Chapter 5

The LDC Debt Crisis

Introduction

The spark that ignited the LDC (less-developed-country) debt crisis can be readily identified as Mexico's inability to service its outstanding debt to U.S. commercial banks and other creditors. The crisis began on August 12, 1982, when Mexico's minister of finance informed the Federal Reserve chairman, the secretary of the treasury, and the International Monetary Fund (IMF) managing director that Mexico would be unable to meet its August 16 obligation to service an $80 billion debt (mainly dollar denominated). The situation continued to worsen, and by October 1983, 27 countries owing $239 billion had rescheduled their debts to banks or were in the process of doing so. Others would soon follow. Sixteen of the nations were from Latin America, and the four largest—Mexico, Brazil, Venezuela, and Argentina—owed various commercial banks $176 billion, or approximately 74 percent of the total LDC debt outstanding.[1] Of that amount, roughly $37 billion was owed to the eight largest U.S. banks and constituted approximately 147 percent of their capital and reserves at the time.[2] As a consequence, several of the world's largest banks faced the prospect of major loan defaults and failure.

This chapter provides a survey of the LDC debt crisis for the years 1973–89. The discussion covers the crisis year of 1982, as well as two periods that preceded it and one that followed. The opening sections examine the first two periods, 1973–78 and 1979–82, enabling us to gain some understanding of the economic conditions and prevailing psychology that not only generated increased LDC borrowing but also produced overlending by the banks. The role bank regulators played during the years leading up to the outbreak of the crisis is also explored, as are contemporary opinions on the LDC situation. The final section of the chapter discusses the post-1982 crisis years that consumed bank regulatory officials and the international banks with damage-control activity, including restructuring existing

---

[1] Philip A. Wellons, *Passing the Buck: Banks, Government and Third World Debt* (1987), 225. In this chapter, the term "Latin America" refers to all Caribbean and South American nations.

[2] Federal Financial Institutions Examination Council (FFIEC), *Country Exposure Report* (December 1982), 2; and FDIC, *Reports of Condition and Income* (December 31, 1982).

loan portfolios, preventing the failures of large banking organizations, and containing the repercussions for the U.S. financial system.

Roots, 1973–1978

The causes and consequences of the Third World debt crisis have been analyzed by scholars for more than a decade.[3] Its origin lay partly in the international expansion of U.S. banking organizations during the 1950s and 1960s in conjunction with the rapid growth in the world economy, including the LDCs. For example, for more than a decade before oil prices quadrupled in 1973–74, the growth rate in the real domestic product of the LDCs averaged about 6 percent annually. For the remainder of the 1970s, the growth rate slowed but averaged a respectable 4 to 5 percent.[4] Such growth generated new U.S. corporate investment in these markets, and the international banks followed by establishing a global presence to support such activity. This multinationalism in providing financial services contributed to the emergence of a new international financial system, the Eurodollar market, which gave U.S. banks access to funds with which they could undertake Third World loans on a large scale.

The sharp rise in crude oil prices that began in 1973 and continued for almost a decade accelerated this expansion in lending (see figure 5.1). In addition to generating inflationary pressures around the industrial world, these price movements caused serious balance of payments problems for developing nations by raising the cost of oil and of imported goods. Developing countries needed to finance these deficits, and many began to borrow large sums from banks on the international capital markets.[5] The oil price rise that caused the deficits also increased the quantity of funds available in the Eurodollar market through the dollar-denominated bank deposits of oil-exporting countries, thereby fueling the lending boom.[6] The banks rechanneled the funds to the oil-importing developing countries as loan credits. In addition to having those effects, the rise of oil prices in 1973 helped to bring on the world recession of 1974–75, which would eventually produce a decline in world com-

---

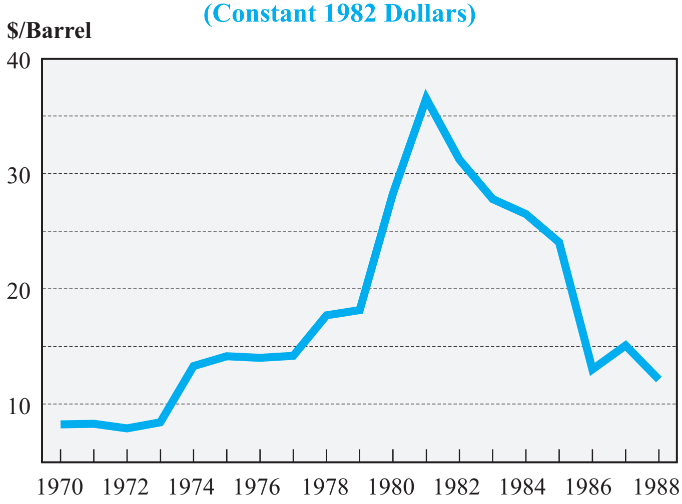
[3] See especially William R. Cline, *International Debt* (1984); Raul L. Madrid, *Overexposed* (1990); and Michael P. Dooley, "A Retrospective on the Debt Crisis," working paper no. 4963, National Bureau of Economic Research, Inc., New York, 1994.

[4] David C. Beek, "Commercial Bank Lending to the Developing Countries," Federal Reserve Bank of New York *Quarterly Review* (summer 1977): 1.

[5] Between year-end 1973 and 1975, current-account trade deficits for the non-oil-producing LDCs increased from approximately $8 billion to $31 billion (Benjamin J. Cohen, *Banks and the Balance of Payments* [1981], 10).

[6] Between 1972 and year-end 1974, the annual oil revenues of the Organization of Petroleum Exporting Countries (OPEC) increased from $14 billion to nearly $70 billion. In 1977, OPEC revenues were $128 billion. By year-end 1978, OPEC had approximately $84 billion in bank deposits, mostly in the Eurodollar market. See Cohen, *Banks and the Balance of Payments*, 7, 32.

Figure 5.1
U.S. Crude-Oil Refiner Acquisition Cost, 1970–1988
(Constant 1982 Dollars)



Source: Energy Information Administration, *Annual Energy Review* (1988).

modity prices for minerals and agricultural goods, thereby further exacerbating the developing countries' debt burden (see figure 5.2).

In Latin America borrowing had increased steadily in the early 1970s, and after the 1973 oil embargo it escalated significantly. As of year-end 1970, total outstanding debt from all sources amounted to only approximately $29 billion. By year-end 1978, these outstandings had risen to approximately $159 billion—an annual compound growth rate of almost 24 percent (see figure 5.3).[7] It was estimated that approximately 80 percent of this debt was sovereign.[8] The range in the annual growth rate of outstandings went from a low of 12 percent for Argentina to a high of 42 percent for Venezuela. In absolute terms, however, Mexico and Brazil accounted for approximately $89 billion, or more than half of the total outstanding debt as of December 31, 1978.

The typical LDC loan consisted of a syndicated medium- to long-term credit priced with a floating-rate contract. The variable rate was tied to the London Interbank Offering

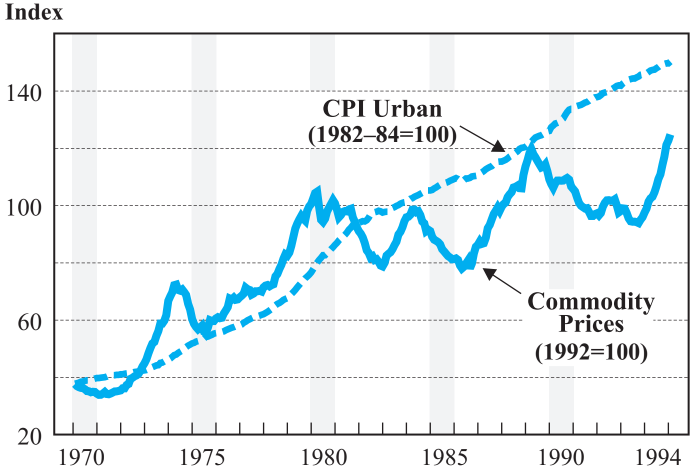
---

[7] The burden of the debt was more moderate after adjustments were made for the inflation of the 1970s. However, the weight of this burden increased dramatically with the world recession and deflation of the early 1980s. See Cline, *International Debt*, 4.

[8] World Bank, *World Debt Tables* (1990–91 ed.), cited in Robert Grosse and Lawrence G. Goldberg, "The Boom and Bust of Latin American Lending, 1970–92" (1995), table 1. Sovereign debt refers to claims owed by national governments, by government agencies, or by private firms with public guarantees.

Figure 5.2

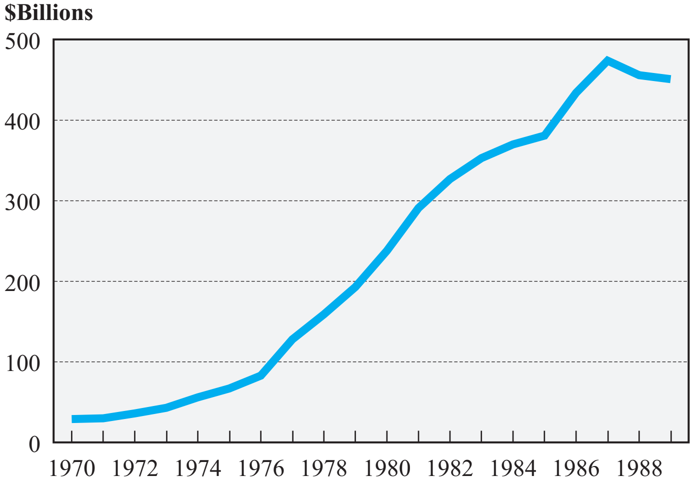
Monthly Commodity and Consumer Prices, 1970–1994



Source: Haver Analytics.

Figure 5.3

Total Latin American Debt Outstanding, 1970–1989



Source: World Bank, *World Bank Debt Tables* (1990–91 ed.).

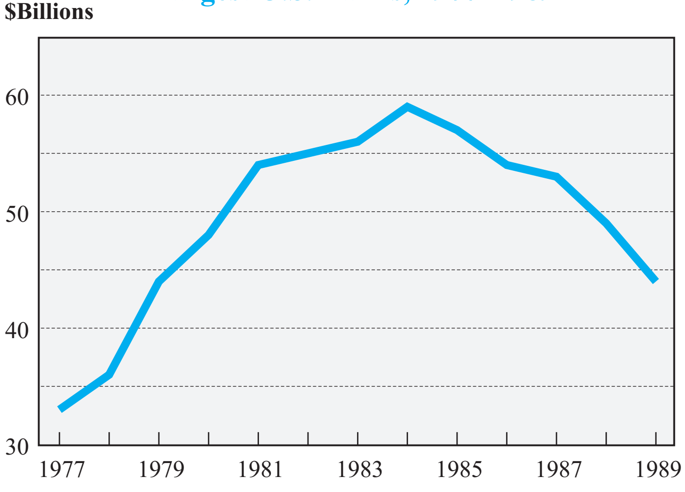
Rate (LIBOR), which repriced approximately every six months. It was estimated that approximately two-thirds of outstanding developing-country debt was tied to floating LIBOR rates.[9] Thus, these credits were especially vulnerable to repricing risk driven by changes in the macroeconomic conditions of the creditor nations.

The largest portion of Latin American claims originated from U.S. banking organizations, primarily the money-center banks, which specialized in managing large syndicated Eurodollar loans. Mid-sized regional and other non-money-center banks often participated in these credits, as well as competing for smaller, trade-related credits. LDC lending by U.S. banks overall increased rapidly in the 1970s, and it especially increased for the eight largest money-center banks. By year-end 1978, they held approximately $36 billion in outstanding credits to Latin America (see figure 5.4). This accounted roughly for 9 percent of total assets and 208 percent of total capital and reserves for the average of the eight money-center banks (see table 5.1a).[10]

The primary motivation for overseas expansion of U.S. banks during the 1970s was the search for new markets and profit opportunities in response to major structural changes

Figure 5.4

Total Outstanding LDC Loans by the Largest U.S. Banks, 1977–1989



Source: FFIEC, *Country Exposure Report* (year-end reports, 1977–89).

[9] World Bank, *World Debt Tables* (1981–82 ed.), xvi.
[10] This total excludes Continental Illinois, which received open-bank assistance in 1984.

Table 5.1a

Average Financial Ratios for Eight Money-Center Banks, 1974–1989

(Percent)

Year	Net Income/ Capital	Net Income/ Assets	LDC Loans/ Total Assets	LDC Loans/ Total Loans	LDC Loans/ Capital	LDC Loans/ Cap + Reserves
1974	13.8	0.51	N/A	N/A	N/A	N/A
1975	13.3	0.53	N/A	N/A	N/A	N/A
1976	11.5	0.49	N/A	N/A	N/A	N/A
1977	10.9	0.45	9.4	16.9	227.9	205.8
1978	12.4	0.49	9.1	16.5	232.0	207.6
1979	13.5	0.51	9.7	17.9	256.3	228.1
1980	13.8	0.53	9.7	17.3	251.7	224.3
1981	12.9	0.51	10.3	17.2	263.9	232.6
1982	12.4	0.51	10.0	16.4	247.1	217.3
1983	11.8	0.53	10.3	16.5	230.1	201.6
1984	10.6	0.51	10.4	16.3	219.5	190.2
1985	9.0	0.43	9.5	15.6	200.5	168.0
1986	8.8	0.44	9.0	15.0	179.2	145.7
1987	–22.2	–0.93	8.9	15.6	211.3	125.3
1988	21.3	1.09	8.5	14.8	167.2	107.3
1989	–9.9	–0.45	7.5	12.7	164.7	93.2

in the domestic market.[11] U.S. commercial banks had been losing their share of household savings to other types of intermediaries and to the capital markets for decades, and shares of traditional loan products had dwindled.[12] For example, since the early 1970s, commercial banks had been losing some of their best clients to the commercial paper market, which would grow rapidly in the 1970s and 1980s (see figure 5.5).[13] L. William Seidman, former chairman of the FDIC, noted in retrospect that "banks' troubles began when they lost their big corporate customers to the commercial paper market early in the 1970s."[14] This reduced share of one of the banks' primary staples, the working capital loan, placed pressure on

[11] The 1970s were relatively unprofitable for the largest commercial banks in the U.S. market. The domestic earnings of the 13 largest U.S. banks actually declined in real terms during the first half of the decade (Thomas H. Hanley, *United States Multinational Banking: Current and Prospective Strategies* [1976], 13).

[12] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts* (various years).

[13] Commercial paper consists of short-term borrowings or IOUs by the largest and best-known corporate organizations.

[14] L. William Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas* (1993), 39.

Table 5.1b
Aggregate Financial Data for Eight Money-Center Banks, 1974–1989
($Millions)

Year	Total Assets	Total Capital	Net Income	Total Loans	LDC Loans	Total Reserves	Provisions for Loans	Total Loan Charge-offs*
1974	$265,916	$ 9,803	$1,348	N/A	N/A	N/A	$ 547	N/A
1975	275,393	11,014	1,461	N/A	N/A	N/A	1,127	N/A
1976	304,307	12,950	1,486	$169,615	N/A	$ 1,431	1,136	$1,084
1977	347,495	14,282	1,554	192,571	$32,554	1,538	905	829
1978	392,572	15,437	1,911	217,269	35,811	1,814	866	598
1979	451,834	17,166	2,320	246,468	43,999	2,123	751	447
1980	490,753	18,918	2,614	274,920	47,614	2,310	873	667
1981	519,436	20,348	2,629	312,275	53,703	2,736	1,065	654
1982	546,729	22,115	2,764	332,799	54,655	3,036	1,583	1,254
1983	541,968	24,211	2,853	337,542	55,704	3,416	1,933	1,518
1984	560,921	26,655	2,835	359,018	58,515	4,107	2,575	1,957
1985	593,235	28,233	2,550	361,849	56,595	5,451	4,301	3,003
1986	605,566	30,343	2,659	362,495	54,387	6,988	4,779	3,426
1987	593,584	24,954	–5,529	338,617	52,720	17,107	13,065	2,875
1988	577,589	29,397	6,268	332,452	49,146	16,390	2,270	2,793
1989	584,847	26,438	–2,616	344,130	43,543	20,284	9,535	5,544

* Total loan charge-offs are net of annual recoveries.

banks to seek new sources of revenue and provided an impetus for them to turn to the lucrative overseas loan markets.[15]

The potential risks of the growing involvement of U.S. banks in LDC debt were not unnoticed. Economists, government officials, and other observers warned of the possible dangers for both individual institutions and the banking system as a whole. In 1977 Arthur Burns, chairman of the Federal Reserve Board, criticized commercial banks for assuming excessive risks in their Third World lending, noting in a speech at the Columbia University Graduate School of Business on April 12 that

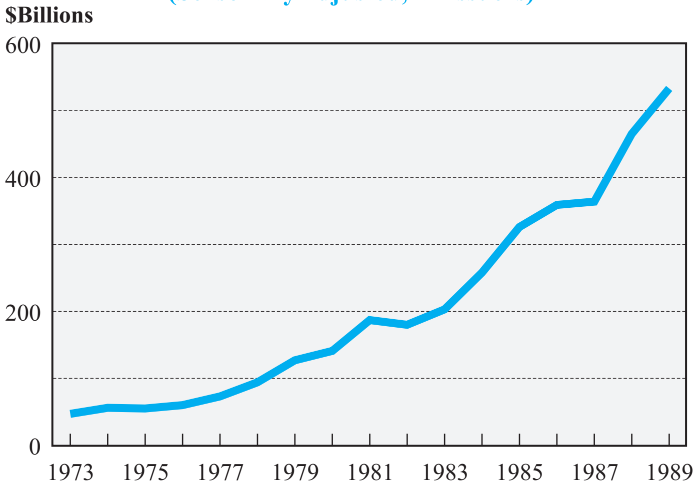
> under the circumstances, many countries will be forced to borrow heavily, and lending institutions may well be tempted to extend credit more generously than is prudent. A major risk in all this is that it would render the international credit structure especially vulnerable in the event that the world economy were again to experience recession on the scale of

[15] Short-term working capital loans were a relatively low-risk product for banks in comparison to the typical medium- to long-term Third World syndicated credit.

Figure 5.5

U.S. Commercial Paper Outstanding, 1973–1989

(Seasonally adjusted, all issuers)



Source: Haver Analytics.

> that from which we are now emerging . . . commercial and investment bankers need to monitor their foreign lending with great care, and bank examiners need to be alert to excessive concentrations of loans in individual countries.[16]

Other economists argued that international organizations should take a more active role in the recycling efforts and warned that the U.S. government would be forced to bail out any U.S. banking organizations that failed.[17]

Congress held hearings on the LDC issue in 1975 and expressed concern about the excessive concentration of Third World loans and its related threat to the capital position of U.S. banks. A 1977 published staff report from the Senate Subcommittee on Foreign Relations noted, "The most immediate worry is that the stability of the U.S. banking system and by extension the international financial system may be jeopardized by the massive balance of payments lending that has been done by commercial banks since the oil price hike."[18]

---

[16] Arthur F. Burns, "The Need for Order in International Finance," Address (April 12, 1977), 4, 5, 13. Seidman recalled that when Burns brought up his misgivings about Latin American debt with the Ford administration, he was not taken seriously (*Full Faith and Credit*, 37–38).

[17] Marina Whitman, "Bridging the Gap," *Foreign Policy* 30 (spring 1978): 148–56.

[18] U.S. Senate Committee on Foreign Relations, Subcommittee on Foreign Relations, *International Debt, the Banks, and U.S. Foreign Policy*, 95th Cong., 1st sess., 1977, 5.

Such pronouncements, however, were frequently greeted as exaggerated even by those who felt some caution was appropriate with regard to LDC debt, and belief in the likelihood of a crisis was not widespread.[19]

Prelude, 1979–1982

During the late 1970s, the signs of impending crisis began to become clearer and were more widely recognized. Some observers believed that the ability of the LDCs to continue servicing their debts (interest on short- and long-term debt plus amortization of long-term debt) was deteriorating quickly. The second major oil shock of the decade occurred in 1979, intensifying LDC debt-service problems.[20] At this time, the debt-service ratios of Latin American nations averaged more than 30 percent of export earnings, a level above what bankers traditionally considered acceptable. Some developing countries, such as Brazil, had debt-service ratios near 60 percent during this period. In addition, rising dollar exchange rates in response to the high U.S. interest rates of the early 1980s increased the difficulty of meeting debt commitments. The value of the dollar increased by 11 percent in 1981 and 17 percent through most of 1982 against the strongest currencies (see figure 5.6). Because the bulk of LDC debt was placed in dollars, the burden of servicing dollar debt became increasingly more difficult over time.[21] Capital flight was also taking place because overvalued exchange rates for some of the larger LDC nations generated fears of devaluation and added to liquidity problems.[22]

Nevertheless, Latin American nations continued their heavy borrowing during these years. Between the start of 1979 and the end of 1982 total Latin American debt more than doubled, increasing from \$159 billion to \$327 billion (figure 5.3). In response to this demand, U.S. banks increased their lending to the LDCs during the crucial four years leading up to the outbreak of the crisis: the outstanding loans of the eight largest money-center banks rose from approximately \$36 billion to \$55 billion, more than a 50 percent increase (figure 5.4 and table 5.1b). This overall risk exposure was reflected in the concentration of LDC loans to total capital and reserves, which was 217 percent at the end of 1982 for the average money-center bank (table 5.1a). This heavy concentration put some of the largest international banks at risk.

---

[19] See, for example, Beek, "Commercial Bank Lending," 1–8. One observer noted that "developing countries look to be good credit risks worthy of a continued flow of new loans as well as refinancing. . ." (Robert Solomon, "A Perspective on the Debt of Developing Countries," *Brookings Papers on Economic Activity* 2 [1977], 479). As late as 1979, an editorial in a daily newspaper described the LDC debt situation as a "major nonproblem" (*American Banker* [March 28, 1979], 4).

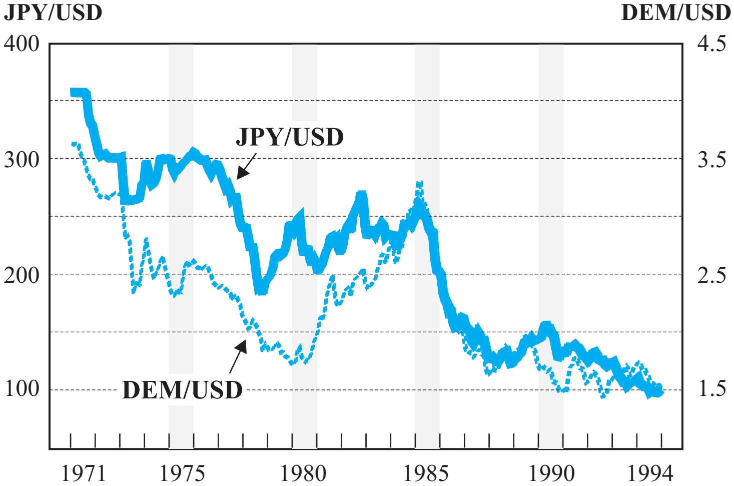
[20] Between year-end 1978 and October 1980, the price of oil more than doubled, reaching \$30 per barrel, while the import bill of all non-oil-producing developing nations rose from \$26 billion to \$63 billion (Madrid, *Overexposed*, 76).

[21] Ibid., 77.

[22] The World Bank estimated that between 1979 and 1982, capital flight from Argentina, Mexico, and Venezuela was almost \$70 billion, or 67 percent of gross capital inflows (*World Development Report* [1985], 64).

Figure 5.6

German Mark and Japanese Yen U.S. Dollar Exchange Rates, 1971–1994



Source: Haver Analytics.

As the LDC debt increased after 1979, so did the warnings of possible problems for U.S. banks. Paul Volcker, the chairman of the Federal Reserve Board during this period, suggested that rising oil prices would mean some rescheduling of debts owed by developing countries.[23] Henry Wallich, a Federal Reserve Board governor, criticized the rapid growth in LDC debt and indicated that the money-center banks' exposure to sovereign risk placed their capital in jeopardy. He believed that additional lending should be restrained by regulatory officials.[24] Others also warned about the potential implications of the accumulation of LDC debt for the U.S. and world financial systems. *The Wall Street Journal* noted in 1981:

> It doesn't show on any maps, but there's a new mountain on the planet—a towering $500 billion of debt run up by the developing countries, nearly all of it within a decade . . . to some analysts the situation looks starkly ominous, threatening a chain reaction of country defaults, bank failures and general depression matching that of the 1930s.[25]

---

[23] James Grant, "Day of Reckoning? Foreign Borrowers May Have Trouble Repaying Their Debts," *Barron's* (January 7, 1980): 7.

[24] Henry C. Wallich, "LDC Debt: To Worry or Not to Worry," *Challenge* (September/October 1981): 8–14.

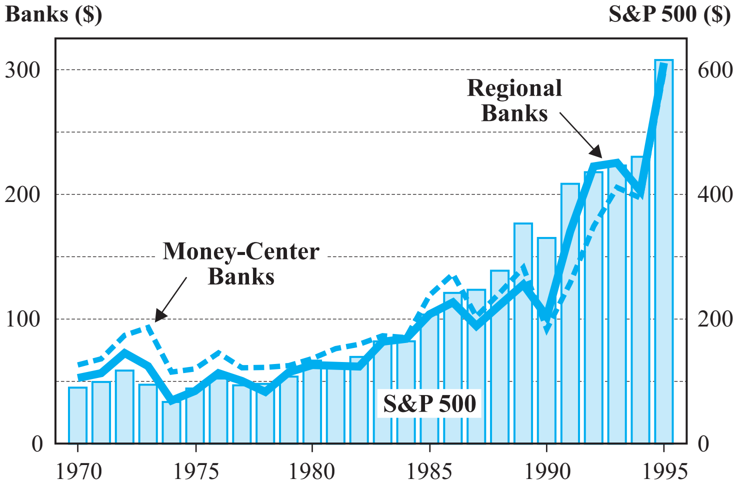
[25] *The Wall Street Journal* (January 23, 1981), 25–28.

But although increasing numbers of observers were paying attention to the signs of approaching problems, the financial markets were generally not sending explicit signals of an impending crisis. For example, an analysis of the trend in annual stock prices for the U.S. money-center and regional banks against the S&P 500 market averages indicates no significant discounting of prices by the market in the years leading up to the crisis (see figure 5.7). For the most part, even up through 1986 the index of stock prices paralleled changes in the overall market averages. From 1987 through the early 1990s, the broader market averages appear to have outperformed bank stocks, producing a gap that partially reflected the effect on bank earnings of the heavy provisioning for LDC loan losses as well as the commercial real estate problems in the late 1980s (see Chapter 3).[26]

Nor did corporate bond ratings of the money-center banks reveal any trend toward weakness or deterioration in the financial position of these institutions in the years leading

Figure 5.7

Share Price of Money-Center Banks and Regional Banks vs. S&P 500, 1970–1995



Source: Salomon Brothers, *Bank Annual* (1996 ed.).

[26] However, at least one study found that from 1966 through 1979 the stock market reacted adversely to the large syndicated loans made to Latin American countries by the money-center banks. According to this study, "syndicated loans to Latin American countries, mainly for the years 1966 to 1979, are associated with significant reductions in shareholder wealth of the participating banks. The continued issuance of these loans throughout the 1970s raises questions about the motives of bank managers or their susceptibility to political pressure or both" (William L. Megginson et al., "Syndicated Loan Announcements and the Market Value of the Banking Firm," *Journal of Money, Credit and Banking* 27 [May 1995]: 498).

Table 5.2
Long-Term Debt Ratings of U.S. Money-Center Banks, 1977–1989

Organization	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
BankAmerica	Aaa	Aaa	Aaa	Aaa	Aaa	Aa1	Aa2	Aa3	Aa3	Baa1	Ba1	Ba3	Baa2
Bankers Trust New York	Aaa	Aa	Aa	Aa	Aa	Aa2	Aa2	Aa2	Aa2	Aa2	Aa3	A1	A1
Chase Manhattan	N/A	N/A	Aaa	Aaa	Aaa	Aa1	Aa1	Aa2	Aa2	Aa2	A2	Baa1	Baa1
Chemical New York	Aaa	Aaa	Aaa	Aaa	Aaa	Aa2	Aa2	Aa2	Aa2	Aa2	A2	Baa1	Baa1
Citicorp	Aaa	Aaa	Aaa	Aaa	Aaa	Aa1	Aa1	Aa1	Aa1	Aa1	A1	A1	A1
First Chicago	Aaa	Aaa	Aaa	Aa	Aa	Aa3	Aa3	Aa3	A1	A3	A2	A3	A2
Manufacturers Hanover	Aaa	Aaa	Aaa	Aaa	Aaa	Aa2	Aa2	Aa3	Aa3	A1	A3	Baa3	Baa3
J. P. Morgan & Co.	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa	Aa1	Aa1

Source: Moody's Bank and Finance News Reports.

up to the crisis (see table 5.2).[27] Primarily because of income from overseas loans, the 1970s and early 1980s were periods of average profitability for the money-center banks. From 1974 to 1982, for example, the average money-center bank averaged a 12.7 percent return on equity and a 0.50 percent return on assets (table 5.1a), approximately equal to and slightly below the overall industry averages of 12.0 percent and 0.70 percent for the same period. Also during this period, for almost all of the large banks, interest and fee income on overseas loans accounted for a substantial portion of total income.[28] Thus, at that time the bond rating agencies did not appear to foresee the consequences of Third World lending.

The corporate bond ratings of the money-center banks did, however, begin to deteriorate in 1982 and continued deteriorating for the remainder of the decade, as LDC losses mounted. In 1982, Bankers Trust New York Corporation, Chemical New York Corporation, First Chicago Corporation, and Manufacturers Hanover Corporation were downgraded below Aaa or the highest levels of Aa status. By 1989, four of the eight organizations (BankAmerica Corporation, Chase Manhattan Corporation, Chemical New York Corporation, and Manufacturers Hanover Corporation) were rated only slightly above investment grade. Citicorp was rated Aa1 in 1982, and by 1987 its rating had deteriorated to A1. Only

---

[27] The only exceptions were Bankers Trust Co., which was downgraded from Aaa to Aa in 1978, and First Chicago Corporation, from Aaa to Aa in 1980.

[28] Between 1977 and 1981, the largest U.S. banks earned $3.4 billion in pre-tax income from Third World loans (Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation, *Developing Country Lending Profitability Survey* [1989], 6).

J. P. Morgan & Co. Incorporated managed to retain its triple-A rating until 1988, when it was downgraded to Aa1.

In the years leading up to the outbreak of the crisis, bank regulatory authorities were aware of the heavy concentration of Third World lending in the large international banks and the threat it posed to bank capital, and they attempted to deal with it in a variety of ways. Trying to slow down the growth of LDC loans, they issued “warning letters” to the boards of lending banks, urging voluntary restraint in new lending. In addition, in 1979 the Interagency Country Exposure Review Committee (ICERC)—composed of officials of the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board, and the FDIC—was established to monitor the exposure of U.S. banks to foreign lending as part of the broader bank examination process. The committee adopted a uniform examination system for evaluating and commenting on country risk to U.S. banks that had relatively large foreign lending exposure. The system became effective in the spring of 1979 and entailed identifying countries with actual or potential debt-servicing problems, drawing bank management’s attention (in examination reports) to loans to these countries, and evaluating bank internal country-exposure management systems. The overall objective was to ensure adequate diversification of bank foreign-lending risk.

However, the efforts made by the regulators appear to have had no significant effect upon the rate of bank lending during the late 1970s and the early 1980s. An analysis of the program by the U.S. General Accounting Office in 1982 suggested that the “special comments by bank examiners have had little impact in restraining the growth of specially commented exposures.”[29] These findings were supported by data that showed continued strong growth of LDC lending by the heavily exposed U.S. money-center banks leading up to the outbreak of the crisis in August 1982 (figure 5.4).

One key bank regulatory decision that did have a bearing on the crisis, however, came in 1979, when the OCC issued a new interpretation of a statute that set limits on the amount of loans a bank could make to a single borrower:[30] by law a national bank was not permitted to make loans to a single borrower in excess of 10 percent of the bank’s capital and surplus.[31] In reality, some of the largest U.S. banks had loaned more than 10 percent of their capital to the various government agencies and government-related corporations of LDCs like Mexico and Brazil during the 1970s (and they would continue doing so into the early 1980s). Such exposure appeared to be in violation of the 10 percent rule.

---

[29] See U.S. General Accounting Office, *Bank Examination for Country Risk and International Lending*, GAO/ID-82-52 (1982).

[30] The OCC is the chartering and primary regulatory authority for all national banks, a category that includes all money-center banks and almost all large U.S. banking organizations.

[31] Title 12 U.S. Code, sec. 84, established 10 percent of capital as a limit of total loans to a single borrower for all national banks. These limits held until passage of the Garn–St Germain Act of 1982, which expanded the limit to 15 percent of capital, and if certain collateral conditions were satisfied, this limit could increase to 25 percent.

In January 1978, the OCC issued a proposed interpretation of the law to address the question of whether all public sector corporations and agencies should be considered one "person" under the loans-to-one-borrower rule and should thus be combined into one group for purposes of regulatory action. In 1979, after 15 months, the OCC issued its final ruling: it concluded that public sector borrowers did not have to be counted as part of a single entity if each borrower had the "means to service its debt" and if the "purpose of the loan involved the borrower's business."[32] The OCC delegated authority for making decisions on these issues to the lending banks. The banks in turn relied upon the statements of the public sector corporations and host governments for compliance with the "purpose" and "means" tests. If the ruling had been that the borrowers should be combined, during the LDC crisis years almost all the money-center banks would have been in violation of the 10 percent requirement.

According to at least one scholar, the OCC's interpretation of this statute during the debt buildup in the late 1970s was an example of regulatory forbearance.[33] This individual maintains that the OCC's ruling gave the large banks tacit approval to continue lending and sent a message from the regulatory authorities that such concentrations of LDC loans did not constitute "unsafe and unsound" banking practices. A Senate committee that examined this issue at the time questioned the effectiveness of the 10 percent rule as interpreted by the OCC, noting that "a single U.S. bank may have loans outstanding to 20 different public entities in Brazil, none of which individually exceeds 10 percent of the bank's capital, but which taken together may far exceed the limit, and still not be in violation of the rule."[34] The decision bank regulatory officials made in 1979 to reinterpret the key loans-to-one-borrower rule may have rested partly on the historical differences between domestic and international regulation of financial institutions. That is, the regulation of the international activities of the nation's largest banks may have been influenced more by issues of competition, trade, and foreign policy than by concerns about domestic safety and soundness.[35] Traditionally banks had greater leeway in their international operations than they were allowed at home, so that U.S. banks had the opportunity to finance Third World deficits while at the same time assuming greater concentrations of risky overseas loans in their portfolios. Regulatory authorities apparently were not anxious to interfere with the overseas lending operations of the international banks. Furthermore, there is some evidence that political pressure was put on bank regulators not to interfere with the Third World lending.[36]

---

[32] *Federal Register* 44 (April 17, 1979): 22712.

[33] See Wellons, *Passing the Buck*, 100–112.

[34] Ibid., 107.

[35] Ibid., 99–100.

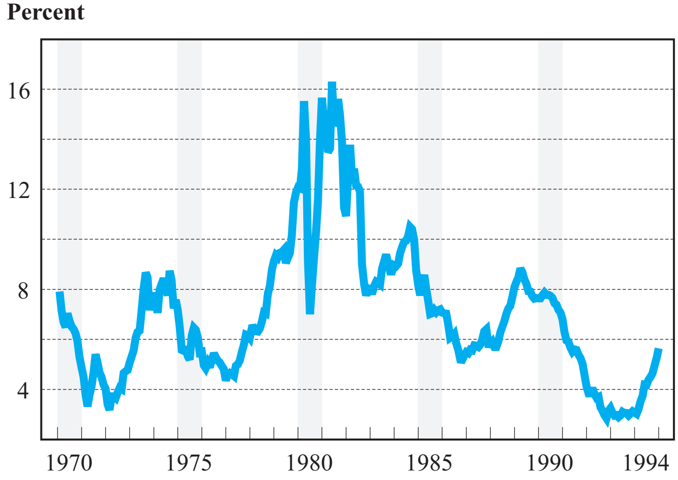
[36] Wellons (99–100) discusses these issues in detail. Seidman discusses attempts by authorities in the executive branch to interfere with the policies of the bank regulatory agencies (*Full Faith and Credit*, 121–24).

Eruption, August 1982

The record-high interest rates of the early 1980s (see figure 5.8), caused by the Federal Reserve's efforts to curb the oil-based inflation of the 1970s, brought on a global recession and helped to trigger the overall crisis.[37] Because most Third World credits were priced to LIBOR rates, debt-service costs grew progressively greater as these rates reached record levels.[38] This situation, coupled with the slowdown in world growth and the drop in commodity prices for the second time in eight years (figure 5.2), left exports stagnant and debt-service commitments hard to meet. Many scholars point to another factor that com-

Figure 5.8

Monthly Treasury Bill Rate (3-Month), 1970–1994



Source: Haver Analytics.

[37] As mentioned, the crisis began with the Mexican government's notification that it was unable to meet its debt-service requirements in August 1982. What specifically triggered the Mexican situation was the combination of high interest rates, which exacerbated debt-service costs for Mexico and the other debtor nations, and the sharp decline in oil prices in 1982. Falling revenues associated with lower oil prices made it especially difficult for Mexico and other oil-exporting debtor nations to service existing debts on schedule.

[38] LIBOR rates were sensitive to changes in short-term U.S. interest rates because Eurocurrency deposits were primarily a dollar-denominated market. LIBOR rates averaged 10.2 percent through 1980; for 1981 and 1982 they averaged 15.8 percent (IMF, *International Financial Statistics* [1983], 92). It was estimated that for every percentage point increase in LIBOR, debt-service costs for all developing nations rose by $2 billion. For these countries, interest payments almost tripled during 1978–80, rising from $15.8 billion to $41.1 billion (Madrid, *Overexposed*, 76).

pounded the debt-service problems: most of the new bank loans to the LDCs from 1979 to 1982 went to cover accrued interest on existing debt and/or to maintain levels of consumption, rather than for productive investments.[39]

In August 1982 the Mexican finance minister indicated that his nation could no longer meet interest payments. By year-end 1982, approximately 40 nations were in arrears in their interest payments, and a year later 27 nations—including the four major Latin American countries of Mexico, Brazil, Venezuela, and Argentina—were in negotiations to restructure their existing loans. For the remainder of the decade bank lending declined significantly, as many banks refrained from new overseas lending and attempted to collect on and restructure existing loan portfolios. From the end of 1983 to 1989, money-center bank loans outstanding to Latin America decreased from $56 billion to $44 billion, a decline of more than 20 percent (figure 5.4 and table 5.1b).

In hindsight, many observers have asked what role, if any, outside pressure played in affecting the banks' lending decisions. There is no evidence to suggest that creditor governments or international organizations forced or pressured banks to make loans in order to recycle funds to Third World nations. Clearly, however, banks were encouraged to do so.[40] Seidman, former economic counselor to President Ford, later remarked that "the entire Ford Administration, including me, told the large banks that the process of recycling petrodollars to the less developed countries was beneficial, and perhaps a patriotic duty."[41] Both the U.S. and other creditor governments believed resources would be allocated more efficiently through private financial intermediaries.[42] Moreover, creditor governments and international organizations such as the World Bank and the IMF did not possess sufficient resources to deal with the recycling issue.[43]

---

39 Seidman, *Full Faith and Credit*, and others (for example, Cline, *International Debt*, and Madrid, *Overexposed*) discuss this issue at some length.

40 As previously indicated, if any outside pressure had been exerted, it would have been directed at regulatory officials to restrain them from interfering with the international banks' LDC lending.

41 Seidman, *Full Faith and Credit*, 38. Seidman also noted that in the 1970s the Ford administration "had a chance to deal with the creation of the LDC debt problem as well as other problems in the financial system, but we just did not see the magnitude of the trouble ahead. We saw only the short-term benefits of the loans to our industry and finance. But then, long-range planning has never been an outstanding attribute of our governmental process."

42 Margaret Garritsen DeVries, *The International Monetary Fund, 1972–1978: Cooperation on Trial* (1985), 923–42.

43 According to one researcher, profit was the primary motive behind commercial bank lending, and direct political pressure played no important role. The same researcher also posited that the banks thought creditor governments or international organizations might rescue the debtor nations in the event of default so that the threat to the banks' capital would have been limited (Madrid, *Overexposed*, 44–60). To what extent this belief led to the psychology of overlending that helped produce the crisis is not known.

Resolution, 1983–1989

The seven-year period after the most serious international financial crisis since the 1930s was devoted to restructuring existing loans, setting aside loss reserves, and attempting to protect the solvency of the U.S. financial system. A decade or more would pass after the crisis before the economies of the LDCs would recover and the banks would clear their books of the bad loans. Bank advisory committees were established to represent the banks in bilateral negotiations with the individual debtor countries for debt reschedulings. These talks lasted until the end of the 1980s and were supported by creditor governments and international financial institutions.

Unlike some European regulatory authorities, immediately after the Mexican crisis U.S. banking officials did not require that large reserves be set aside on the restructured LDC loans or on the succeeding arrearages by other LDC nations.[44] Such a policy was not feasible at the time and might have caused a financial panic because the total LDC portfolio held by the average money-center bank was more than double its aggregate capital and reserves at the end of 1982 (table 5.1a). Thus, regulatory forbearance was also granted to the large banks with respect to the establishment of reserves against past-due LDC loans. According to Seidman, this forbearance was necessary because seven or eight of the ten largest banks in the U.S. might have been deemed insolvent, a finding that would have precipitated an economic and political crisis.[45] He noted that "U.S. bank regulators, given the choice between creating panic in the banking system or going easy on requiring our banks to set aside reserves for Latin American debt, had chosen the latter course. It would appear that the regulators made the right choice."[46]

---

[44] In fairness to the U.S. banks, it should be noted that the European banks were able to establish "hidden reserves" by agreement between regulatory officials and the banks that to some extent were shielded from public scrutiny. In addition, the European banks had less exposure to Third World lending than did the U.S. banks, which made establishing reserves less difficult (Seidman, *Full Faith and Credit*, 127–28).

[45] The regulatory authorities did begin to raise capital standards in the banking industry starting with the OCC's decision to raise minimum capital requirements in 1979 for national banks. Furthermore, the International Lending Supervision Act of 1983 (ILSA) required that all bank regulators achieve and maintain adequate capital standards in the industry by establishing minimum capital levels regardless of whether an institution was heavily involved in international lending. As a consequence of ILSA, all financial agencies established rules that for the first time set uniform capital requirements for all commercial banks, effective April 1985.

[46] Seidman, *Full Faith and Credit*, 127. Another analysis concluded: "Had these institutions been required to mark their sometimes substantial holdings of underwater debt to market or to increase loan-loss reserves to levels close to the expected losses on this debt (as measured by secondary market prices), then institutions such as Manufacturers Hanover, Bank of America, and perhaps Citicorp would have been insolvent." See Robert A. Eisenbeis and Paul M. Horvitz, "The Role of Forbearance and Its Costs in Handling Troubled and Failed Depository Institutions," in *Reforming Financial Institutions in the United States*, ed. George G. Kaufman (1993), 49–68.

In retrospect, this strategy proved to be successful by avoiding a major domestic or international financial crisis. During this period no large U.S. banks failed because of delinquent or nonperforming LDC loans.[47] The large banks were able to maintain funding and liquidity while being given time to raise capital and increase reserves. The overall debt strategy also forced structural adjustments in the LDCs, such as trade liberalization, privatization, deregulation, and tax reform, that eventually brought both growth and investment to several LDC nations. Seidman contrasted the regulatory forbearance of the debt crisis with that of the savings and loan crisis in the United States during the 1980s:

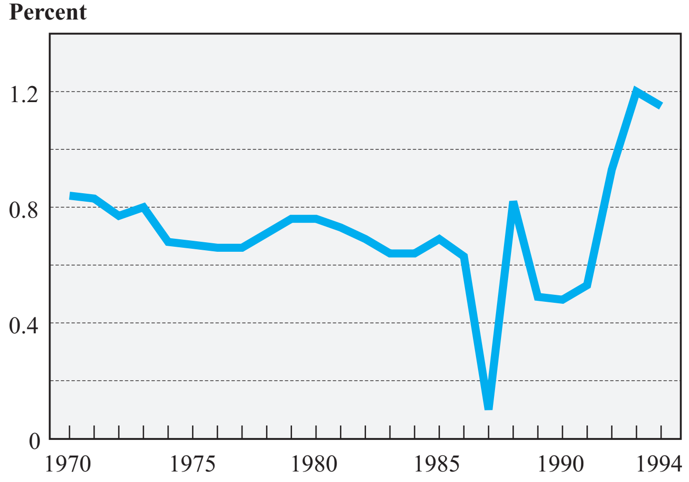
> Sometimes forbearance . . . is the right way to go, and sometimes it is not. In the S&L industry, all rules and standards were conveniently overlooked to avoid a financial collapse and the intense local political pressure that such a collapse would have generated. But in this case there was not a visible plan for a recovery, so the result of this winking at standards was, as we know, a national financial disaster. On the other hand, in the case of Latin American loans, forbearance gave the lending banks time to make new arrangements with their debtors and meanwhile acquire enough capital so that losses on Latin American loans would not be fatal. Like medicine and the other healing arts, bank regulation is an art, not a science.[48]

The average profitability of money-center banks in the earlier periods contrasts sharply with that in the post-1982 years. For the average money-center bank during the 1983–89 period, net income to total capital and net income to total assets averaged only 4.2 percent and 0.23 percent—returns significantly below the industry averages of 9.0 percent and 0.55 percent. Moreover, for the years 1987 and 1989, the average money-center bank experienced negative returns (table 5.1), bringing down total earnings for the U.S. banking industry during the two years (see figure 5.9).

This slowdown in earnings was reflected in the substantial buildup in loan charge-offs, loan-loss provisions, and the accumulation of total reserves recorded over the 1983–89 period (tables 5.1a and 5.1b). Although between 1982 and 1986 the loan-loss reserves for the average international bank more than doubled, as of year-end 1986 they were still only approximately 13 percent of the total LDC loan exposure. Starting in 1987, however, the money-center banks began to recognize massive losses on LDC loans that in some instances had been carried on the books at par for more than a decade. After extensive bilateral negotiations with the LDCs beginning in 1983, the banks realized that a large portion of the loans would not be repaid. In May 1987 Citicorp was the first major bank to break ranks and recognize a loss, establishing loss provisions for $3.3 billion, or more than 30 percent of its total LDC exposure. Shortly thereafter all of the other major banks followed

[47] Continental Illinois National Bank failed in 1984 primarily because of losses on energy and energy-related loans.
[48] Seidman, *Full Faith and Credit*, 128.

Figure 5.9
Return on Assets,
U.S. Banking Industry, 1970–1994



suit. By year-end 1989, the average money-center bank had total reserves that were almost 50 percent of their total outstanding LDC loans.

The creation of a plan in 1989 by Nicholas Brady, secretary of the treasury in the Bush administration, was a recognition by the U.S. government that troubled debtors could not fully service their debts and restore growth at the same time; the plan therefore sought permanent reductions in principal and existing debt-servicing obligations. This recognition paved the way for negotiations between the creditor banks and debtor nations to shift primary focus from debt reschedulings to debt relief. As part of the process, substantial funds were raised from the IMF, the World Bank, and other sources to facilitate debt reduction. Debtor nations used such funds to exercise options such as debt-equity swaps, buybacks, exit bonds, and other solutions. To qualify for borrowing privileges, debtor countries had to agree to introduce economic reforms within their domestic economies in order to promote growth and enhance debt-servicing capacity. It is estimated that under the Brady Plan agreements between 1989 and 1994, the forgiveness of existing debts by private lenders amounted to approximately 32 percent of the $191 billion in outstanding loans, or approximately $61 billion for the 18 nations that negotiated Brady Plan reductions. These losses accrued primarily to the shareholders of lending banks.[49]

[49] See William R. Cline, *International Debt Reexamined* (1995), 234–35. The losses mentioned here accounted for the majority of all losses derived from the LDC crisis. Some additional losses accrued to individual creditor nations that forgave direct loans to various LDC countries.

The Brady Plan set the stage, therefore, for finally solving the LDC debt problem. But negotiations were tedious, and they dragged on for years under the direction of the United States, other creditor nations, and the international lending organizations. In the end, the Brady Plan was the only basis on which a comprehensive solution to the Third World debt problem could be achieved. As one money-center banker stated, "It's an imperfect, inefficient, frustrating system but in the end, it's the best that we've been able to devise."[50]

Conclusion

From the middle to late 1970s, a number of economists, government officials, and journalists expressed concerns that the volume of lending to less-developed countries could entail serious problems for U.S. money-center banks and the international financial system. At the same time, however, the market—as reflected in both money-center bank equity prices and corporate bond ratings—apparently did not perceive a problem until the crisis actually broke out. Regulators' attempts to urge banks to curtail LDC lending appeared to have had no significant effect on lending practices, even as evidence suggested that Latin American nations were having increasing difficulty meeting current debt obligations. The regulatory system therefore broke down and was unable to forestall the crisis. In the final stages, the realization that banks would not recover the full principal value of existing loans turned international efforts from debt rescheduling to debt relief, and substantial funds were raised through the IMF and the World Bank to facilitate debt reduction. The shareholders of the world's largest banks assumed the losses under the Brady Plan, which ended the crisis after a decade of negotiations.

The LDC experience, as reflected in the regulators' handling of large banks after the crisis erupted, illustrates the high priority given by banking authorities to maintaining stability in the banking system. It also represents a case of regulatory forbearance with respect to certain supervisory rules and standards. The 1979 interpretation of the loans-to-one-borrower rule allowed banks to continue lending, and the delay in recognizing loan losses avoided the repercussions that could have threatened the banks' solvency. Over time forbearance proved to be successful, however, because loss reserves and charge-offs were greatly increased and no money-center bank failed because of LDC lending.

[50] Interview published in *Latin Finance* (March 1989): 39, as cited in Madrid, *Overexposed*, 110.