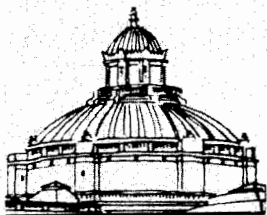


Issue Brief

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THE STABILITY OF THE INTERNATIONAL BANKING SYSTEM
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ISSUE DEFINITION

The rapid growth of international banking in the last decade, combined with the recent debt problems of Mexico, Brazil and Argentina, have given rise to considerable concern about the stability of the international banking system. This issue brief, which focuses on the international banking system, assesses the special risks of international bank lending, major cases of international bank failures, the LDC debt problem, the possibility of default, governmental actions to reduce the risks of international lending, and policy options.

BACKGROUND AND POLICY ANALYSIS

International banking, as used here, is the accepting of deposits from, or making of loans to, foreign governments or private entities in foreign countries by private banks. It includes, but is not limited to, the Eurocurrency market. The Eurocurrency market consists of deposits in and loans of a bank in one country, but in the currency of another country.

Growth of International Banking

Regardless of how it is measured, international banking has grown very rapidly since 1970. For example, the net size of the Eurocurrency market grew from \$65 billion in 1970 to \$1,351 billion in September 1984. Another example is claims (largely loans) on foreigners by U.S. banks (including foreign branches), which increased from \$42 billion in 1970 to \$409 billion at the end of September 1984.

The following are the main reasons for the rapid growth in international banking:

1. The growth of world trade and multinational corporations increased the need for financial facilities in many countries;
2. OPEC countries deposited a large part of their "petrodollars" (mainly dollars acquired from oil exports minus OPEC imports of goods and services) in commercial banks, which were eager to take advantage of the large potential profits in foreign lending;
3. U.S. capital controls, such as the interest equalization tax on long-term bank loans to foreigners and the voluntary limitation on bank lending abroad, both in effect from 1965 to 1974, stimulated the growth of the Eurodollar market. The removal of capital controls increased the international mobility of funds; and
4. The freedom of Eurocurrency activities from regulations such as reserve requirements and deposit insurance lowers their costs. Spreads between borrowing and lending rates are then lower, which attracts both deposits and loans.

Country Risk

Both domestic and international loans are subject to credit risk -- the risk that borrowers will not earn enough to pay the principal or interest on the loan. In addition, international loans are subject to country risk, which is generally defined as the risk that social, political, legal, or economic changes in a country may prevent a foreign government or foreign firms from servicing their debt. Country risk includes such possibilities as nationalization of companies, expropriation of assets, as well as economic changes (such as excessive inflation rates or government spending) that may ultimately prevent the country from meeting its foreign debt obligations. Also included is the possibility that exchange controls may be imposed by the borrowing country or that currency fluctuations may reduce the value of the loan to the lender.

A bank can minimize the effect of country risk on its operations by ---

1. continuing to evaluate the borrowing country's economic, social, and political development and taking appropriate action with regard to loans and deposits if these factors change; and
2. limiting country exposure (the total amount of loans outstanding to a country, including public and private, as a proportion of the bank's capital) to a reasonable amount.

Maturity Mismatching

The acceptance of short-term deposits combined with long-term loans involves both an interest rate risk and a liquidity risk. The interest rate risk is the risk that the rates banks pay for deposits may rise relative to the rate they receive on loans. Although rates on most foreign loans "float" (change at intervals such as every six months in line with general rates of interest), the volatility of interest rates in recent years has increased the possibility of profits or losses from this source.

The liquidity risk, or chance that a bank will not be able to maintain its existing level of deposits, is thought to be greater in international lending than in domestic lending. Instead of maintaining large amounts of liquid assets, international banks rely heavily on their ability to borrow funds from other banks as needed in the interbank market (the market in which banks loan excess funds to other banks). It is estimated that the number of banks in the interbank market has grown from about 200 in 1973 to over 1,000 in 1982. (including many U.S. banks) and that interbank transactions may account for as much as 70% of total Eurocurrency deposits.

The potentially long chain of transactions in the interbank market means that the problems of one bank may spread quickly to other banks. Furthermore, since very little public information is available on the interbank market, rumors may spread quickly and one bank's alleged problems may soon lead to liquidity problems for other banks, even if the rumors are unfounded. In other words, a crisis of confidence can spread very rapidly in the interbank market.

Foreign Exchange Mismatching

If a bank has a substantially unequal amount of deposits and loans in one currency, changes in foreign exchange rates may result in large profits or losses. The volatility of foreign exchange rates since the floating exchange rate system was adopted in March 1973 makes this risk considerable at times.

Inadequate Supervision, Regulation or Disclosure

Supervision, regulation, and disclosure requirements are not consistent for banks operating in different countries. This means that, within the international banking system, attention given to loan loss reserves, capital adequacy ratios, and country exposure is not uniform and may be inadequate in some cases. Also, inadequate disclosure may prevent private market participants from knowledgeably evaluating the bank's performance; where this occurs effective "market discipline" is not available.

Lender of Last Resort

Considerable uncertainty exists with regard to Lender of Last Resort (LLR) facilities in international banking. A LLR is the provision by an official body (usually the central bank of a country) of credit to banks or the banking system generally when the financial system is under stress. The purpose of LLR arrangements is to maintain the stability of the banking system, not to provide aid to individual banks. The Federal Reserve system is the LLR to domestic banks in the United States.

In general, the following are the concerns about LLR arrangements in international banking:

1. Will all international banks have access to a LLR?
2. Will the central bank of the host country or the parent country be responsible for branches, subsidiaries and consortium banks?
3. Will LRRs have enough foreign exchange to meet possible needs?

MAJOR INTERNATIONAL BANK FAILURES

Three major international banks have failed since 1974. In only one case, that of the Franklin National Bank, did the national central bank act as an LLR to international banks.

The German authorities closed I. D. Herstatt on June 26, 1974, after the bank lost more than half of its assets. It had been relying on profits from foreign exchange trading and gold speculation for income. Herstatt was closed at 4 p.m. West German time, after part of the intra-day foreign exchange settlements had been made. Herstatt had received Deutsche marks from foreign banks but the matching dollar payments to the foreign banks had not yet been cleared. The Deutsche Bundesbank (the West German central bank) did not take responsibility for the matching payments and several foreign banks lost considerable sums of money.

The Franklin National Bank, the twentieth largest bank in the United States with assets of over \$4 billion in mid-1974, was declared insolvent by the Comptroller of the Currency on Oct. 8, 1974. A reduced credit rating and large losses on foreign exchange and municipal securities trading caused depositors to withdraw substantial amounts of funds. The liquidity crisis was particularly severe in the London and Nassau (Bahamas) branches, which could not obtain funds in the interbank market and borrowed from the head office, which borrowed from the Federal Reserve. This was the first time outflows at foreign branches were covered by borrowing from the Federal Reserve. The Federal Reserve also took responsibility for Franklin National's foreign exchange commitments.

In August 1982, Banco Ambrosiano was liquidated by the Italian authorities and declared bankrupt in court. The Bank of Italy, in June 1982, had requested details of loans made by Banco Ambrosiano Holdings, a Luxembourg subsidiary of Banco Ambrosiano. To prevent a run on the parent bank, the Bank of Italy arranged for six Italian banks to support the parent bank, but no support was given to the subsidiary. The Luxembourg banking commissioner argued that since the subsidiary was not a bank (actually it was a holding company) in Luxembourg, it was not his responsibility. Since then, the subsidiary's assets have been frozen by the Luxembourg courts because the subsidiary was in default on a loan. The liquidated parent bank has been succeeded by the Nuova Banco Ambrosiano S.P.A., which includes only the domestic activities of the Banco Ambrosiano group.

Continental Illinois National Bank and Trust Co., a U.S. bank, nearly collapsed in the spring of 1984. After making imprudent domestic loans, especially in the energy area, confidence in the bank was reduced and, according to press reports, many foreign depositors withdrew funds, which precipitated a crisis. In May 1984, Federal regulators announced an interim financial assistance program, in which all deposits were protected. A permanent assistance program was announced by the U.S. Government in July 1984. The Federal Deposit Insurance Corporation (FDIC) will assume most of Continental's problem loans and provide permanent capital and other direct assistance to Continental.

LDC DEBT PROBLEM

As of mid-1983, the international debt of non-oil developing countries is estimated to be about \$640 billion. About \$327 billion of this amount was owed to foreign banks (the remainder to governments and international organizations). Of the \$327 billion, about \$104 billion was owed to banks in the United States. Of the \$104 billion, about \$64 billion was owed to the nine largest U.S. banks, and was about 212% of their capital. The nine largest U.S. banks are highly exposed in Mexico, Brazil and Argentina; loans to these three countries combined, \$32 billion, represent 106% of the capital of the top nine U.S. banks.

The LDC debt problem became serious in August 1982 when Mexico, whose total foreign debt was about \$80 billion, announced it could not service its foreign debt. Since then, the debt problem has spread to many other countries, but is most serious in Brazil and Argentina.

Two major causes of the LDC debt problem are believed to be the global recession and high interest rates. First, the world recession caused a substantial decline in the volume of LDC exports and a drastic drop in commodity prices. This reduced the value of LDC exports and the amount of

foreign currency available to service foreign debt. Second, in recent years, most large bank loans have been made at "floating" interest rates, which change daily. The current market interest rate applies to all outstanding floating-interest debt (with an average time lag of about 6 months), not only to new debt. Consequently, the increase in market interest rates from 1979 through mid-1982 had a large effect on interest payments by developing countries and on their ability to service foreign debt.

Most analysts believe that inappropriate domestic policies in some developing countries also contributed to the debt problem. For example, in 1982, the Mexican government permitted its budget deficit to increase substantially relative to GNP, and allowed the peso to become seriously overvalued, which led to a large capital flight abroad, and exhausted Mexico's foreign exchange reserves.

According to some analysts, the commercial banks were at least partly responsible for the debt crisis. Their argument is that banks overloaned to developing countries because foreign loans were very profitable. Furthermore, it is argued, foreign loans were assumed to be relatively risk-free because country borrowers would be unlikely to default and, if a problem arose, governments or the IMF would come to the aid of commercial banks.

The LDC debt crisis caused considerable uncertainty regarding the stability of the international banking system. The current strategy for dealing with the debt problem of a particular country involves the country, the commercial banks, governments of industrial countries, the International Monetary Fund (IMF) and the Bank for International Settlements (BIS). In the first instance, bridge financing has been provided to the country, usually by industrial-country governments and, until recently, by the BIS, while the country negotiates with the banks and applies for an IMF loan. Ultimately, an agreement is reached whereby the IMF makes a loan to the country, the country agrees to adopt negotiated austerity conditions to stabilize its economy, some of the debt is rescheduled, and the commercial banks agree to continue lending to the country.

POSSIBILITY OF DEFAULT=

The possibility of a country default can be analyzed in two ways. First, a country may be unable to service its debt due to adverse world economic conditions or to mismanagement of the borrowing country's economy. As discussed earlier, adverse world economic conditions are an important cause of the current problems of developing countries.

Secondly, a country may be unwilling to service its debt. In international lending, ~~the possibilities of attaching~~ the assets of a defaulting country are very limited. The lender's most effective weapon is the threat of withholding future loans to a defaulting country. This threat has been effective in the past and most observers believe that it will continue to be effective, since the economic growth and international trade of most borrowing countries would be severely restricted if international loans were not forthcoming. On the other hand, some analysts argue that a default is possible because the burden of debt for some countries may be so great that freedom from the debt would outweigh the disadvantages of reduced access to future international borrowing.

Some analysts argue that the high exposure of the banks to countries such

as Mexico puts the borrowing country in a stronger negotiating position than the bank when rescheduling the debt. According to an old adage "if a loan of \$1 million cannot be repaid, the borrower is in trouble; if a loan of \$1 billion cannot be repaid, the bank is in trouble." Moreover, several small countries could, by combining to negotiate debt rescheduling and with the implied threat of a joint default, be in a strong bargaining position vis-a-vis the banks.

If a default occurred, loans would have to be written off as bad debts, although since only the loans coming due in each year would be written off in that year, the effect would be spread out over several years. Bank capital and bank earnings (and tax revenues) would decline, perhaps causing a decline in capital/loan ratios, which would restrict bank loans to domestic firms in the future. A default also might make banks less willing to finance international trade, leading to a reduction in U.S. exports and ultimately in U.S. production and jobs. The ultimate effect of a country default is difficult to predict, since it depends on the size of the defaulting loans relative to bank capital and what, if any, actions governments would take to mitigate such a default.

In the post World War II period, no free-world country has defaulted on its debt; instead, debt has been rescheduled which, in the case of the private banking system, is a time-consuming, costly, and to some extent, cumbersome procedure. As the number of banks involved in loans to each country has become very large, and the size of the loans to be rescheduled has also grown, the rescheduling process has become more difficult. Since many loans have cross-default clauses (if one bank declares a loan in default, all other loans to that country are in default), the possibility exists that one bank could cause a widespread default; consequently, rescheduling has become more risky.

One or more country defaults or serious possibilities of defaults could cause a crisis of confidence, in which depositors withdraw or shift funds. Liquidity problems, especially in the interbank market, might spread rapidly. While central banks could supply credit, the LLR arrangements in international banking are not clearly defined. Moreover, provisions of credit by LLRs would increase national money supplies and ultimately might well be inflationary.

GOVERNMENTAL RESPONSE

Steps have been taken to reduce the risks in international banking on both the international and national levels.

International Cooperation

Bank for International Settlements: The Central bank governors of the Group of 10 (Belgium-Luxembourg, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, and United States) and Switzerland have been meeting at the Bank for International Settlements (BIS) in Basel since 1960. Prior to 1974, however, regulation and supervision were generally regarded by the central banks to be only of national concern.

In response to the bank problems of 1974, the governors issued the following communique in September 1974:

"The governors had an exchange of views on the problem of lender of last resort in the Euromarket. They recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary."

This was interpreted by some to mean that the major central banks would act as a LLR to banks experiencing difficulties. A Committee on Banking Regulation and Supervisory Practices (known originally as the Blunden Committee and later as the Cooke Committee) was established at that time.

Perhaps the main achievement of the Cooke Committee was the Basel Concordat, which was endorsed by the central bank governors in December 1975. The goal of the Basel concordat is to maintain a healthy international banking system through effective supervision. In general, the Concordat provides the following guidelines:

1. All foreign banks should be supervised adequately;
2. Supervision of foreign banks should be the joint responsibility of the host and parent authorities;
3. Supervision of liquidity should be the responsibility mainly of the host authorities. The supervision of solvency of foreign branches should be the responsibility of the parent authorities. Supervision of subsidiaries' solvency should be mainly the responsibility of the host authorities, although parent authorities should be concerned with exposure of subsidiaries and joint ventures because of the parent bank's moral commitment; and
4. Parent and host authorities should provide information to each other and allow bank inspections by parent authority in the host country.

In May 1983, a statement entitled "Principles for the supervision of banks' foreign establishments", which replaces the 1975 Concordat, was released by the Cooke Committee. Although the guidelines for bank supervision remain basically the same as those given in the 1975 Concordat, the 1983 statement reformulates and elaborates on the 1975 guidelines. In addition, the 1983 statement includes the principle of supervision on a consolidated basis (including foreign branches, subsidiaries and affiliates, so that a bank's total capital adequacy and risk exposure can be evaluated, a principle that was endorsed by the Cooke Committee after the 1975 Concordat was released. The 1983 statement also specifically notes that: (1) the statement is concerned with supervision of international banking, not the lender-of-last resort function of central banks; and (2) the guidelines provided in the statement are goals toward which members have agreed to work, but are not at present implemented in the laws of all member countries. Copies of the 1975 Concordat and the 1983 statement can be obtained by calling the author at CRS.

International Monetary Fund: One of the function of the International Monetary Fund (IMF) is to provide temporary balance of payments financing to countries under certain conditions. Since balance of payments problems are often closely related to borrowing countries' inability to service their

debt, the IMF has often been involved in the debt negotiation process. Perhaps more important, however, is that balance of payments financing by the IMF is conditional upon the acceptance by the debtor country of austerity measures, such as monetary and fiscal policy changes, which will ultimately improve the conditions leading to the balance of payments crisis. This IMF conditionality requirement is important to the commercial banks in a debt negotiation process because the IMF is the only organization that can force a country to "put its house in order."

The size of IMF quotas (the basic resource of the IMF) are evaluated periodically and increased by the members when necessary. Since IMF resources were relatively low in late 1982, negotiations for the IMF quota increase scheduled to take effect in 1985 were speeded up. On Feb. 10-11, 1983, the Interim Committee of the IMF decided to increase IMF quotas by 47%, from \$67 billion to about \$98 billion, subject to ratification by national governments. The U.S. share of the IMF quota increase, \$5.8 billion, was authorized and appropriated by Congress in P.L. 98-181, which became law on Nov. 30, 1983. By Mar. 15, 1984, 142 countries (out of a possible 145) had consented to the quota increase; consequently, quotas have been raised to SDR 89 billion.

In addition, on Jan. 18, 1983, the finance ministers of the Group of 10 countries and Switzerland agreed to expand the General Arrangements to Borrow (GAB) from the present \$7 billion to about \$19 billion. The GAB, which were established in 1962, are loan commitments between the IMF and each of the Group of 10 countries and Switzerland under which the IMF may, with the agreement of the lending country, borrow up to specified amounts from each country when needed for IMF loans to other Group of 10 countries. Under the agreement of Jan. 18, Switzerland will become a full member of the Group of 10 (making it the Group of 11) and IMF borrowings from the expanded GAB will be made available to developing countries as well as Group of 10 countries. P.L. 98-181 authorized and appropriated the funds for the U.S. participation (\$2.6 billion) in the enlarged GAB.

U.S. Government Response

After the 1974 banking problems, the U.S. regulatory authorities (the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation) examined their procedures for the disclosure and supervision of international banking activities of U.S. banks and their foreign offices. Effective in the spring of 1979, bank examination procedures were changed to include a uniform system for evaluating and commenting on country risk to those U.S. banks who are large foreign lenders. The uniform risk examination system is managed by the Interagency Country Exposure Review Committee, which is composed of nine members, three from each of the regulatory agencies. Under this system, countries with actual or potential debt problems are identified and brought to the attention of bank managers in examination reports, and the country exposure management systems of banks are evaluated.

International bank lending is now measured on a consolidated bank basis (including foreign lending of both head offices and foreign offices). Country exposure data for all banks combined are available in a report, Country Exposure Lending Survey, published jointly by the Comptroller the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve Board.

In October 1982, the Securities and Exchange Commission (SEC) announced a guideline for disclosure of foreign problem loans by U.S. bank holding companies. If payment is delayed by any country, bank holding companies whose loans to that country exceed 1% of their total loans must disclose the problem loans.

On June 13, 1983, the Federal Reserve Board and the Comptroller of the Currency announced a guideline that the 17 largest U.S. banking organizations maintain capital equal to at least 5% of their assets. For purposes of the 5% guideline, capital includes equity, reserves for loan losses and mandatory convertible securities. Twelve of the seventeen largest banking organizations already meet the 5% guideline; the remaining five have 2 years in which to comply. The 5% guideline is the same as that which already applies to bank holding companies (other than the 17 largest) with assets exceeding \$1 billion.

During congressional discussions of the IMF legislation, possible bank regulatory changes were a major topic of discussion. The main provisions of the International Lending Supervision Act of 1983 (part of P.L. 98-181, enacted Nov. 30, 1983) require:

1. strengthened supervision of international lending;
2. establishment of special reserves for problem foreign loans;
3. amortization of front-end rescheduling fees;
4. increased collection and disclosure of international lending data; and
5. maintenance of adequate capital by banks.

Several steps have been taken to implement some of the above provisions. In February 1984, the three U.S. bank regulatory agencies issued a regulation regarding the establishment of reserves for bank loans to countries having protracted difficulty servicing their debt. Also, in February, the Federal Reserve adopted a rule requiring banks to submit quarterly reports on their foreign lending. Regulations have been issued requiring banks to maintain capital/asset ratios of 5%, and to limit fees in rescheduled loans to administrative costs, spread over the life of the loan.

RESPONSE OF PRIVATE BANKS

As the banks became aware of the problems of Mexico, Argentina and Brazil, they reduced lending to these and other developing countries, which worsened the problem. The IMF, and governmental authorities in the industrial countries are urging banks to continue lending as discussed earlier. The large U.S. commercial banks, which are heavily exposed, continued making loans to the LDCs, but many smaller banks resisted increasing their relatively small exposure abroad.

After a meeting of officials of 31 North American, European, and Japanese banks (known as the Ditchley International Financial Group) in New York City in October 1982, the establishment of an international banking institute was announced. The main purpose of this institute, which began operating in January 1984, is to identify future debt problems by improving the quantity and quality of data on the economic and financial condition of borrowing countries.

POLICY OPTIONS

Policy options fall into two major categories: those aimed at strengthening the international banking system generally and those concerned with alleviating the current LDC debt problem. The main options aimed at strengthening the international banking system are listed below. It should be noted that international cooperation is necessary for successful implementation of most of these options.

Require Banks to Establish Larger Reserves for Potential Loan Losses. While larger reserves reduce the riskiness of foreign loans, they also reduce bank earnings and, if only one country requires larger reserves, that country's banks would become less competitive than foreign banks. The International Lending Supervision Act of 1983 required the establishment of reserves for problem foreign loans of U.S. banks.

Impose Limits on Country Exposure of Banks. This option was mentioned during congressional discussions of the IMF legislation. In the current situation, commercial banks are being asked to continue lending abroad, and country limits would be counterproductive.

Increase Disclosure of Data. Improved data availability and timeliness, especially regarding the interbank market, might encourage more effective market "discipline" of international bank lending. Some steps are already being taken to improve data on bank lending abroad; for example, the International Lending Supervision Act of 1983 requires increased collection and disclosure of data for U.S. banks.

Improved Supervision of International Banks. The International Lending Supervision Act of 1983 requires improved supervision of U.S. banks, and supervision of international banks by other industrial countries has been considerably strengthened in recent years. The lack of adequate supervision of banks in certain offshore banking centers, however, is a weak link in the international banking system.

Establish an International System of Deposit Insurance. To be effective in preventing a run on deposits, such a system would have to cover all bank deposits in all countries, which appears to be politically impossible.

Clearer Worldwide LLR Assurances. This option might improve confidence in the banking system and make sudden withdrawals of deposits less likely. On the other hand, LLR assurances may cause banks to take greater risks when making loans, since the banks may believe the central bank will always "bail them out." To prevent excessive risk taking by banks, well-specified LLR assurances should be combined with supervision and regulation by the authorities. The disparity of regulatory and supervisory practices among countries makes it difficult to specify LLR terms internationally.

As mentioned earlier, the LDC debt problem is currently being managed by a combination of loan rescheduling, IMF loans, negotiated austerity conditions for the borrowing country, and new lending by commercial banks. According to

many analysts, the strong U.S. economic recovery and continued strengthening of the economies of the borrowing countries has reduced the severity of the crisis.

Other analysts argue that the economic recovery, even if it continues strong, will not be adequate to resolve the problem, and that the austerity conditions adopted by the borrowing countries are too restrictive and will lead to political problems in those countries. According to this argument, the LDC debt problem will only be resolved by reducing the burden of the debt to the LDCs by proposals such as restructuring the debt at lower interest rates for longer time periods, or by requiring the banks to write off part of the debt. Opponents of these proposals argue that they would reduce the willingness of commercial banks to continue lending to LDCs and, in the absence of increased official lending to LDCs, the LDC problem would not be manageable.

CONCLUSION

Most analysts believe that the probability of a collapse of the international banking system is small. Substantial progress has been made in improving supervision and information disclosure since 1974 and cooperation among central banks and bank supervisory authorities in different countries is greater than ever before. It is likely that, in the event of a crisis, international arrangements would quickly be negotiated to stem the crisis.

One or more country defaults are possible, however, although not likely. It is possible, for example, that political pressures in some LDCs may force their governments to default on foreign loans. And, of course, if a country with a large amount of foreign debt defaulted, it could have a substantial adverse effect on the international banking system.

LEGISLATION

Legislation in the 98th Congress

P.L. 98-181, H.R. 3959

Title VIII authorizes U.S. participation in the IMF quota increase of \$5.8 billion and the U.S. share of the enlarged GAB of \$2.6 billion. Title IX appropriates the funds for the IMF quota increase and the expanded GAB. Title IX requires changes in bank supervision and practices. Introduced Sept. 22, 1983; passed the Senate, amended, Nov. 17, 1983; passed the House, amended, Nov. 18, 1983. Signed into law Nov. 30, 1983.

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