The U.S. Response to the International Debt Crisis: The International Lending Supervision Act of 1983

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The U.S. Response to the International Debt Crisis: The International Lending Supervision Act of 1983

CYNTHIA C. LICHTENSTEIN*

Since 1982, Third World countries have repeatedly fallen short in their attempts to maintain payments on their debt obligations to Western banks. This has triggered a series of reschedulings of this foreign debt and considerable uncertainty as to the general health of the global economy. Other scholars have outlined the causes and dimensions of this international crisis.¹ This Article will address the U.S. response to the crisis embodied in the International Lending Supervision Act of 1983² ("Supervision Act" or "Act").

The congressional and regulatory experience with the enactment of the Supervision Act illustrates the dilemmas inherent in any governmental response to the debt crisis. The U.S. banking regulators³ are directed by their authorizing statutes to be primarily con-

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3. Federal regulation of U.S. commercial banks is carried out chiefly by three separate
cerned with the financial prudence of bank loans and lending policies. At the same time, there are foreign policy and national security considerations related to the maintenance of a flow of funds to developing countries. The United States may prefer (because of the political difficulties of foreign aid) to have this funding carried out by private intermediaries rather than by official (governmental) lending. There are indications that it has been U.S. policy to encourage bank lending to lesser developed countries since the 1960's. In light of such a national economic policy, the bank regulators must attempt to oversee the process of private bank lending and restructuring of foreign debt in accordance with this policy as well as in accordance with the interests of the bank depositors and shareholders.

A further dilemma arises when such lending goes sour. The regulators must persuade the legislature that the public sector should support the private banks in fulfilling the public function of continued lending, despite contentions that the government is merely

regulators: the Federal Deposit Insurance Corporation (FDIC), the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System ("Fed"). See 12 U.S.C. §§ 1, 241, 264 (1982). All three agencies work together to regulate U.S. commercial bank lending, and thus the three agencies will hereinafter be referred to collectively as the "regulators."

5. See infra text accompanying notes 24-28.
6. Some scholars, such as Dr. Riordan Roett, argue that the precarious economic situation of the Latin American borrowing countries is a national security issue for the United States. Those who espouse this view of the implications of the crisis tend to stress the interest of the United States in ensuring an adequate flow of hard-currency funds to our Latin neighbors in order to avert a contraction in their standard of living which might produce political instability. See Roett, The Foreign Debt Crisis and the Process of Redemocratization in Latin America, in A Dance Along the Precipice: The Political and Economic Dimensions of the International Debt Problem ch. 9 (W. Eskridge ed. 1985) (forthcoming); Roett, Democracy and Debt in South America: A Continent's Dilemma, 62 For. Aff. 695 (1984).
“bailing out” the banks from deserved consequences of imprudence.  

This Article will explore the political and regulatory tensions underlying the enactment of the Supervision Act in three steps. Part I relates the background of the 1970's, when a large portion of the foreign debt to the commercial banks was incurred, and presents reasons why both the regulators and the banks failed to anticipate the risks to banks' financial soundness inherent in sovereign lending. Part II examines the legislative compromise generated by the tension between regulatory inability to control the international lending and congressional outrage at what was viewed by some as regulatory weakness. Part III of this Article analyzes the regulations implementing the legislation and assesses their impact, or lack of impact, on the effective governance of international sovereign lending.

I. U.S. Regulation of International Lending in the 1970's

When the Mexican foreign exchange crisis burst upon the financial world in August 1982, the major U.S. commercial bank lenders had loans outstanding to Mexico, Brazil and Argentina, totaling 137 percent of their capital. If these loans were written off, the nine banks involved would become insolvent. It seems that since losses in foreign loans had traditionally been quite low, few bankers or regulators in the 1970's fully appreciated the risks involved in sovereign lending. Moreover, neither the banks nor the regula-

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8. Representative James Coyne, for example, criticized the "young bankers" for urging Third World countries "to borrow, and borrow, and borrow, because after all they had valuable mineral resources or commodities" and for "rushing one after another to every economic backwater trying to lend money at a time when they didn't really understand the credits they were dealing with." International Financial Markets Hearing 1982, supra note 7, at 96 (statement of Rep. James Coyne).
11. Given that the loans to these countries exceeded the banks' capital, if the loan values on the banks' books were to be written down to actual worth (or the debtor countries were to repudiate the loans and cause their value to be recognized as zero), the capital of these banks would be impaired.
12. For example, in 1978, the Comptroller of the Currency wrote to the Chairman of the American Bankers Association's International Banking Division requesting comment on the
tors had expertise in techniques of "country risk analysis." The market test of potential insolvency used to evaluate private lending cannot be applied to sovereign loans. In addition, dollar lending to foreigners, unlike lending to domestically-based entities, is subject to "transfer risk."\(^{13}\)

Of greatest importance to the risk analysis was the difficult determination of the composition and magnitude of a country's debt. Private banks did not have the mechanisms to force their sovereign debtors to provide accurate financial reports of their borrowing activities, and often the countries themselves did not have a precise accounting of all debts incurred by their agencies.\(^ {14}\) The International Monetary Fund (IMF) assisted member countries in generating adequate governmental statistics, but could not share with private lenders any information gathered in reports from, or consultations with, member countries without the sovereign's permission.\(^ {15}\) The private banks responded to this problem, not by limiting lending, but by meeting first in the Ditchley Group,\(^ {16}\) and

legal lending limit concept as it applied to international lending. The American Bankers Association (ABA) replied that it saw a strong need for an increase in the established 10% legal lending limit as applied to foreign governments and their related entities. Specifically, the ABA noted that "[t]he inherent ability to raise revenue through the capacity to borrow, to tax, and to command the allocation of natural resources distinguishes governmental borrowers from private sector borrowers. . . . Additionally the repayment and debt servicing record of foreign governments has been stronger than that of private borrowers." Letter from Gerald M. Lowrie, Executive Director, Government Relations, American Bankers Association, to John E. Shockey, Chief Counsel, Office of the Comptroller of the Currency (March 13, 1978) (comment letter on proposed rules for determining lending limits to foreign borrowers) (copy on file at the Offices of the Virginia Journal of International Law).

13. "Transfer risk" is defined as the possibility that a country or the central bank that holds its hard-currency reserves may not be able to come up with the dollars needed to service the country's debt.

14. See Hurlock, Debt Restructure Agreements: Perspective of Counsel for Borrowing Countries, in A Dance Along the Precipice: The Political and Economic Dimensions of the International Debt Problem chap. 5 (W. Eskridge ed. 1985) (forthcoming) (noting that lesser developed countries lack a centralized system for the collection of debt information and further, that the records that are maintained may be inaccurate).


16. In May 1982, the Ditchley Group first congregated at Ditchley Park, England, at a meeting organized by the Committee on Changing International Relations, a subgroup of the National Planning Association. Participants included major commercial bankers from countries involved in the Organization of Economic Cooperation and Development; Jacques de Larosière, Managing Director of the IMF; representatives from the World Bank; and C.T. Conover, the U.S. Comptroller of the Currency. The intention of the participants was "to discuss the general international financial picture for the early and mid-1980's." Instead, the discussion turned to the drastic repayment problems of specific debtor nations, and to "the proper role of the banks in responding to this global financial crisis." Surrey & Nash,
then by setting up the Institute for International Finance to gather and exchange debtor country information. Unfortunately, this interbank cooperation came only after the banks had collectively committed so much capital to a small group of middle-income developing countries, including Mexico, Brazil and Argentina, that a sudden refusal to roll over these loans might have brought down the international financial system.

The bank regulators recognized the problem brought about by the banks' over-exposure in the developing countries. Under the structure of federal banking regulations, however, the regulators are not empowered by the legislature to force the banks to diversify or to otherwise dictate allocation of assets. The only federal regulatory diversification requirement (applicable only to national banks, albeit a category that includes most of the major money center banks) is the single borrower rule. This rule limits the covered extension of credit to a single borrower to fifteen percent of the bank's capital and surplus. Thus the Office of the Comptroller and its bank examiners could take action with respect to the banks' over-exposure only if the loans were in violation of the single borrower rule. The statute that established the single borrower rule, however, was not drafted in terms of sovereign lending. The

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17. The Institute for International Finance, Inc. "is an organization of private commercial banks from both developed and developing countries which seeks to improve the process whereby banks make international lending decisions, and, more broadly, to improve the process of international lending itself." Id. at 111. The organization was "conceived" in May 1982 and established in January 1983. Id. For a general discussion of the Institute and its functions, see id.

18. By June 1982, U.S. bank loans to developing nations totaled $93.6 billion, $52.4 billion of which comprised the loans to Mexico, Brazil and Argentina. International Financial Markets Hearings 1983, supra note 10, at 71 (statement of Paul A. Volcker, Chairman of the Board of Governors of the Federal Reserve (Table II)).


21. See 12 U.S.C. § 84 (1982). This section was completely revised in 1982. Prior to its amendment, the lending limit was 10% of a bank's capital rather than the current 15% limit. For the current implementing regulations, see 12 C.F.R. §§ 32.1-32.7 (1984). See generally, Lichtenstein, supra note 20, at 510-11.

22. The original statute did not include a definition of "person" as does the amended statute. "'Person' means an individual; sole proprietorship; partnership; joint venture; association; trust; estate; business trust; corporation; not-for-profit corporation; sovereign government or agency, instrumentality, or political subdivision thereof; or any similar entity or
statute refers to any one "person," and in the early 1970's, the regulations under the statute did not address how this term should be applied to extensions of credit to foreign governments, their agencies and their instrumentalities.23

In 1977, the Comptroller attempted to deal with the exposure problem while staying within the bounds of his statutory authority. He instructed the bank examiners to determine whether a governmental instrumentality had a source of revenue apart from the sovereign's budget with which to repay extensions of credit and whether the special purpose of the loan to the governmental instrumentality had been documented by the bank extending the credit.24 As a result of these instructions, Mexico publicly voiced concern that "its ability to borrow in the United States [was] being restricted by growing pressure on United States banks to curb their lending to developing nations carrying heavy debt burdens."25 The Mexican Ministry of Finance suggested that a new examination approach might force "Mexico to turn increasingly to Western Europe and Japan to meet its enormous borrowing needs."26

Nevertheless, the Comptroller persisted in his attempts to interpret his statutory authority in such a way that he could force banks to consider seriously the total loans outstanding to governments and their instrumentalities. In January 1978, after meetings with counsel for the major banks and consultations in Mexico, the Comptroller proposed a rule incorporating a functional test to determine which state entities should be grouped together as one "person" for purposes of the single borrower rule.27 A discussion of this test is beyond the scope of this Article. However, it is important to note that the Comptroller, in dealing with the problem of sovereign lending, recognized the U.S. foreign policy need to support the continued growth of our continental neighbors to the organization." 12 U.S.C. § 84 (1982).

23. The implementing regulations, 12 C.F.R. §§ 7.1310 and 7.1320 (1977), addressed the aggregation of loans to partnerships, corporations and their subsidiaries and certain other enterprises. The regulations, however, did not address the question of which governmentally-owned corporations should be associated with the sovereign itself for the purpose of assessing whether the legal lending limit had been exceeded.


25. Id.

26. Id.

south. The Comptroller could have stopped the lending to Peru, Mexico or Brazil by defining all government agencies and instrumentalities as the same “person” as the central government itself, thus limiting all covered extensions of credit to a country's public sector to ten percent of a bank's capital and surplus. Such a regulation, however, would have generated immediate protests from banks in addition to creating foreign relations problems. In short, the single borrower statute was not then and is not now a good tool for the supervision of foreign public sector lending by U.S. multinational banks. The limited definition that the Comptroller adopted did not restrain the Latin American lending, but it certainly indicated the authority's concern.

Whatever the banks' justification for their high level of Latin American lending prior to 1979, one wonders why the lending increased after the second OPEC price shock in 1979. The congressional hearings on the crisis detailed some of the possible reasons for the continued lending. For example, the allocation of loan fees to present earnings made continued lending and rescheduling attractive to bank managers under pressure to generate annual increased earnings. The main reason for continued lending was that

28. With regard to the foreign affairs ramifications of such a strict regulation, consider the comment of the Central Bank of Mexico on the much milder 1978 rule proposed by the Comptroller. It began by emphasizing the Central Bank's understanding of “the need to have a banking system based on a reasonable diversification of risks as well as on other practices contributing to its soundness.” It went on, however, to complain that the proposed regulation had already led some bank examiners “to adopt procedures that have been even more restrictive than those proposed,” and to protest that such restrictiveness, if generalized, “could result in a harmful restriction on access of foreign borrowers to U.S. financial markets.” The letter then detailed why foreign governments should not be considered a single “person” for purposes of the statute:

From our point of view, the proposed regulation fails to grasp fully the particular characteristics of a “mixed economy” such as ours. It is for us difficult to understand why the nature of such a system should affect its creditworthiness or bring about the combination of a particular borrower with the government.


29. The final regulation was added in 12 C.F.R. § 7.1330 (1979). This section was removed in 1983, but its language was adopted in 12 C.F.R. § 32.5(d), which is currently in force.

In the period from early 1979 until the Mexican crisis in 1982, the nine major U.S. commercial bank lenders increased the total of their loans to public and private borrowers in Mexico, Argentina and Brazil from 114% to 137% of equity. International Financial Markets Hearings 1983, supra note 10, at 386 (statement of Richard S. Dale, Brookings Inst.).


31. International Bank Lending Hearings, supra note 7, at 83 (statement of Richard S.
the banks were, in a very real sense, hostages of their earlier optimism. Once the large banks had lent substantial sums to sovereign borrowers or to private borrowers with sovereign guarantees, they had little choice but to continue lending to those borrowers. According to Richard Dale:

A key feature of the market in international lending is that, in the presence of sovereign immunity, lenders and borrowers are bound together not by enforceable contractual obligations but by crude sanctions [such as repudiation by the debtor and exclusion from financial markets by the creditors], which, because they are mutually damaging, are seldom invoked. One consequence of this situation is that lenders have no control (as they do in the domestic context) over the total indebtedness that country borrowers may incur.  

Before 1977 and the Comptroller's experiments with the loan limitation, federal regulatory policy essentially ignored the issue of diversification in international lending. Although federal bank examiners were supposed to monitor imprudent loan practices, they did not have the statutory authority to prohibit large loans that did not violate the single borrower rule or the concentration of those loans in several similarly situated developing countries. Apart from this statutory problem, the failure to criticize loans to specific countries is understandable, since adverse classifications of certain countries by government regulators might have had diplomatic and political ramifications for the United States abroad.

After the second OPEC price shock in 1979, the federal regulators instituted a new system of guidelines for evaluating country risk under the direction of an Interagency Country Exposure Review Committee (ICERC). The ICERC was charged with monitoring bank exposures, evaluating banks' internal systems for managing country risk, assessing the credit-worthiness of particular countries, identifying problems that could arise because of transfer

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33. Id. at 84-89 (statement of Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System (Appendix II)). The Interagency Country Exposure Review Committee (ICERC) was established by the Federal Financial Institutions Examination Council. See infra text accompanying note 75.
risk, and bringing these problems to the attention of bank management. The ICERC, however, failed to prevent the escalation of risky sovereign debt. This problem resulted because banks could ignore the committee classifications without fear of sanction from the ICERC; market sanctions did not exist because the classifications were not public. The failure of the ICERC approach has led some commentators to argue that "jawboning" for diversification is not enough and that stronger, binding legal constraints are needed. Better tools for encouraging bank prudence, however, lead to a political bind. Improved bank practices must be obtained without damaging foreign friendly states or imperiling the increasingly precarious debt situation.

In the 1970's, this political dilemma sometimes meant that the banks were encouraged to take or withhold action for political reasons rather than economic ones. An example of such a situation came to light in the 1977 Senate hearings and is related here at length to illustrate both the dilemma of U.S. banking regulators and the problems inherent in using the private sector to finance developing countries. The story concerns commercial bank lending to the Indonesian government-owned oil company, Pertamina. The government of President Suharto was attempting to restructure and develop the Indonesian economy. In conjunction with the plan, President Suharto put General Ibnu Sutowo, his advisor and

34. International Financial Markets Hearings 1983, supra note 10, at 84-89 (statement of Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System (Appendix II)). ICERC employs a system for categorizing borrower nations according to transfer risk. Countries are subject to ICERC classification only when an interruption in external payments occurs or appears imminent. Based on ICERC review of a nation's reasons for non-payment, its prospective sources of financing, and its potential for renewed debt-serviceing, ICERC classifies the nation's loan as substandard, doubtful or loss. See id. at 87-88. Bank regulators recently have proposed a revision of the transfer risk classification system. See infra text accompanying notes 61-66.

In addition to assessing transfer risk, ICERC classifies the debt-serviceing potential of borrowing nations as strong, middle or weak. When a bank's exposure to a weak country exceeds 10% of its total capital or when exposure to a middle country exceeds 15% of total capital, the federal bank examiners note the condition in their bank examination report. The purpose of such comment is to alert the bank to the situation; no action by the bank is required. International Financial Markets Hearings 1983, supra note 10, at 86-87 (statement of Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System (Appendix II)).

35. See, e.g., id. at 405 (statement of Richard S. Dale, Brookings Inst.).

personal friend, in charge of the oil sector of the economy. The President appointed a number of technocrats with economic credentials but no personal power base as the managers of the remainder of the economy. Unfortunately General Ibnu Sutowo never consulted with the technocrats in his management of the oil sector, but proceeded with his plan to develop Pertamina by borrowing money. At that time, there were many bankers anxious to utilize the deposits that they had obtained in the very liquid Eurocurrency markets of the early 1970's and thus more than willing to provide financing for General Ibnu's undertakings.

In the meantime, Indonesia experienced general economic difficulties, and a stand-by agreement with the IMF to assist with balance of payments problems was concluded in 1972.37 The stand-by agreement set a ceiling on external borrowing by Indonesia.38 According to the then U.S. Economic Counselor in Indonesia, the private commercial banks, anxious to continue lending to Pertamina, did not observe the ceiling. They colluded with General Ibnu in drafting loan agreements which appeared to conform to the debt ceiling but in fact evaded it.39 The U.S. Embassy directly encouraged the U.S. banks to cooperate fully with the technocrats in the Indonesian government who wanted to carry out the IMF program and maintain the ceiling.40 The State Department appealed both to U.S. bank representatives in Jakarta and to the banks' home offices in the United States to restrain private bank lending to Indonesia.41

By the end of 1974, Pertamina's situation had deteriorated dramatically and the oil company became unable to repay its obligations. At the same time, as the result of a tightening of the Eurocurrency market following the failure of Herstatt bank, the

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37. Id. at 22. When a country seeks balance of payments assistance from the IMF, it typically enters into an arrangement in which the IMF agrees to lend the country money in return for the country's commitment to an economic stabilization program. For a good explanation of the process of IMF aid to developing countries and the negotiation of "stand-by arrangements," see A. Lowenfeld, The International Monetary System § 2.3 (3d ed. 1984).

38. The stand-by agreement stated the total permitted amount of medium-level external debt (loan maturities of one to fifteen years) that Indonesia would be permitted to incur and still be in compliance with the economic program for its recovery worked out with Fund officials. 1977 Senate Report, supra note 36, at 22.

39. Id. (statement of Erland Heginbotham, former U.S. economic counselor at the U.S. Embassy in Indonesia).

40. Id.

41. Id.
commercial banks' excess liquidity was disappearing. At this point, the U.S. Embassy changed its position. Rather than urge the banks to reduce their lending to Pertamina, the Embassy began to encourage the banks not to declare their unpaid loans in default and moreover, to elicit assurances from the Indonesian government that the Indonesian Central Bank would support Pertamina so that it could repay the private foreign banks. In other words, after having told the banks not to lend, the U.S. Embassy then found itself asking the banks not to call in the loans because the United States could be hurt politically.

In the end, the situation was resolved. The banks did not call the loans but rather worked with Indonesia to muddle through the crisis. When Congress heard this story in 1977, however, it asked why the regulators had permitted the banks to make the loans to Pertamina in such an unrestrained and indeed, uncooperative fashion. The Senate Committee was particularly concerned that the banks had made loans that violated the IMF conditions on external borrowing by Indonesia and its instrumentalities. The senators argued that if the IMF thought borrowing in excess of a certain level was imprudent for Indonesia, then the lenders could be considered imprudent for violating the IMF agreement. In their opinion this was the sort of imprudence which the regulators were supposed to control. In response to this and other lending activity involving developing countries, Congress admonished the regulators in 1977 to be more diligent in preventing inadvisable foreign loans. However, Congress did not include any specific directions for the bank regulators concerning oversight of international lending by U.S. banks in the Bretton Woods Agreements Act Amendments of 1977.

II. THE INTERNATIONAL LENDING SUPERVISION ACT OF 1983

When the question of additional funding for the IMF came up again in 1983, the Senate focused on the extent to which imprudent lending by the private commercial banks had contributed to

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42. Id. at 22-23. See also J. Spero, The Failure of Franklin National Bank 110-13 (1980).
43. 1977 Senate Report, supra note 36, at 23.
44. Id. at 24-25.
45. Id.
46. Id. at 25.
the economic crises in the developing countries. After the Pertamina disaster and the Senate's rebuke in 1977, the Senate wanted to know why the banking regulators had not been more vigilant in guarding against excessively risky sovereign lending since that time and how the regulators proposed to deal with the present situation.48

The regulators responded with a Joint Memorandum on the "Program for Improved Supervision and Regulation of International Lending," submitted to the Senate Banking Committee by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.49 They explained that after the concern in 1977 over the role that private lending had played in Indonesia's economic crisis and pursuant to Congress' directive in the creation of the Federal Financial Institutions Examination Council,50 they had jointly instituted a system for uniform examination procedures for evaluating country risk factors in international lending by U.S. banks. This was the ICERC system previously described.51 The Joint Memorandum reflected a sophisticated understanding of the special transfer risks associated with sovereign lending and acknowledged that the prior procedures had been inadequate.

In the Joint Memorandum, the regulators expressed concern over the risk to the banks themselves represented by the enormous amount of developing country external debt. They intended, therefore, to integrate the country exposure reports with their reviews of capital adequacy. Banks that had over-concentrated their loans in one particular country would be required to add to their capital base.52 In addition, the regulators proposed a five-point program to "help assure earlier recognition of potential international payments problems, encourage orderly responses to these problems,

51. See supra notes 33-34 and accompanying text.
52. Joint Memorandum, supra note 49, reprinted in Senate Hearing, supra note 48, at 27.
and provide for stronger reserves to meet adverse conditions when they infrequently, but inevitably, arise.\textsuperscript{53} The program contained the following proposals:

1. Strengthening of the existing program of country risk examination and evaluation;
2. Increased disclosure of banks' country exposures;
3. A system of special reserves [called the "Allocated Transfer Risk Provision"];
4. Supervisory rules for accounting for fees [collected for loans]; and
5. Strengthening international cooperation among foreign banking regulators and through the International Monetary Fund.\textsuperscript{54}

The first proposal, dealing with country risk evaluation, was an extension of the ICERC policies to avoid risk concentration and to increase diversification.\textsuperscript{55} The third proposal, regarding special reserves, reflects a novel approach to encourage lenders to be more cautious when making new foreign loans.\textsuperscript{56} The fourth proposal would assure uniformity in bank accounting practices to reduce artificial incentives for foreign lending.\textsuperscript{57}

As a package, the regulators' proposals reflect a duality in policy which was also evident in the U.S. response to the Indonesian situation in 1977.\textsuperscript{58} The regulators were concerned with encouraging the banks to be more prudent in their international lending and in their exposure to country risk. At the same time, the regulators were well aware of the risk to the entire international monetary system if the banks called their loans or failed to agree to a restructuring of the debt and the input of new money to permit some continuing payment on old loans. Although the Joint Memorandum is phrased in typically cautious regulatory language, the concern of the regulators over the need for continued flow of capital to the developing nations is perfectly clear. According to the regulators, their five-point program

\textsuperscript{53} Id. at 25.
\textsuperscript{54} Id.
\textsuperscript{55} Id. at 27.
\textsuperscript{56} Id. at 29.
\textsuperscript{57} Id. at 30.
\textsuperscript{58} See supra text accompanying notes 42-43.
has been designed to create incentives for prudent lending but without establishing arbitrary obstacles to international capital movements or preventing the continuation of credit flows to credit-worthy borrowers. Depending upon particular circumstances, continued capital flows to basically credit-worthy countries in current strained economic conditions remains [sic] appropriate—especially in the context of IMF-approved economic stabilization programs—in order to encourage appropriate adjustment by borrowers to their problems, to maintain their capacity to service their outstanding debt, and therefore to preserve the integrity of existing bank assets.59

In other words, congressionally-imposed harsh measures against the banks would only cause them to stop any new lending, and this the system cannot afford.

The dual concerns of the regulators mirror the dual goals of national monetary control. The Board of Governors of the Federal Reserve System acts not only as a bank regulator, but is also the nation's central bank in charge of the money supply. The Federal Reserve System, together with the Treasury, is responsible for participation in international monetary cooperation. Therefore, it should be no surprise that the Joint Memorandum stresses that "broader considerations of the stability of the international financial and economic system are at stake as well [as the particular considerations of the ability of borrowers "to service their outstanding debt" and "preserve the integrity of existing bank assets."]."60 Both of the novel suggestions in the regulators' five-point program, the "Allocated Transfer Risk Provision" and the rules on bank accounting for fees collected in connection with international syndicated loans, must be understood as means of using private bank lending to encourage compliance by debtor countries with IMF remedial programs and of discouraging special incentives for international lending except where it is needed.

With respect to the first of the two suggestions, the regulators proposed a system of "provisioning against certain country exposures."61 When a borrower has been unable to service its debts over

60. Id.
61. Id. at 29.
a protracted period of time, whether or not that borrower is a sovereign, it is appropriate to recognize the risks and diminished quality of the assets represented by these loans. Generally, "banks are required to review their credits to determine whether all or parts of particular loans should be declared 'loss' and charged off or whether additional provisions should be made to the allowance for possible loan losses in light of such credits." 62 The regulators reported, however, that countries' transfer risks were not routinely or uniformly used to adjust the net carrying value of the affected assets as they should have been. To remedy that problem, the regulators proposed that banks make special allocated provisions against certain assets found to be severely affected by transfer risk problems. These special reserves would be called "Allocated Transfer Risk Provisions." 63

As described, these special reserves appear to be a prudent measure analogous to the loan loss reserves kept by banks against ordinary credit risk on lending. However, the regulators were relatively honest in their admission that the special reserves were more of a goad to urge banks towards desirable social behavior than protection for depositors and investors. As described by the regulators:

Such provisions 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. 64

Because of the requirement that any such reserves be deducted from current income, the proposed transfer risk reserve, as far as the banks are concerned, would operate somewhat like a tax in reducing the reported earnings of the banks. Since banks report publicly how much they earn, any reduction in reported earnings affects the value of their stock. Thus no bank would want to be required to keep such a reserve, particularly since the regulators

62. Id. at 40 (Appendix C). In conjunction with this proposal, assets subject to deficiencies in debt-servicing would be categorized as "reservable" by the ICERC, rather than "substandard" or "doubtful." Id. at 41 (Appendix C). See supra note 34.
64. Id. at 29 (emphasis added).
were suggesting that the reserve not be counted as part of capital. The banks would have to take money out of income, put it into a special fund, and still be subject to the regulatory objection that the bank capital was inadequate to support its lending. As a result, the proposed requirement of a special reserve constituted a very powerful threat by the regulators which could influence bank conduct.

When the regulators stated in the Joint Memorandum that "such reserve provisions would not apply to lending to a country where the terms of any restructuring of debt were being met, where interest payments were being made and where the borrowing country is complying with the terms of an IMF-approved stabilization program," it is perfectly clear that the regulators were suggesting a system that would motivate private lenders to ensure country compliance with an IMF stabilization program. This is in contrast to the Pertamina situation in the 1970's when the banks, anxious to lend, were in effect abetting Indonesian evasion of the IMF restrictions.

The other novel proposal in the Joint Memorandum was the new accounting rule for loan fees. The regulators had noticed that the multinational bank lending syndicates for Eurodollar loans were behaving very much like syndicates of investment banks and were assessing a number of special fees. In addition to commitment fees generally charged in connection with loans, one or more of the banks in these syndicates were also charging front-end fees, agency fees, advisory fees and expense reimbursements. The special fees

65. Id. at 29-30.
66. See supra text accompanying note 39.
67. "Front-end fees" are flat fees paid by the borrower to the lending banks, often on the date of the loan signing or disbursement. They resemble an origination fee because they are expressed as a percentage of the credit facility and are paid to cover the administrative expenses of originating a loan. The front-end fees include "management fees," paid to some of the lending banks in return for "additional service provided or 'underwriting risk' assumed." Joint Memorandum, supra note 49, reprinted in Senate Hearing, supra note 48, at 51.

An "agency fee" is paid by the borrower to the agent bank to reimburse it for expenses resulting from administrative duties such as telex, printing and travel. The calculation of this fee is based upon the number of banks participating in the transaction, the complexity of the loan, and the amount of anticipated communication between the borrower and the banks. Id. at 52.

"Commitment fees" compensate the lending banks for a legal commitment to lend to the borrower according to set terms at some future time. This fee has also been called the "reservation fee" and is based upon a percentage of the future commitment. Id.

"Advisory fees" are paid by the borrower as compensation to a bank or banks, for "spe-
are of considerable importance to banks to the extent that, as an accounting matter, the banks report them as income at the moment the lending arrangements are put together rather than treating the fees as additional interest which, under accounting rules, must be accrued over the term of the loan. The regulators were concerned that some of these fees "provide an added incentive to seek out international loans in order to boost earnings immediately and, once this has occurred, to sustain past earnings levels." The regulators proposed that the fees "be treated as interest except when they are identifiable as reimbursement of direct costs." The accounting proposal was designed so that the regulators could remove any artificial incentive for the banks to prefer foreign lending over ordinary commercial lending.

In recommending the transfer risk reserves, the accounting rules and the proposals on examination of country risk and disclosure, however, the regulators also urged the Senate Banking Committee that they be allowed adequate flexibility in issuing their regulations in order to ensure that the banks continue to roll over the loans, and not withdraw from the business of international lending. They thus recommended that the proposed legislation not include any specific provisions concerning international banking supervision.

The Senate Banking Committee agreed that "great care should be taken not to complicate upcoming debt restructurings or to impede future prudent growth in foreign lending." But the Committee "also concluded that specific legislative action [was] needed to mandate permanent improvements in the supervision and regulation of international lending, to improve the timeliness and com-

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68. Id. at 30.
69. Id.
70. Id.
71. The regulators argued that their enabling statutes and the Financial Institutions Supervisory Act of 1966, 12 U.S.C. §§ 1464, 1724, 1728, 1730, 1730a, 1813, 1817-1821 (1982), gave them the authority to implement the five-point program.

In view of the existence of this authority it would not be desirable to establish rigid or inconsistent legislative rules that could limit the ability of the banking regulators to adapt the program as they gain experience with its implementation and could have the unwarranted and unintended effect of discouraging the international lending necessary to support world trade and economic recovery.

Joint Memorandum, supra note 49, reprinted in Senate Hearing, supra note 48, at 33.
prehensiveness of public information on foreign borrowing and lending, and to assure that appropriate accounting procedures are used to report the true results of international lending."  

Essentially, the Senate was agreeing with the regulators that flexibility was necessary, but in light of the Pertamina situation and the regulators' failure since 1979 to restrain lending, the Senate chose to cut back on regulatory discretion.

The House Banking Committee was prepared to go even further. As far as the Committee was concerned, the lending banks had been opportunistic and imprudent, and the regulators had been almost criminally lax and complacent.  

The Committee criticized the regulators' recommendation that they be allowed to formulate new rules on their own.

In 1977, such a recommendation would have been meaningful. In 1983, after six years of agency assurances, a reform proposal consisting of general comments and guidelines yet to be specified . . . was insufficient. The long history of banker excess and regulatory neglect in the area of international lending made the agencies' proposal and legislative recommendation unacceptable.

As a result, the House bill contained detailed mandatory rules to be implemented by the Federal Financial Institutions Examination Council, an organization established in 1978 to coordinate the examination procedures of the various federal agencies and which later produced the ICERC.  

The House Banking Committee expressed an utter lack of faith in the traditional bank regulators to devise or enforce adequate rules.


74. Id.


76. In the Committee's view, the testimony of witnesses, the reports of the GAO, and other information available to the Committee, indicate that the supervisory failings which permitted the build-up of U.S. bank foreign debt is [sic] attributable to failures in supervisory followup by the Federal Reserve, the Comptroller of the Currency, and the FDIC, and not to the Council itself.
Arguably, this initial reaction by the House Banking Committee was extreme. The regulators' recommendation was a sound one notwithstanding Pertamina and the other shortcomings of the prior decade. Given the precarious balance between protection against unwise foreign lending and the preservation of the international financial system through the continued flow of new money, it is necessary to allow the regulators flexibility in making the rules. The regulators must be able to adjust the rules as the conditions change, and calibrate their enforcement to encourage the banks to be more prudent in their future lending. Hard and fast legal restrictions written into a statute ill serve the requirements of an intrinsically fluid situation.\(^\text{77}\)

The Conference Committee reached a compromise in drafting the International Lending Supervision Act. Thus, the only mandatory provision in the Act is section 906(a)(1) which provides that "no banking institution shall charge, in connection with the restructuring of an international loan, any fee exceeding the administrative cost of the restructuring unless it amortizes such fee over the effective life of each such loan."\(^\text{78}\) This provision reflects the concern of some of the members of the House of Representatives that the additional charges known as rescheduling fees were adding to developing countries' debt burden. Section 906(a)(1) takes away the regulators' discretion in providing for the accounting treatment of fees charged in connection with the restructuring of an international loan. Presumably, the regulators continue to have a certain amount of discretion in determining what are "administrative cost[s] of the restructuring[s]."\(^\text{79}\)

The other provisions of the Act do not set mandatory requirements for the banks. Each simply directs the appropriate federal banking agency\(^\text{80}\) to promulgate regulations to carry out the pro-

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\(^{77}\) The prominence of the Council in implementing the Act, is seen by the Committee as conducive to greater international regulatory cooperation and coordination. House Report, supra note 73, at 28.

\(^{78}\) IMF Managing Director de Larosière recently stressed to the Council on Foreign Relations that "there is also a critical role for the commercial banks in the future, as in the past, in any constructive and meaningful resolution of the debt problems. The banks will have to continue to provide restructuring and new money on realistic terms to debtor countries implementing adjustment policies." IMF Survey, Dec. 10, 1984, at 380.

\(^{79}\) ILSA § 906(a)(1), 12 U.S.C.A. § 3905(a)(1).

\(^{80}\) ILSA uses the term "Federal banking agencies" to refer to the FDIC, the Comptroller of the Currency, and the Federal Reserve System. Id. § 903(1), 12 U.S.C.A. § 3902(1).
Congress wisely permitted the regulators the flexibility they needed to manage the developing problems of the debt crisis. Indeed, the congressional statement of policy, "to assure that the economic health and stability of the United States and the other nations of the world shall not be adversely affected or threatened in the future by imprudent lending practices or inadequate supervision," reflects the multi-faceted goals of the regulators.

III. REGULATORY IMPLEMENTATION OF THE INTERNATIONAL LENDING SUPERVISION ACT OF 1983

In 1983 and early 1984, the regulators issued a series of proposed and final regulations to implement the five-point program set forth in the Joint Memorandum and ratified by the International Lending Supervision Act. The remainder of this Article will analyze the implementation of the statutory mandate for special reserve requirements and the accounting rules for loan fees. The analysis will illustrate and develop the thesis that the U.S. response to the debt crisis, as demonstrated by the banking regulators, is to attempt simultaneously to respond to the congressional desire to restrain the banks in their foreign lending while accommodating the need of the international system for continued inflow of funds to developing countries to avoid a world-wide domino effect in the system if one or more major countries become unable to pay their external bills.

A. Allocated Transfer Risk Reserve Rules

Section 905 of the Act incorporates the regulators' proposal for the possible imposition of special reserves against loans to certain debtor countries. Specifically, section 905(a)(1) provides that the regulators

shall require a banking institution to establish and maintain a special reserve whenever, in the judgment of such appropriate Federal banking agency—

(A) the quality of such banking institution's assets has been impaired by a protracted inability of public or pri-

81. See id. §§ 904-905, 907-909, 12 U.S.C.A. §§ 3903-3904, 3906-3908; see also id. § 910(a), 12 U.S.C.A. § 3909(a) (statutory authority for federal agencies to issue regulations).
82. Id. § 902(a)(1), 12 U.S.C.A. § 3901(a)(1).
vate borrowers in a foreign country to make payments on their external indebtedness as indicated by such factors, among others, as—

(i) a failure by such public or private borrowers to make full interest payments on external indebtedness;

(ii) a failure to comply with the terms of any restructured indebtedness; or

(iii) a failure by the foreign country to comply with any International Monetary Fund or other suitable adjustment program; or

(B) no definite prospects exist for the orderly restoration of debt service.83

Presumably, under this provision, if a country was continuing to make the scheduled payments on its bank loans but was also continuing to borrow new money from the private banks in violation of an IMF program, the regulators would be authorized to "encourage" the banks to stop such new lending in violation of the IMF program by the imposition of the expensive special reserves against those loans. Obviously, Congress had not forgotten the Pertamina episode.

Section 905(a)(2) provides that the special reserves "shall be charged against current income and shall not be considered as part of capital and surplus or allowances for possible loan losses for regulatory, supervisory, or disclosure purposes."84 In one sense this provision gives the regulators more than they requested. In the Joint Memorandum, they asked for the power to choose such treatment.85 Section 905(a) suggests that Congress accepted the idea that the special reserves are much more of a goad to the banks than they are reserves against lending risks.86

On the other hand, Congress was aware of the necessity of not discouraging the flow of new money to a developing country in the

83. Id. § 905(a)(1), 12 U.S.C.A. § 3904(a)(1); see Joint Memorandum, supra note 49, reprinted in Senate Hearing, supra note 48, at 29-30 ("such reserve provisions would not apply to lending to a country where the terms of any restructuring of debt were being met, where interest payments were being made and where the borrowing country is complying with the terms of an IMF-approved stabilization program.").


86. See supra text accompanying note 64.
process of rescheduling its debt. Thus, the House Committee Report notes that

[s]ome Members of the Committee were concerned that [the similar provision of the House bill] could cause smaller banks to stop lending to countries which are in the process of reorganizing their finances and desperately need credit to prevent having to default. . . . It cannot be emphasized strongly enough that the language of the bill regarding reserves in [sic] intended to be used by the Examination Council and the banking agencies to stabilize international financial conditions and assure orderly credit markets.87

The context of this House Committee Report makes clear that to “assure orderly credit markets” means not discouraging banks from making new loans as a part of restructuring agreements. This flexibility is all the more striking because it came from the House of Representatives. Historically, the attitude of the House toward bank lending and the oversight of that lending by the banking regulators have been less than wholly supportive. The House Committee Report’s vehement rejection of the regulators’ suggestion that legislation was not required evidences this attitude.88

The regulators’ response to section 905 of the Act indicates how clearly they understand the necessary role of the private banks in the continued functioning of the international financial system. The proposed regulations concerning the special reserves were published by the three agencies in late December 1983.89

Apart from choosing a special name for the reserves, the “Allocated Transfer Risk Reserve” (ATRR), the proposed regulations did not expand on the congressional language in the Act. The proposed regulations simply repeated the congressional language and asked for comments. The proposals noted that the federal banking agencies would jointly determine which “international assets”

88. Id. at 26-27. See supra text accompanying notes 73-77.
would be subject to the reserve and the amount and timing of the reserve for specified assets. In this way, the regulators were ensuring that there would be no "competition of laxness" among the agencies.

Finally, the proposed regulations contained a replenishment provision. Rather than having to establish an ATRR against assets found to be impaired by the transfer risk problems as described in the statute, banking institutions would have the option to write down all or part of the assets subject to the special reserves against the reserve for loan losses ordinarily kept by banks. Consequently, the amount of ATRR balances that would otherwise be required would be reduced. In the event the option were exercised, however, the regulators proposed a requirement that the reserves be replenished out of current earnings by the amount that such reserves were written down. In other words, the provisions for special reserves would in no case allow a bank to avoid a reduction to its current earnings if a particular country's borrowings were found to fall into a special reserve category.

The proposals asked for comments not only as to the percentage norms for the reserve and the factors to be used in determining the amount of reserves, but also "the appropriate treatment of new loans where comparable outstanding loans are subject to reserves required by this regulation." The Board of Governors of the Federal Reserve received thirty-nine responses. Virtually all the banks recognized the inevitability of special reserve rules, and their comments focused on a rational implementation that would not be so burdensome to the banks. The main criticisms related to the replenishment provision. Commenters argued that if a bank chose to write down an asset instead of establishing an ATRR, the loan loss reserve account should be replenished only to the extent

90. 48 Fed. Reg. 57,142 (1983) (to be codified at 12 C.F.R. § 211.44). Generally, the assets would be those subject to transfer risk such that the quality of the assets was impaired by a country's protracted inability to pay or a lack of definite prospects for restoration of debt service. The Allocated Transfer Risk Reserve (ATRR) thus established would initially be 10% of the principal amount of those specified international assets (or a greater or lesser percentage as determined by the banking agencies.) Id. (to be codified at 12 C.F.R. § 211.43(b)).
91. Id. (to be codified at 12 C.F.R. § 211.46).
92. Id. at 57,141.
93. There were 17 comments from U.S. banks and bank holding companies, 5 from trade associations, 8 from foreign banks, 8 from Federal Reserve banks, and 1 from New York's Banking Department. The Comptroller of the Currency received 17 comment letters, largely from national banks, while the FDIC received 6 comments. 49 Fed. Reg. 5588 (1984).
necessary to restore it to a level adequate to reflect the remaining risks in the loan portfolio.\textsuperscript{94} For example, several commenters noted that the proposed rule could put responsible banks that previously had charged weak loans against earnings at a competitive disadvantage vis-à-vis less responsible banks that made no provision for weak loans.\textsuperscript{95} This would, in turn, discourage conservative practices. The commenters suggested that the size of the general reserve for loan losses has traditionally been a discretionary matter for bankers and their accountants. Therefore, if the banks have prudently written off bad loans promptly, they should not have to replenish the general loan loss reserve account by the amount of an ATRR asset when they believe that the loan loss account is sufficient to cover their remaining assets.\textsuperscript{96}

The other major point made in the comments concerned the treatment of additional loans to borrowers in a country already on the special reserves list. The banks stressed that any provision requiring the application of the ATRR to new loans would be counterproductive. The banks noted that this would mean that the cost of new money going to countries in severe difficulty would be even greater and the attempts to reschedule more difficult because of the requirement of reserves against the additional loans.\textsuperscript{97} The banks stressed that requiring such reserves would not encourage banks to participate in new lending to developing countries.

The regulators' response to the comments was accommodation and the final regulation follows the good sense of the comments.\textsuperscript{98} The major alteration of the proposed regulation resulted from the banks' criticism of the replenishment provision. The final regulation does not require replenishment of the allowance for possible loan losses by the amount of an ATRR asset written down unless such replenishment is "necessary to restore it to a level which adequately provides for the estimated losses inherent in the banking

\textsuperscript{94} Id. at 5589.
\textsuperscript{95} Id.
\textsuperscript{96} Id.
\textsuperscript{97} See Letter from Douglas E. Ebert, Executive Vice President, Manufacturers Hanover Trust Company, to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System (Jan. 11, 1984) (copy on file at the Offices of the Virginia Journal of International Law).
\textsuperscript{98} The final regulation for all three agencies was issued February 9, 1984. See Allocated Transfer Risk Reserve, 49 Fed. Reg. 5590-91 (1984) (to be codified at 12 C.F.R. §§ 20.1, 20.2, 20.6-20.8); id. at 5591-93 (to be codified at 12 C.F.R. §§ 211.41-211.43); id. at 5593 (to be codified at 12 C.F.R. § 351.1).
institution's loan portfolio.\textsuperscript{99} The same provision counts write-downs in prior periods as well as reductions in principal against the allowance for possible loan losses as acceptable alternatives for an ATRR.

Moreover, the agencies' preamble to the final regulations states that "an ATRR normally would not be required initially for net new lending when the additional loans are made in countries implementing economic adjustment programs, such as programs approved by the International Monetary Fund, designed to correct the countries' economic difficulties in an orderly manner."\textsuperscript{100} The reasoning, in accord with that of the comments, was that new loans would improve the quality of outstanding credit and thus "be consistent with" the Act's objective of "improved supervision of international lending."\textsuperscript{101} In short, the final regulations suggest that the regulators were willing to accede to virtually all of the banks' suggestions, especially those indicating the need for continued bank involvement in the restructuring process.

Finally, and most interestingly, the regulations turned out to be completely in terrorem, because the reserve provisions only come into effect to the extent that the ICERC determines that assets in particular countries should be subject to an ATRR.\textsuperscript{102} As of the spring of 1984, the regulators had announced only five countries for which the special reserves are to be created and charged against income if the loans to those countries have not already been written off against the general loan loss allowance. These countries, Zaire (seventy-five percent reserves), Sudan (fifty percent reserves), Poland (fifteen percent reserves), Nicaragua (fifteen percent reserves), and Bolivia (ten percent reserves)\textsuperscript{103} are those against whose borrowings the banks in general have already made provision in their allowance for possible loan losses. Since under

\textsuperscript{99} Id. at 5591 (to be codified at 12 C.F.R. § 20.8(c)(4)); id. at 5592-93 (to be codified at 12 C.F.R. § 311.43(c)(4)); id. at 5593 (to be codified at 12 C.F.R. § 351.1(c)(4)).

\textsuperscript{100} Id. at 5598.

\textsuperscript{101} Id.

\textsuperscript{102} For the standards used by the regulators to determine whether specific loans require a special reserve, see id. at 5591 (to be codified at 12 C.F.R. § 20.8(a)(2)); id. at 5592 (to be codified at 12 C.F.R. § 311.43(b)(2)); id. at 5593 (to be codified at 12 C.F.R. § 351.1(b)(2)(ii)).

\textsuperscript{103} See 42 Wash. Fin. Rep. (BNA) No. 1, at 3 (Jan. 2, 1984). During the summer of 1984, the ICERC put pressure on banks to be more cautious about making more loans in countries like Venezuela which was not yet on the ATRR list. Witcher, Possibly Bad News for U.S. Banks, Wall. St. J., Aug. 7, 1984, at 36, col. 2.
the final regulation, write-off against such coverage can substitute for the creation of an ATRR, it should not be expensive for the banks to comply with the Allocated Transfer Risk Reserves for those five countries. Moreover, in light of their concern that lending to developing countries on the brink be continued in the interest of a resolution to the crisis of developing country debt, it would not be surprising if the regulators choose not to add other countries to the list.

The final regulation simultaneously results in appeasing Congress with the special reserves and protecting the public interest in continued lending to developing countries by not discouraging banks with ATRR’s. Thus, in the area of special reserves, the regulators seem to be trying both to respect the domestic political process and appear as dutiful regulators and to relieve the banks of the effects of a very burdensome provision. Of course, the risk they run is another round of congressional blame if the accommodation does not work and the reschedulings do not successfully avoid defaults on loans that are not offset with sufficient reserves.

B. Fee Accounting Rules

Section 906(a)(1) of the International Lending Supervision Act seeks to “avoid excessive debt service burdens on debtor countries” by forbidding banks from charging “any fee exceeding the administrative cost of the restructuring” unless the fee is amortized over the life of the restructured loan. This section reflects Congress' belief that additional fees paid to banks upon an extension to existing international loans represent an added interest charge to compensate for the additional credit risks incurred with the rescheduled principal, and thus such fees should be amortized over the effective life of the loan.

In contrast, section 906(b)(1) instructs the federal banking agencies to “promulgate regulations for accounting for agency, commitment, management and other fees charged by a banking institution in connection with an international loan.” Section 906(b)(2) explains that the purpose of the regulations is “to assure that the appropriate portion of such fees is accrued in income over the ef-

105. Id.
106. See Senate Hearing, supra note 48, at 76-77.
fective life of each such loan.” The legislative history of the Act clearly indicates that section 906(b) was intended to curtail the front-end loading of various fees charged in connection with international syndicated loans, a practice that the regulators viewed as an artificial incentive for banks to make international loans.

The concern of Congress and the regulators was well founded. Under generally accepted accounting principles, if payments by a borrower are labeled “fee for services,” the full payment can be taken into income at the time the loan agreement is signed. If, however, the fee is considered simply a way of increasing yield on the loan, then it is “interest” and should be accounted for over the life of the loan. To the extent that banks can claim fees as service-related rather than yield-related, they can gain short-term boosts in earnings.

In addition to front-end fees, there are other opportunities in international syndicated lending to report fees as current earnings. For reasons about which legal anthropologists can only speculate, foreign sovereign lending syndicates of multinational commercial banks are put together in a fashion that resembles investment banking syndicates. Thus, for example, the lead bank in such sovereign lending syndicates refers to its undertaking to round up the group of lenders as “underwriting.” Since the lending function is referred to as “underwriting,” then function follows form; the banking syndicates charge the borrowers “fees,” and some


109. The current practice of taking front end fees into income in the quarter or year in which they are charged, rather than spread over the life of the loan is an incentive to promote international loans in order to boost earnings. Banks should be making loans based on the creditworthiness of the borrower not on short-term profitability considerations. The establishment of an accepted accounting treatment for front end fees will contribute to the future stability of the international financial system by eliminating artificial incentives to make international loans.

110. In the United States, investment banking, the process by which funds are raised for economic enterprises by investment banks that publicly distribute securities of these enterprises, has been separated from the business of commercial banking, the raising of funds by deposit-taking and the reselling of the funds by lending. See 12 U.S.C. § 378 (1982). Investment bankers traditionally consider their “underwriting” a “service” for the client corporation.

111. This, of course, is a misuse of the term “underwriter.” A true “underwriter” bears the risk of securities it has purchased but cannot resell. See Black’s Law Dictionary 1389 (5th ed. 1979). No court would ever force a single lead bank or group thereof to lend the full amount of a promised loan if the promised participants could not be found.
banks thereby account for those payments as fees for services includable immediately in income.

Since large domestic borrowers are not in the habit of paying such a variety of fees to their commercial bankers, the practice of receiving and counting as immediate income these fees on international sovereign loans tends to make such activity unusually attractive to bankers concerned with maintaining or increasing current earnings. It is this practice that the regulators and Congress thought might be giving an "artificial incentive" to international lending. Thus, at the time of promulgation of the final ATRR rule in February 1984, the banking regulators also issued proposed regulations on accounting for international loan fees, in accordance with Congress' mandate in section 906(b).112

The proposed regulations sought to cut through the various semantic distinctions among the fees and to create a unified functional accounting approach for the commercial banks making foreign loans. Thus the proposed regulations made no distinction between fees received in connection with a restructuring and various other fees received in connection with international lending.113 The proposed regulations simply provided that all fees received in connection with international loans other than loan commitment fees should be recognized over the loan period to the extent they exceed the administrative costs of the international loan. "Loan commitment fees were to be deferred and amortized over the term of the combined commitment and loan period."114 In short, the practice of "front-end loading" was made much less attractive. The preamble of the proposed regulation indicated that the reasoning behind the regulators' sweeping proposal was that "accounting practices should not result in artificial incentives for banking institutions to make international loans premised on the immediate recognition of all fee income."115

The regulators had proposed strict accounting rules in the Joint

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113. Id. at 5595.
114. Id. at 5598 (to be codified at 12 C.F.R. § 211.45(b)(2)).
115. Id. at 5595.
Memorandum;\textsuperscript{116} Congress had concurred;\textsuperscript{117} and the proposed regulations seemed unusually firm. Nevertheless, perhaps doubtful of the impact of the proposed rules on the multinational banks, the regulators asked for industry comment on such subjects as the lack of differentiation between fees collected for restructured loans and those related to other international loans; the proposed deferral and amortization of loan commitment fees; the accounting methods for costs and fee income associated with merchant banking activities; and the accounting treatment in the proposed regulations that was inconsistent with domestic loan accounting practices.\textsuperscript{118}

The reaction from the international banks was an immediate protest. The regulators received 67 comments.\textsuperscript{119} The commenters argued that while Congress had mandated a stop to the front-end loading of fees received in connection with restructurings,\textsuperscript{120} it had not mandated any particular accounting treatment for fees received in connection with international loans.\textsuperscript{121} The banks commenting, therefore, asked for a narrow definition of "restructuring" in order that Congress' mandate would only apply to loans that were rescheduled by debtor countries because of lack of foreign exchange to pay their external debt and not to loans that were refinanced for other reasons.\textsuperscript{122}

Above all, the commenters wanted to ensure that they could continue to take into income as "service income" the management fees on the syndicated international loans.\textsuperscript{123} A reading of the London-based magazine "Euromoney" over the years gives a picture of how fierce the competition is among the banks in the Eurocurrency markets to be lead bank on the sovereign loans because the lead bank receives the management fee for arranging the loan.\textsuperscript{124} In effect, the banks saw the profitability of these fees being reduced by the new proposed regulations. The comment letters

\textsuperscript{116} See supra text accompanying notes 67-70.
\textsuperscript{117} See supra text accompanying notes 78-79.
\textsuperscript{119} The Federal Reserve and the Comptroller received 30 letters from banks and bank holding companies, 10 from trade associations or firms, 7 from accounting firms or groups, and 6 from Federal Reserve banks. The FDIC received 14 letters, all duplicates of comments received by the other two agencies. Id. at 12,193.
\textsuperscript{120} See ILSA § 906(a), 12 U.S.C.A. § 3905(a).
\textsuperscript{123} Id. at 12,194-95.
raised elaborate arguments as to why the management fees were fees for services and the extent to which the new regulation would make competition with the multinational banks' competitors, the merchant banks, much more difficult. In response to the comments received, the agency addressed the issue of syndication fees as follows:

[t]here can be little dispute that banking institutions that are “lead” or “managing” banks provide services, as described by the commenters, in connection with international loan syndications. These banking institutions also frequently participate in the loan, and often their share in the loan is among the largest of all participants. In such circumstances, the activities of the institution in syndicating the loan are, to at least some extent, integral to the lending of funds."

The preamble cautions, however, that “what additional portion of the syndication fees is intended to compensate a managing bank for making the loan, as compared with arranging loans for others, is not easily determined using any generalized standard and may vary from case to case.”

Apparently, the regulators realized that in this area, they were confronting a dilemma. In theory, the banking agencies are regulating commercial banks that are forbidden by the Glass-Steagall Act to act like merchant banks. On the other hand, the Glass-Steagall Act does not apply to foreign merchant banks that do no underwriting within the United States, nor does it prevent U.S. banks from participating in such activity abroad. In short, there are major U.S. multinational banks abroad that do compete with merchant banks and have mixed commercial and merchant banking functions, just like foreign institutions. There really is no reason why such institutions should not be allowed to receive fees for arranging loans by others. The problem, of course, is that in the case of foreign syndicate lending, the lead bank also acts as a lending bank, and could be viewed as merely doing what it would do in

126. Id. at 12,195.
127. Id.
128. Id.
a very large domestic loan, that is, participating out the portion of the loan too large for its own capital base. In this case, its functions look much more like "banking" than "underwriting."

In the final regulation the regulators appeared to accept the banks' arguments concerning the provision of services and accounting for the lead or managing bank fees. The preamble to the final regulation, however, makes clear that there is some limitation on the ability of the lead bank to take the fee into income:

In order to assure that, in practice, the appropriate portion of the fee is amortized, the final regulations allow the banking institution to take the fee into income when the loan is closed only to the extent the institution can identify and document the services for which the specified fee was received. Documentation for this purpose shall include the loan agreement, signed by all of the parties to the loan, which identifies the services provided and the total fee received by the institution for provision of such syndication or management services. If the portion of fees received representing compensation for such services cannot be so identified and documented, then the fee will be presumed to be an adjustment to yield [i.e., additional interest] and must be amortized over the life of the loan.

The requirement that the total fee be included in the loan agreement may cause problems in loan syndications in which the exact amount of the management fee has been negotiated between the debtor country and the managing or lead banks and the other bank participants are not aware of the full amount of the fee. If the other banks in the syndicate become aware of the amount of the management fee, they might ask why the sovereign could not afford to pay a higher interest rate if it could afford such a fee.

Indeed, it has become a custom in syndicated loans to share some of the management fee with other participating banks to induce them to participate. This portion of the fee the regulators have insisted both in the proposed regulation and in the final regu-

130. See Accounting for International Loans Fees, 49 Fed. Reg. 12,196 (1984) (to be codified at 12 C.F.R. §§ 20.7, 20.9); id. at 12,197-98 (to be codified at 12 C.F.R. §§ 211.42, 211.45); id. at 12,198-99 (to be codified at 12 C.F.R. § 351.2).
131. Id. at 12,195.
132. Id. at 12,194.
luation represents an adjustment to yield and must be amortized. It seems clear from the preamble that in order to take the portion of the management fee not shared with the other banks into income immediately, the lead bank must insert the amount of the management fee into the loan agreement.\textsuperscript{133} This will enable the participating banks to demand a greater portion of the management fee as the price of their participation. To the extent that they do so, the accounting treatment of that portion of the fee will change for all participating banks, including the lead bank.

It will be very interesting to see how the final regulations for accounting change the drafting work of the British and U.S. lawyers that specialize in the documentation of the syndicated loan agreements. In this instance, the regulators, while appearing to accommodate the multinational banks, may have in fact found a way of tracking Congress' purpose and reducing the amount of fees for sovereign lending that can be front-ended, thus reducing the attractiveness of foreign sovereign loans vis-à-vis domestic lending.

\textbf{IV. Conclusion}

It can only be concluded that the response of the U.S. Congress to the international debt "crisis" in the form of the International Lending Supervision Act has not changed the regulation of U.S. commercial banks' international lending to any significant degree. The regulators have been given statutory authority to use small tools to discipline lending to countries that are failing to adhere to their IMF austerity programs and to discourage a preference for international lending for financial statement purposes. Neither of these tools will have any significant effect on the volume of international lending by U.S. banks.\textsuperscript{134} The decision-making power over

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\textsuperscript{133} Id. at 12,195.
\textsuperscript{134} This is not to say that the Act has not given the regulators a powerful new weapon in their fight for bank prudence. The contrary is true, but the weapon is directed specifically to control of sovereign lending as such.

Once again, space limitations preclude even minimal discussion of the relation of bank capital adequacy to issues of safety and soundness, but in the hearings, Congress became aware of the very low levels to which bank, particularly major money market bank, capital had fallen vis-à-vis total assets. See supra text accompanying notes 10-11.

Congress also became aware that the federal regulators did not have specific legislative authority to force the banks to raise capital levels, although adequate capitalization is always a factor in regulatory approvals of acquisitions under the Bank Holding Company Act, 12 U.S.C. §§ 1841-1850 (1982). Thus, section 908 of the Act, entitled "Capital Adequacy," directs the regulators to "cause banking institutions to achieve and maintain adequate capi-
the prudent quantity and quality of international loans ends up where it started, with the management and boards of directors of the multinational banks.135

This form of response is hardly surprising for two reasons. The first is the continuing need for a flow of funds into the debtor countries. As has been continually stressed in this Article, even the House of Representatives recognized, for the moment, the necessity of rolling over the loans, and of allowing the rescheduling process to continue with the addition of new money to keep the interest payments on the old loans current, or at least current enough by establishing minimum levels of capital for such banking institutions” and specifically grants to the regulators “the authority to establish such minimum level of capital for a banking institution as [the regulator], in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the banking institution.” ILSA § 908(a)(1)-(2), 12 U.S.C.A. § 3907(a)(1)-(2). The section also provides that the failure of a banking institution to maintain the minimum level of capital prescribed may be deemed by the regulator, “in its discretion, . . . an unsafe and unsound practice,” thus permitting regulatory action as prescribed by the Act. Id. § 908(b)(1), 12 U.S.C.A. § 3907(b)(1). The section also specifically authorizes the imposition on banks “of a plan acceptable to the [regulator] describing the means and timing by which the banking institution shall achieve its required capital level.” Id. § 908(b)(2)(B)(i), 12 U.S.C.A. § 3907(b)(2)(B)(i).

Section 908 of the Act is the legislative authority behind the recent imposition of formal agreements to bolster capital on the boards of directors of BankAmerica and Continental Illinois. See Profit Rises 38.9% at Big Coast Bank, N.Y. Times, Jan. 22, 1985, at D1, col. 6. This article noted that

because of BankAmerica’s high level of . . . problem loans, the Comptroller of the Currency last year required the company’s directors to sign legally binding pledges that they would . . . increase the primary capital of the Bank of America, the holding company’s principal subsidiary, to 5.5 percent of total assets by the end of 1984. Id. See also “Citicorp Widens Lead Over BankAmerica,” N.Y. Times, Jan. 30, 1985, at D1, col. 4.

135. British scholar, Richard S. Dale, strongly criticized the ICERC supervisory mechanism and the reluctance of the regulators to allocate credit. Stressing the need for added safeguards against bank failures, Dale noted that “at the very least banks should be prevented from getting into a situation where they can be brought down by a single country’s default.” International Financial Markets Hearings 1983, supra note 10, at 388 (statement of Richard S. Dale, Brookings Inst.). To this end he recommended the imposition of a ceiling on foreign sovereign lending such as 25% of capital. Id. However, it was this kind of rigid regulation that was not adopted.

Instead, the provisions of the Act directed specifically at international lending are keyed into the new capital adequacy section, section 908. See supra note 134. Thus section 905(b) directs the regulators to

analyze the results of foreign loan rescheduling negotiations, assess the loan loss risk reflected in rescheduling agreements, and, using the powers set forth in section 3907 of this title (regarding capital adequacy), ensure that the capital and reserve positions of United States banks are adequate to accommodate potential losses on their foreign loans.

ILSA § 905(b), 12 U.S.C.A. § 3904(b).
to prevent a mandatory recognition of default,136 and a conceivable international financial breakdown.137

The second reason is the international competition for banking services. This reason has not been stressed, nor was it articulated in the public debate on the Supervision Act, but it may have been a cause of the apparent but less than significant U.S. legislative and regulatory "response." This Article has noted that as long as states themselves are unwilling to undertake the necessary job of balance of payments financing, either individually or collectively through international agencies, the need will be filled at a price by private banking institutions.138 This has been the international monetary history of the 1970's and 1980's.

These private international intermediaries are hardly all U.S. owned and regulated. The multinational banks in syndicated sovereign lending are British, German, Swiss and Japanese, with considerable participation by other European Economic Community or Canadian based banks as well. No discussion of world markets for steel or automobiles proceeds without recognition of the national origin of the economic actors and the consequent effects of their ability to compete in world markets. The same, in fact, is true for consideration of the regulatory structure of the international lending market: the United States cannot itself regulate international lending without the acknowledgement and examination of government-imposed bank regulations in other lender nations. U.S. banks at present are more regulated in their international activi-

136. This Article has been unable, given space limitations, to delve into the accounting and disclosure questions involved in international lending. The rules are set by a combination of generally accepted accounting principles, the banking regulators' call report requirements, and the SEC financial disclosure requirements for bank holding companies. See generally Coombe & Laic, Problem Loans, Foreign Outstandings, and Other Developments in Bank Disclosure, 40 Bus. Law. 485 (1985). The total effect, however, is to force banks to take any interest income they have accrued (once that interest is more than ninety days in default) out of reported income and thus reduce reported earnings. Until banks in the Argentine rescheduling negotiations stopped the game by publicly announcing the actual effect on income, fear of such announced reductions in income was a card in the hands of the debtors. At some point, however, if debts due are never rescheduled, they must be written off as "bad" and then the banks could be insolvent from an accounting point of view. To Mr. Dale's credit, his proposal for an absolute ceiling on lending insisted that "there would, of course, have to be extended transitional arrangements, although the most heavily exposed banks might reasonably be required to increase their capital in order to expedite adjustment to the new regime." International Financial Markets Hearings 1983, supra note 10, at 388 (statement of Richard S. Dale, Brookings Inst.).

137. See supra text accompanying notes 87-88.

138. See supra note 77.
ties than the banks of any other nation. To restrict further their discretionary lending (or to raise the costs of such lending by additional reserves) will only inhibit, at considerable cost to the U.S. balance of payments deficit, their capacity to compete with—or participate with—the other multinational banks in global lending. Significant regulation of international lending by private institutions will have to be achieved on an international basis, either through international coordination or harmonization of regulation or through what may be an impossible dream, a supranational regulator. The International Lending Supervision Act indicates that Congress was well aware of this reality: among other reports required, the Act directs the Chairman of the Board of Governors of the Federal Reserve System to “review the laws, regulations, and examination and supervisory procedures and practices, governing international banking in each of the Group of Ten Nations and Switzerland with particular attention to such matters bearing on capital requirements, lending limits, reserves, disclosure, examiner access, and lender of last resort resources. . .”

In this author’s opinion, it is this pointing to international action with respect to the international debt “crisis” and the role of banking supervision therein that is the effective and appropriate U.S. response.

139. See International Financial Markets Hearings 1983, supra note 10, at 391-92 (statement of Richard S. Dale, Brookings Inst.). “In general, foreign supervision of banks’ international lending is more cursory than in the U.S. On the other hand, given the advisory nature of the U.S. supervisory system, there is little reason to suppose that U.S. banks’ lending practices differ significantly from those of foreign banks.” Id. at 392 (statement of Richard S. Dale, Brookings Inst.).

140. See generally Lichtenstein, supra note 20. The extent to which Congress was aware of the international competitive position of U.S. banks is indicated by the last provision of the capital adequacy section of the Act, discussed supra note 134. Section 908 directs the Chairman of the Federal Reserve to “encourage governments, central banks, and regulatory authorities of other major banking countries to work toward maintaining and, where appropriate, strengthening the capital bases of banking institutions involved in international lending.” ILSA § 908(b)(3)(C), 12 U.S.C.A. § 3907(b)(3)(C).

141. For this author, it is the deference shown to the supervising function of the IMF in its conditionality—i.e., to the IMF restrictions on sovereign external borrowing in IMF adjustment programs—in the provisions on the Allocated Transfer Risk Reserves that makes the provisions so interesting.
