Journal of Commerce 4/14/89

Money Center Banks Positioned To Forgive Some LDC Loans

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CHICAGO — Money center banks are well-positioned to forgive a large portion of their Third World loans without threatening the stability of the financial system, Duff & Phelps analysts said.

Since mid-1987, most U.S. money center banks have substantially increased their reserves against less-developed country loans. As a result, they are now ready to begin to write-down some of the debt, the analysts said Thursday.

"During the time that LDC debt was greater than 100% of most bank's equity and reserves, material mark-downs could have threatened bank solvency," said Richard Mueller, a vice president at Duff & Phelps, a Chicago-based rating agency. "Now, with bank reserves considerably higher, they are better able to deal with the situation."

To a considerable extent, the move by banks to increase their reserves provided the conditions under which debt forgiveness could be considered, thus paving the way for the Brady initiative, Mr. Mueller said.

Under the Brady initiative, banks are expected to write down some LDC debt in exchange for guarantees on the remaining credits. Although details have yet to be worked out, the Brady initiative marks a sea change from the previous approach that basically involved continued lending to LDCs in order to fund interest payments on the original debt.

Since mid-1987, when U.S. banks began building reserves against LDC credits, many banks simultaneously began to cut back on their new lending to LDCs, a move that has hindered the ability of LDCs to make interest payments and has led to social unrest in some LDCs.

> Duff & Phelps analysts maintain most U.S. banks could write down 50% of their LDC debt without causing irreparable harm.

"As it stands now, the countries are having difficulty paying because they can't get new loans and the banks are better able to write down the debt. That's what's driving the system," Mr. Mueller said.

In assessing the impact of the Brady initiative on U.S. banks, Mr. Mueller noted, the crucial question is how much the LDC debt on their books is worth.

On the secondary market, the value of LDC debt in general has dropped from around 65 cents to 40 cents on the dollar in the last two years, Mr. Mueller noted.

Another measure, the debt capacity of the borrowers, indicates that LDC debt theoretically could be valued at 55 cents to 65 cents on the dollar, Mr. Mueller said, although this does not take into account social and political pressures that could reduce debt service capabilities.

In any case, Duff & Phelps analysts maintain, most U.S. banks could write down 50% of their LDC debt without causing irreparable harm and without impairing their ability to meet new capital guidelines that go into effect in 1992.

"Most banks will sustain healthy earnings retention levels despite a 50% LDC write-off," said Claire Percarpio, an assistant vice president at Duff & Phelps. "And the stronger banks will still be able to build capital at a respectable rate of 40 to 70 basis points."

Manufacturers Hanover is the only U.S. bank that may have trouble absorbing a 50% write-down and meeting the 1992 capital guidelines, Ms. Percarpio said. In contrast, Bank of America, which is considered by many analysts to be particularly vulnerable to LDC debt, could withstand a 50% write-down and still have "healthy earnings retention and meet the capital test."