GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-207990

May 30, 1989

The Honorable John J. LaFalce
House of Representatives

Dear Mr. LaFalce:

This responds to your request for specific information concerning federal reserve requirements for foreign loans made by U.S. banks.

Three federal bank supervisory agencies, the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Federal Reserve, promulgate uniform risk ratings for loans and uniform reserve requirements as determined by a committee of agency representatives called the Interagency Country Exposure Review Committee. Currently the rating categories, from least risky to most risky, are "strong," "moderately strong," "weak," "other transfer risk problems (OTRP)," "substandard," "value-impaired" and "loss." These ratings are defined in enclosure II. Additional information on how the Committee determines the ratings and how accurate they were in predicting debt servicing problems appears in our report, International Banking: Supervision of Overseas Lending Is Inadequate, (GAO/NSIAD-88-87, May 1988).

In enclosure I we present a table which compares reserves based on April 1989 secondary market prices for the most risky four rating categories to those required by the federal bank supervisory agencies since November 1983 when the International Lending Supervisory Act was enacted until February 1989. Although market based reserves for the $70.67 billion in loans in these four categories have an average market based reserve rate[1] of 62.2 percent, the average rate of required reserves is only 5.1 percent. The principal cause is that the supervisory agencies have required reserves only for loans rated "value-impaired" and "loss."

[1]Market based reserve rates are computed by subtracting market prices from 100 percent; for example, a secondary market price of 40 percent of face value implies a market based reserve rate of 60 percent.

In our May 1988 report, we recommended that reserves also be required for loans rated "OTRP" and "substandard" as well as "value-impaired" and "loss," because these categories also had considerable risk. We also recommended that the agencies use secondary market price data as the primary consideration in setting reserve requirements. Secondary market prices principally reflect financial investors' risk assessments; however, as explained in our previous report, there were market impediments which probably caused secondary market prices to be too high for the level of risk in these loans. Consequently, market based reserves were a conservative measure of reserves needed for these loans' risk.

If you have questions on the information provided, please contact me on .

Sincerely,

Allan I. Mendelowitz

Allan I. Mendelowitz, Director
Trade, Energy, and Finance Issues

MARKET BASED AND REQUIRED RESERVE RATES[a]

Rating	Debt Owed U.S. Banks	Market-Based Reserve Rate	Required Reserve Rate
	($ billions)	- - - - - (percent) - - - - -	
OTRP	$38.17	55.4	0.0
Substandard	29.60	68.5	0.0
Value-impaired	2.89	87.5	48.7[b]
Loss	c	98.1	100.0
total	$70.67	avg 62.2	avg 5.1[d]

[a]Book value of debt as of December 1988; market based reserve rates based on prices as of April 1989; required reserves up to February 1989; market and required reserve rates based on weighted average of book value.

[b]Because banks generally respond to reserve requirements by writing down assets by the required amounts, a decline in book value of the asset results. Therefore in order to compare required reserves to a meaningful base, we used the book value of exposure just prior to the setting of reserve requirements. Most of the base we used consisted of December 1983 book value of exposure.

[c]Total exposure less than $0.1 billion, but not presented in order to prevent disclosure of confidential, individual country reserve requirements.

[d]Based on exposure as of December 1988 and comparable to the market based reserve rates presented above. This figure cannot be derived from other information in the table because the required reserve rate for "value-impaired" loans uses mostly a December 1983 exposure base rather than December 1988 exposure.

Source: The ratings and required reserve rates for countrys' debt were collected from federal bank regulators and aggregated by GAO to prevent disclosure of data for a particular nation. Debt owed U.S. banks obtained from Federal Financial Institution Examination Council's Country Exposure Lending Survey, April 1989. Market based reserve rates derived from weighted average of bid-offer April 1989 prices collected from a financial institution which trades less developed country debt.

DEFINITIONS OF RISK RATINGS

1. "Strong - The country does not experience economic, social, or political problems which could interrupt repayment of external debt.

2. "Moderately strong - The country experiences a limited number of identifiable economic, social, or political problems which do not presently threaten orderly repayment of external debt.

3. "Weak - The country experiences many economic, social, and political problems. If not reversed, these problems could threaten the orderly repayment of external debt.

4. "Other transfer risk problems - Countries not complying with their external debt-service obligations, as evidenced by arrearages or forced restructuring or rollovers, but which are taking positive actions to restore debt service through economic adjustment measures, such as an International Monetary Fund (IMF) program; countries meeting their debt obligations but whose non-compliance appears imminent; or countries previously classified (categories 5, 6, and 7 below) which now demonstrate sustained resumption of orderly debt service.

5. "Substandard - Countries not complying with their external debt service obligations and (a) not in the process of adopting or adequately adhering to an IMF or other economic adjustment program or (b) not negotiating a viable rescheduling of their debts to banks or likely to do so in the near future.

6. "Value-impaired - Countries having prolonged debt-servicing arrearage as evidenced by more than one of the following: (a) have not fully paid their interest for 6 months, (b) have not complied with IMF programs and there is no immediate prospect for compliance, (c) have not met rescheduling terms for over 1 year, and (d) show no definite prospects for orderly restoration of debt service in the near future.

7. "Loss - Countries whose loans are considered uncollectible, such as, a country which has repudiated its obligations to banks, the IMF, or other lenders."