ach appropriate Federal banking agency."[151] If Congress had granted the FFIEC the authority to issue regulations in these areas, the three federal agencies overseeing bank regulation would have been forced to agree on the content of the regulations.[152] The change may have eliminated an innovation in the Act that could have helped create consistent international lending policies.

The initial regulations promulgated pursuant to the Act, however, may have allayed the fears of disunity. In the earliest recorded reaction to the Act,[153] the FDIC, the Federal Reserve Board, and the Comptroller established "new uniform examination categories"[154] for identifying credits that have been adversely affected by transfer risk problems.[155] The subsequent publication of banking regulations also has been uniform.[156] Therefore, despite the Act's vague division of authority among the federal banking agencies, to date the agencies have acted in concert to implement its provisions.

Third, because the Act may allow banks to include front-end fees for originating loans in their current income, the Act fails to limit banks' incentive to make international loans. As noted before, the Act provides that the portion of front-end fees charged for rescheduling loans which cannot be attributed to the actual costs of the rescheduling process may not be included in current income. The costs must be considered as interest and am-

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148. H.R. REP. No. 175, *supra* note 23, at 41, *reprinted* at 1923-24.
149. *Id.* at 41, *reprinted* at 1924.
150. *Id.* at 40, *reprinted* at 1923.
151. *See, e.g.,* 12 U.S.C.A. § 3904(a), 3906(a)-(b), 3907(a).
152. *See supra* note 57 (discussing the composition of the FFIEC).
153. Emergency Statement on Examination Treatment of International Loans, *supra* note 143.
154. *Id.* at 1971.
155. *See id.* at 1972-73.
156. *See, e.g., supra* notes 98-100 and accompanying text (uniform regulations on ATRRs).

ortized over the life of the rescheduled loan.[157] Neither the Act nor the subsequent regulations, however, has considered whether a bank may include in its current income the entire fee charged for originating a loan. It is difficult to determine whether this omission was calculated, especially in light of the congressional testimony that allowing banks to charge front-end fees to current income when rescheduling and originating loans would create artificial lending incentives.[158] The omission also leaves the banks technically free to institute two different types of accounting procedures depending on whether the bank is originating or rescheduling the loan. For these reasons, ambiguity in the regulatory scheme established by the Act fails to limit the artificial incentive for making foreign loans.

Last, Congress has noticeably omitted the establishment of country lending limits from the statutory scheme. Country lending limits would restrict the percentage of a bank's capital that may be committed in any single foreign country.[159] Congressional hearings prior to the passage of the Act discussed country lending limits only in a cursory fashion. Noted banking commentator Martin Mayer provided the only testimony that strongly advocated country lending limits. Mr. Mayer stated:

> I think a legal lending limit is essential, and everything in the [debtor] country should be aggregated against the limit . . . . Fifteen percent of capital is enough for a bank to have outstanding in a single foreign country . . . . Lines of dollar credit to U.S. branches and agencies of foreign banks should also be aggregated for control within these limits except to the extent that these branches are using the money to acquire dollar-denominated assets inside the United States, or the lines are matched with—and can be offset against—credits in the foreign currency extended to foreign branches of U.S. banks by the parents of the branches seeking the dollars credit.[160]

Paul Volcker, Chairman of the Federal Reserve System, disagreed with Mr. Mayer's position. Chairman Volcker urged Congress not to adopt country lending limits for five major reasons: (1) Lend-

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157. *See supra* notes 101-08 and accompanying text.

158. *See supra* notes 103-04 and accompanying text.

159. For a discussion of statutory lending limits, see Note, *supra* note 6, at 219-21.

160. *Senate Hearings on International Debt, supra* note 12, at 154 (statement of Martin P. Mayer).

ing limits based on objective criteria would be too rigid; (2) over time, lending limits would have capricious and abrupt effects on the flow of credit; (3) lending limits often would be subjective and based primarily on "politically charged" decisions; (4) lending limits could not distinguish between countries capable of carrying substantial debt without significant transfer risk and countries in which small amounts of debt still raise large problems of transfer risk; and (5) lending limits would impose serious transitional difficulties.[161]

Although Chairman Volcker's arguments may have been valid in late 1983, recent events do not support most of his objections. Mr. Volcker's argument that country lending limits would be too rigid now may represent one of their major strengths. After the recent failure of the Continental Illinois Bank, which drew into question the regulators' ability to recognize a failing bank, a device that would aid the regulators' ability to evaluate rapidly the condition of a financial institution may be welcome. For example, if Congress were to accept the fifteen percent lending limit proposed by Mr. Mayer, regulators would not have to be as concerned about controlling the quality of the loans. The legislative limit on the size of the loan would limit any harm caused by the default of a single creditor nation. Bank regulators, of course, should not disregard factors relating to the quality of a loan. Congressional concern regarding recent bank failures, however, could be alleviated by limiting the regulators' discretion to determine the status of a loan by placing a statutory limit on the size of the loan.

Mr. Volcker's second argument—that over time country lending limits would have capricious and abrupt effects on the flow of credit—makes sense only if the limits do not change. Stagnancy, however, is totally unnecessary. The Act already requires regulators to monitor a debtor country's ability to make interest payments, its compliance with IMF economic programs, and the terms of its rescheduled loans.[162] These provisions could be used to adjust the country lending limits on a monthly basis. Indeed, a system of sliding scale lending limits could be used to reward compliance with the IMF austerity measures that Congress has recognized as conducive to correcting the economic ills of developing countries.

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161. *Senate Hearing on Proposed Solutions*, *supra* note 73, at 18.
162. 12 U.S.C.A. § 904(a)(1) (West Supp. 1984).

Undoubtedly, Mr. Volcker's argument that country lending limits would be too political is true to a certain extent. On the other hand, a regulator's evaluation of the soundness of a foreign loan under the Act will become to some degree a political exercise. For example, as previously discussed, regulators must consider compliance with IMF austerity programs before imposing reserves.[163] Most IMF measures are conservative measures that often pit the borrowing country's government against its developing labor movement.[164] In addition, the United States Treasury's recent contribution to the loan package, designed to aid Argentina in continuing to make interest payments on its debt, has been criticized as a political maneuver.[165] Although the United States Government had first secured the Argentine loan with valuable collateral, critics have argued that any difference in the treatment given other countries seeking similar aid would constitute favoritism.[166] Thus, enforcing country lending limits would not require judgments that are any more "politically charged" than are other decisions associated with evaluating the status of international loans.

Mr. Volcker also argues that lending limits would fail to distinguish between countries capable of carrying substantial debt without incurring significant transfer risk and countries in which smaller debts would still raise large problems of transfer risk. This argument has merit only if the lending limits are applied inflexibly to allow no loans, or combination of loans, larger than fifteen percent of the bank's capital to be invested in a single country. If the lending limits are determined on a country-by-country basis, however, transfer risk could also be evaluated on an individual basis by a procedure similar to the one used to evaluate the status of a loan.[167] Compliance with IMF programs, maintenance of regularly scheduled loan repayments on existing loans, and compliance with the terms of rescheduled loan agreements could be used to set individual lending limits. Additional factors such as the rate of inflation in the debtor nation, the average rate of inflation in immediately preceding years, and the country's ability to provide for devaluation of its currency in loan

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163. *See supra* note 88 and accompanying text.
164. *See* sources cited *supra* notes 19-21.
165. *See supra* note 14 and accompanying text.
166. *See Argentine Debt Plan, supra* note 14.
167. *See, e.g., supra* notes 89-93, 98 and accompanying text.

agreements could also be used to evaluate transfer risk.

Last, Mr. Volcker argues that regulators would encounter serious transitional problems if Congress imposes country lending limits. Much of this difficulty could be avoided by phasing in country lending limits. A set time period could be established during which financial institutions could alter their operations to comply with the lending limits. The phase-in could be implemented first with countries that pose the worst credit risk and later with countries that pose less threat of default.

V. Conclusion

The ultimate effectiveness of the Act will depend on the stringency of enforcement undertaken by banking regulators. Because Congress drafted the Act to track closely the proposals made in mid-1983 by the banking regulatory agencies, the Act may be applied rigorously.[168] Furthermore, the Act calls for the agencies to report to Congress by the end of May 1984 on the changes that have been made to improve the international lending practices of financial institutions.[169] This provision suggests a strong congressional desire to monitor closely the new regulatory scheme. In some instances, however, the terms of the Act may undermine effective regulation. The Act improperly ties special reserve requirements to IMF policies and uses language that arguably does not encourage regulatory uniformity. Furthermore, Congress' failure to include country lending limits, provisions governing the accountability of origination fees, and provisions requiring feasibility studies on loans made for certain types of projects may weaken the impact of the intended reforms. Thus, while the Act appears to be more than a "wrist-slap" to major United States banks, it did not utilize all available tools to remove the perceived danger of imprudent international lending.

Charles S. Sanger

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168. *Compare* 12 U.S.C.A. § 3904 *with* 49 Fed. Reg. 5590-5593.
169. 12 U.S.C.A. § 3912.