



**Shadow Financial  
Regulatory Committee**

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Statement No. 46

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Statement of the Shadow Financial Regulatory Committee

on

Proposals to Modify Loan Loss Reserves  
for Third World Debt

September 18, 1989

Concern about the willingness of domestic banks to continue participating in official efforts to deal with the Third World debt problem is reflected in recently introduced legislation by Representatives Fauntroy and LaFalce that would provide inappropriate incentives for banks to engage in the debt rescheduling contemplated in the Brady Plan. Under this legislation, institutions would be required to increase substantially their reserves against loans to financially troubled countries unless they participated in the extension of additional credit.

The implication of this legislation is that U.S. banks are currently significantly underreserved for these loans. To the extent this is correct, the increase in reserves is desirable.

However, the responsible bank regulatory agency simultaneously would be directed to treat any new loans

made as part of a debt restructuring or financing program as reducing the exposure on existing loans. This introduces a new form of Congressional loan-loss accounting that intentionally overvalues loans, and hence artificially inflates the stated regulatory capital of banks that cooperate with the Brady Plan, without affecting the banks' real capital.

Prudent bank supervision would require institutions to reserve against declines in credit quality of any outstanding loan. To provide Congressionally mandated forbearance in the form of reductions in required additions to loan loss reserves in return for participating in rescheduling of Third World debt is unsound and corrupts the integrity of the bank supervisory process.