

# Creditor Countries' Banking and Fiscal Regulations: Can Changes Encourage Debt Relief?

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*This article focuses on creditor countries' tax and banking regulations and the possible positive role which certain specific modifications to them can have on encouraging debt relief. A key area for regulatory changes is that of tax treatment of provisions and debt/debt service relief. Changes in banking, fiscal and other regulations are particularly relevant in the context of the current phase of 'officially supported, market based debt reduction' which the Brady plan implies. The author makes some specific suggestions for treatment of loan-loss and proposes an ex-ante definition of tax treatment on international lending.*

## I. INTRODUCTION

The literature on LDC debt, its effects, and debt management is very large (for a broad review see, for example, Faber and Griffith-Jones, [1990]). This study will therefore not look at the whole range of issues affecting LDC debt management, but will focus on one particular aspect: creditor countries' tax and banking regulations and the possible positive role which certain specific modifications to them can have in encouraging debt relief. Following Corden [1991] and others, we define debt relief as any measure or measures that reduce the contractual value of the payments that are due.

In this study we will assume that LDC debt relief is a desirable objective, not just for debtors themselves, but even for creditors. The harmful effects of the debt overhang for middle-income debtors have been argued systematically in the literature in debtor countries (for example in Griffith-Jones, [1988]) and have recently been clearly summarised in ECLAC (1990). More recently, a literature emerged, which argues that debt relief may also be in the interests of the creditors. The reasons given for this are well summarised in Corden [1991]; they include an incentives argument, an investment capacity argument, and a default avoidance argument. For one or more of those reasons, reducing the contractual value of debt may *increase* actual repayments; creditors could get more, while debtors would be left with no less or possibly more.

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The arguments outlined above (presented by such influential economists as Max Corden, John Williamson, Jeffrey Sachs and others in the period between 1987 and early 1989) clearly contributed to a shift in US government policy on LDC debt, which accepted commercial debt relief for middle-income countries as an important objective of debt management and gave origin to the Brady Plan. Another important element in the Brady Plan is the idea that industrial governments should encourage, parties involved in debt bargaining into some debt relief even though pressing the idea that debt reduction should be voluntary. One of the ways through which industrial governments (IG's) – and international financial institutions (IFI's) – can act in this direction are modifications of regulations; indeed, when US Treasury Secretary Brady launched his Plan in March 1989 he stated that 'creditor governments should also consider how to reduce regulatory, accounting or tax impediments to aid debt reduction, where these exist'. There are several other ways in which IG's and IFI's (or 'third party' as Corden op. cit. calls them) can and are participating in debt management and specifically can encourage debt reduction; these include for example the provision of loans or guarantees, mainly by IFI's, for buying back debt or for supporting exchanges of debt for bonds that have a lower face value or lower interest than the original debt.

We would argue that such actions are complementary, and not competitive with the regulatory changes to be discussed below in detail. One important difference between the regulatory and taxation changes and some other 'third party' action is that the former do *not* imply additional financial resources from IG's or IFI's; on the contrary, as shall be explained below, the taxation proposals may imply higher IG tax revenues; provision of loans or guarantees by IGs or IFIs does use up scarce public financial resources, with clear alternative uses. This is an important and not often understood advantage of regulatory and taxation changes.

Up until early 1990, no major regulatory or fiscal reforms were being promoted in the US, Europe or Japan. However, from recent statements by senior US officials, and from recent changes in regulatory treatment linked to the Mexican deal (see below, section III) there is evidence of increased flexibility by US authorities to interpret supervisory and tax regulations, so as to aid the implementation of the Brady initiative. European regulatory and tax authorities have on the whole been somewhat slower to take similar initiatives; however a recent UK initiative on taxation (described below) provides some encouragement of a move towards greater flexibility. In the Japanese case, the regulatory and tax framework seems adequate and flexible enough to encourage debt reduction, when Japanese authorities wish to do so.

The slowness in changing regulations may reflect to an important extent the differences in objectives between those pursuing the reformulation of the debt management strategy with a view to focusing far more on debt/debt service reduction (for example, debtor governments and some parts

of the creditor governments) and those in charge of banking regulation supervision and taxation.

A key area for consideration for regulatory changes is identified in this paper as that of tax treatment of loan loss reserves, and their possible use to encourage debt/debt service reduction options. Indeed, it would seem that the issue of fiscal treatment or provisions and actual write-offs is particularly crucial in defining incentives for debt/debt service reduction.

The issue of tax treatment of provisions against losses (and actual losses) relates both to *the magnitude and the timing of tax incentives*. If full tax incentives are provided at the time of making provisions, then there is clear encouragement to banks to make large provisions, but *not* to transform these provisions into debt service/debt reduction. If the tax benefit is provided only at the time of granting debt reduction, there is no tax incentive to increase provisioning. If one assumes that both high levels of provision *and* debt reduction are desirable objectives, these can be met by granting contingent tax relief on provisions, but withdrawing this relief from banks that fail to participate in an agreed debt restructuring.

Before beginning a description and evaluation of European banking regulations (section II), one final caveat needs to be made. Fears have been expressed that the measures and incentives provided by the Brady Plan may not lead to sufficient debt reduction. If the debt service burden and the reverse transfer of resources is not reduced quickly enough, the objective of the Brady Plan – to ensure that debtor countries can restore sustainable growth and fully service the reduced debt – may not be achieved. An alternative approach has been suggested (see, for example, Islam [1989] and Knox [1990]), that would be based on an 'officially mediated, collective bargaining approach for achieving substantial debt relief'. In such a context, regulatory and fiscal changes would not need to play a major encouraging role, but merely a supporting one, even though regulatory and fiscal disincentives for banks not to stay out of debt reduction could be very appropriate. There is one very interesting option for creditor governments to endorse debtor actions that would limit levels of interest payments to lower than the market ones, provided they are consistent with debtor countries' adjustment and growth programmes, agreed with the IMF and World Bank. As John Williamson [1989] and Robert Devlin [1989] have pointed out, the IMF could use its powers under Article VIII 2(b) to approve exchange controls that would limit the remittance of interest income to a level approved by the Fund, if arrears to banks can be integrated as an appropriate exchange restriction; there is legal support for the view that such a move could be interpreted as an appropriate exchange restriction under the IMF's Articles of Agreement [Debevoise, 1984].

Such an approach would have the advantage (for our 'Third Party' and the IMF) that it would be 'case-by-case' and linked to formally agreed adjustment programmes; it would also have the advantage (for debtor governments) that it could incorporate sufficient debt service reduction to free resources for growth. Indeed, the amount of debt relief required

and the period during which it was required would be defined jointly by the debtor country and the IMF, so as to ensure that sufficient resources would be available to sustain an agreed programme of adjustment, economic growth and reform. Some movement in that direction is reflected in the fact that the Brady Plan has accepted that IMF loans can be disbursed even in the absence of a prior agreement with banks on their financing packages, de facto recognising the possibility of countries' arrears to banks not interfering with IMF disbursements.

We can therefore conclude that changes in banking fiscal and other regulations are *particularly relevant in the context of the current phase of 'officially supported, market based debt reduction' which the Brady plan implies*. For this reason, most of the analysis and policy suggestions in this paper concentrate on regulatory and taxation measures which would make the Brady Plan more effective. The use of Article VIII 2(b) by the IMF is however mentioned as a *contingency*, should the Brady initiative not deliver sufficient debt reduction.

The rest of the study is structured as follows: In the next section (II), we compare European and US banking regulations, and make specific suggestions for modifying tax treatment in Europe and Canada. (This is the central part of the paper). In section III we examine the effects of new international capital guidelines on banks' attitudes to LDC debt. Section IV looks at provisioning policy and section V examines recent changes of regulatory treatment, while section VI summarises the conclusions.

## II. EUROPEAN AND US BANKING REGULATIONS COMPARED

European and Canadian regulations have important differences from those in the US. This is particularly true for continental Europe, where the regulatory and taxation regimes are most sharply differentiated from the US. The UK approach is somewhat hybrid, though approximating increasingly to the continental approach.

Perhaps the main common regulatory feature in Europe and Canada (as opposed to the US and Japan) is the favourable attitude of the authorities to encouraging loan loss provisions in general, and, in particular, through tax deductibility of such provisions. This has both positive and negative effects for the process of debt/debt service reduction. We will focus more on fiscal policy and incentives because it seems to be the most crucial.

As can be seen in Table 1, continental European governments have provided important tax incentives to banks to set up loan-loss reserves against their Third World debt. To an important extent as a result of this, European banks lead the way in establishing large loan loss provisions in the earlier stages of the debt problem, and their level was in mid-1989 well above that of British and US money centre banks, and certainly well above Japanese Banks (see again Table 1). Though tax policies for increased provisions are an important factor for explaining provisioning behaviour of banks in different countries, other factors such as the degree of exposure to highly indebted countries, as well as attitudes to the return/

risk trade off also influence reserving behaviour. Thus for example, Bird [1987] has argued that for example high West German bank provisioning may be attributed not just to tax treatment, but also to relatively lower exposure of German banks (as this represents a relatively lower absolute cost to them), as well as German bankers' more prudential approach.

TABLE 1  
TAX TREATMENT AND LEVEL OF LOAN-LOSS RESERVES - DEC. 1989

<i>Country</i>	<i>Tax deductibility</i>	<i>Reserve Level</i>
France	Yes, up to 60%	60%
Germany	Yes	65%
Switzerland	Yes	10% against trade financing 60% against other exposure
UK	Up to matrix levels (since 1987)	60% (a)
Canada	Yes, up to 45%	45%
US money centres	No	55%
U.S regionals	No	65%
Japan	Only 1%	25%

(a) The Big Four clearing banks have reserve coverage ranging from 48 per cent to 70 per cent.

Source: Bouchet [1990]; IBCA [1989]; own estimates.

The British case is an intermediate one; British banks increased their provisions following Citicorp's and other US banks' decision to increase provisions in May 1987, and before the tax concessions were completely clarified. After that, the Bank of England elaborated a 'matrix', which determines the appropriate level of provision against 'problem debtor countries' that is mandatory for UK banks (see below for details). Since the publication of the first matrix in August 1987, the UK Inland Revenue stated the view that 'the matrix is relevant material for determining the extent to which provisions against foreign debts are deductible for tax purposes'. Initially, it seems that the Inland Revenue (IR) took the view that the provisions reflect a judgement of what is appropriate for supervisory purposes, which will not necessarily be relevant for tax purposes. Bouchet and Hay [1989], report that apparently the allowance for 1987 was some 80 per cent of the specific provision against sovereign risk. Apparently for 1988, the Inland Revenue moved towards recognising, for tax purposes, nearer to 100 per cent of provisions recommended in the 'matrix'.<sup>2</sup> One of the problems in the UK was that the Inland Revenue's position had no legal authority, and that regional tax authorities had different interpretations; tax treatment was developed in negotiation between the Inland Revenue and the parties. Thus establishment of the Bank of England 'matrix' significantly clarified the position, but still did not make the tax position completely clear.

### *How Can the Existing Debt Strategy be Improved Through Regulatory Changes?*

As can be seen from Table 1, a common regulatory feature in Europe and Canada (as opposed to the US and Japan) has been the far more favourable attitude of the authorities in encouraging banks to make loan loss provisions, particularly through the tax deductibility of such provisions. This has had the positive effect of strengthening all the banks in those countries, against potential or real losses on Third World debt, and has also provided a potential cushion for those banks to agree debt or debt service reduction, without their solvency being threatened. However, the fact that full tax incentives are already provided at the time of provisioning implies *there has been no tax incentive to accept debt or debt service relief.*

An alternative approach would be as follows. There is a clear alternative tax treatment of provisioning and debt reduction, which could provide far clearer incentives to European and Canadian banks to participate in debt/debt service relief schemes, while maintaining the encouragement for banks to make adequate provisions against losses. Tax relief would be given, at the time of provisioning. However, these tax concessions *would only be maintained if within a limited time period (e.g., 3 years) the commercial bank accepted debt or debt service relief at least equivalent to the amount of provisioning being accepted for tax concessions.* If a deal was agreed within the context of the Brady Plan for a particular country within the period of three years, the bank would maintain tax relief only if it participated in the debt or debt service relief exercise (or made equivalent contributions), and the tax relief would only be maintained for the proportion of the effective debt/debt service relief granted.

In the case where banks made *donations* of debt to charities (with the proceeds to be used for development spending – particularly for social and/or environmental purposes – in the debtor countries, *in the framework of an agreement between the bank, the charity and the Third World government*), the additional tax relief due would also be immediately and permanently granted.

In the case where banks participated in debt equity swaps, the tax advantage should not be given; following Corden [1991], debt equity swaps imply debt reduction (an action that reduces the present value of *debt* payments due, but increases other future payments from the debtor country) but *not* debt relief, which is more desirable for debtors (and possibly for creditors) because it reduces the present value of any payments due. The tax legislation should therefore encourage the latter, but be neutral towards the former (debt equity swaps). It is further suggested that tax treatment on international lending and debt is explicitly and transparently defined, as far as possible, *ex-ante*. This would imply that not only the desired incentives are created, as suggested above, but that bankers and debtors are aware of them.

The above approach to taxation of banks would be more consistent than

current practice with the basic principle that, to be accepted for tax purposes a loan loss premium *must* relate to the expected irrecoverability, or past irrecoverability of the debt. It should be stressed again that this policy would imply *no additional cost to the taxpayers of the industrial nations*; on the contrary, it could imply a higher tax income, *if* the banks did not agree as high a debt/debt service relief as they had provisioned against. It is therefore a policy that should be attractive to industrial governments and international financial institutions, which see debt relief as desirable. Naturally it is not particularly attractive to creditor banks, as in Europe and Canada, they have currently obtained tax relief independently of the level of debt relief they grant; only *if* they perceive that debt relief may well be in their collective self-interest would commercial banks support such a measure.

This course of action on tax policy would clearly be consistent with both the letter and the spirit of the Brady Plan. Tax incentives for debt or debt service relief clearly will discourage individual banks from free-riding and, perhaps more importantly, will encourage debt agreements to involve more significant levels of relief than would otherwise take place.

The then British Chancellor of the Exchequer, John Major, took in his 1990 Budget a small but very positive step in the direction of using tax incentives to encourage debt reduction.<sup>3</sup> He proposed to change the timing of tax relief given to banks, giving immediate tax relief only if the debt is disposed of to the borrowing country; in all other cases additional tax relief will be given, but in tranches of annual instalments of five per cent of the debt. The proposals (which were subsequently approved by the British Parliament) have two important positive aspects. First, they significantly clarify tax treatment of provisioning, of sales of debt to other financial institutions and to the borrowing country. Clarity about future tax treatment will encourage the search for innovative solutions in debt management. Second, the proposals do provide somewhat more preferential tax treatment when debt is disposed of to the borrowing country, so that it can potentially benefit from some debt/debt service reduction. The *precedent* for using tax incentives to encourage debt reduction has thus been set in Europe. Unfortunately, the tax incentive granted is rather limited, as it only refers to the *timing* of the tax relief, rather than the absolute amount. Second, previous massive tax concessions already granted for provisioning against Third World debt *are not* affected, independently of whether debt/debt service reduction took place or not. The British Shadow Chancellor, John Smith, in a recent speech on Third World debt has put forward a proposal based on that presented above and argued that, 'tax concessions for banks should only be maintained if the bank agreed to participate in debt reduction packages negotiated as part of the Brady Plan'. There is some evidence<sup>4</sup> that the moves by the British Chancellor were at least partly a result of lobbying of parliament by a group of British NGOs, that used as a technical document, an abridged version of this study. It is also noteworthy that the British Bankers' Association (BBA) lobbied against the Chancellor's proposed changes,<sup>5</sup> and that their point of view was argued by some members of

Parliament; however, the BBA's position was not successful in blocking the proposed changes. It is to be hoped that other European countries and Canada will follow the British example and use fiscal and regulatory incentives to encourage debt or debt service reduction.

As is well known, in the US tax policy with respect to provisioning is very stringent, as only a small proportion of reserves against LDC risk is currently tax deductible. It is now clearly established that the decision of US banks to make fairly large provisions in May 1987 and during 1989 were made independently of any tax advantages. Indeed, as Bird [1987] points out, the US Federal Tax Law in 1986 made additional loan loss reserves less attractive to US banks; in spite of this, in early 1987 the US money centre banks increased their reserves.

### III. CAPITAL REQUIREMENTS AND THE EFFECTS OF NEW INTERNATIONAL CAPITAL GUIDELINES

Tax treatment of loan-loss provisions and of actual losses due to debt/debt service reduction seem to be the most crucial elements in determining banks' attitudes to debt/debt service relief. However, another factor of importance is the link between loan loss provisions and capital. This is being modified in the context of convergence towards a common measurement of capital adequacy in the context of the new Basle Agreement.

The regulatory treatment of loan loss reserves is significant because it affects the willingness of banks to accept restructuring options that involve the recognition of loss. In countries, such as France, where reserves are included in regulatory capital, banks were unlikely to want to take losses and write down reserves. In most cases voluntary debt reduction would involve either modifying the terms of an existing asset or the acceptance of a new one; accounting conventions will require that losses be recognised (though the timing could be modified); as Bouchet and Hay [1989] point out, encouraging losses by writing down assets against provisions has a capital cost for banks where the reserves (as in France, and in the US for general reserves) are included in regulatory capital. The situation is different where (in countries like the UK, Germany and Switzerland) loan loss reserves are already excluded from capital, and thus banks recognise no further capital loss when assets are written off against reserves; these banks may not have the disincentive to participate in voluntary debt reduction that is present where loan loss reserves are included in regulatory capital.

In discussions with regulators<sup>6</sup> they have pointed out that the concept and definition of reserves is somewhat different in countries such as France, where regulators consider these reserves only as a 'first line of defence', and therefore still keep them as part of capital. However, recent trends seem to indicate that capital scarcity is not so serious in French banks as had been feared [Williamson, M., 1988], and that therefore the inclusion of loan-loss reserves in capital may not have such negative effects on possible debt/debt service relief as some observers have feared.

Indeed, as can be seen in Table 2, by the end of 1989, the ratio for total capital requirement (as a proportion of risk weighted assets) for France had almost reached the level that will be required in 1992 by the Basle Committee.

TABLE 2  
ESTIMATED AVERAGE BASLE G-10 COMMITTEE RATIOS, END 1989  
(TOTAL CAPITAL REQUIREMENT AS % OF RISK WEIGHTED ASSETS)

Belgium	8.0
Canada	7.6
France	7.5
Germany	above 8.0
Italy	7.5
Japan	9.0
Netherlands	above 8.0
Sweden	8.0
Switzerland	above 8.0
UK	8.9
USA	8.0

Memo item:

Minimum Basle ratio (for 1992)	8.0
Minimum Basle ratio (for 1990)	7.25

Source: IBCA, *Real Banking Profitability*, Dec. 1989.

French regulators point to the fact that the problem will be reduced as the Basle Agreement will impose near uniformity of treatment of loan-loss reserves by the end of 1990, the time at which for banks of all nationalities, loan loss reserves in excess of 1.5 per cent of risk-weighted assets will be excluded from capital. Thus, at the end of 1990, French (and US) banks would consider additions to loan loss reserves to be a capital loss, in similar ways that a British or German bank would. As a result, there would be a more neutral impact on the willingness of these banks to recognise limited losses, and the distinction will tend to lose its importance for debt/debt reduction schemes, though it will not disappear altogether. Examined from the criterion of debt/debt service reduction, it would seem desirable that no exceptions to the Basle agreement remained, as regards inclusion of loan-loss reserves in capital, as this would harmonise incentives in this aspect for debt/debt service reduction.

We will now examine in some detail the Basle Agreement guidelines, their effects on banks and, in particular, on new money and debt relief for debtor nations.

Although the international framework for capital requirements will have an effect on the new money/debt reduction process for LDCs, this effect will be reduced by the large size of provisions. As pointed out above, the crucial issue in determining incentives for banks towards new money/debt reduction options is the tax one. Bank authorities in the creditor countries have agreed, in principle, to implement the Basle Agreement which defines an international framework for the capital requirements for

commercial banks. In July 1988, the members of the Basle Committee on Banking Regulations and Supervisory Practices agreed to a framework for measuring capital adequacy and for setting minimum capital/asset ratios. Although the impact of these guidelines is still uncertain, the new risk-based capital guidelines may have an impact on the way banks manage their assets and price their products. For developing countries that have access to international capital markets the new capital guidelines might be expected to increase the cost of bank loans. For LDCs that have access to markets through forced lending the guidelines may in the *very short term* (say over the next year) support the new money process by pressuring capital constrained banks to engage in new money lending in order to avoid the recognition of capital loss. However, in the medium and longer terms the new capital guidelines are likely to make lending new money less and less attractive for major banks. The most significant impact of the new capital guidelines on the new money process probably results from the limited inclusion of loan loss reserves in capital.

#### *New Capital Guidelines and Effects on Banks*

The new capital guidelines establish major reforms in three areas:

- (i) the structure of capital;
- (ii) the risk weighting of assets for purposes of measuring capital adequacy; and
- (iii) the establishment of guidelines for determining minimum capital coverage required for off-balance sheet activities.

Under the Basle framework the *structure of capital* is divided into two tiers, core or Tier 1 capital and supplementary or Tier 2 capital. Tier 1 capital consists of equity capital and disclosed reserves, Tier 2 of undisclosed reserves, asset revaluation reserves, general loan loss reserves, hybrid (debt/equity) capital instrument, and subordinated term debt.

Certain restrictions and limitations apply to the Tier 2 elements of capital, including the proviso that while specific loan loss reserves are excluded entirely from capital, general loan loss reserves may be included in amounts up to 1.25 per cent (or exceptionally and temporarily up to 2.0 per cent ) of risk assets.

As pointed out above, the Committee set the *minimum target ratio* of capital to risk-weighted assets *to be reached by the end of 1992* at eight per cent of which the core capital element should be at least four per cent. Certain arrangements have been agreed to for the transitional period, which began July 1988. During this period, banks should improve their capital levels and should not diminish – even temporarily – their current capital level. The Committee also set a ratio of capital to risk-weighted assets of 7.25 per cent , of which at least half should be core capital, as an interim target to be achieved by the end of 1990.

The Basle framework establishes a system of *risk weights* to be used to evaluate the capital adequacy of banks. Different categories of assets are assigned weights according to what the Basle committee perceived as their relative riskiness. Five risk weights are used: 0, 10, 20, 50 and 100 per

cent. (Items particularly relevant to developing countries are underlined below):

- \* The 0 per cent risk weight is applied to cash, claims on central governments and central banks denominated in national currency and funded in that currency. LDC claims on central governments that are denominated in local currency might be given a 0 per cent risk weight.
- \* At national discretion 0 per cent to 50 per cent weights may be applied to domestic public sector entities excluding central government) and loans guaranteed by such entities.
- \* A 20 per cent weight is applied to claims on or guaranteed by or collateralised by multilateral development banks (IBRD, IADB, AsDB, AfDB, EIB), claims on or guaranteed by banks incorporated in the OECD, claims on or guaranteed by non-domestic OECD public sector entities, claims on banks incorporated in countries outside the OECD with a residual maturity of up to one year, and loans with a residual maturity of up to one year guaranteed by banks incorporated in countries outside the OECD, and cash items in the process of collection.
- \* A 50 per cent weight is applied to mortgages.
- \* A 100 per cent weight is applied to claims on the private sector, claims on banks incorporated outside the OECD with a residual maturity of more than one year, claims on central governments outside the OECD (unless denominated and funded in national currency), claims on commercial companies owned by the public sector, fixed assets, real estate, capital instruments issued by other banks (unless deducted from capital) and all other assets.

The immediate impact of the capital guidelines is to put pressure on banks to raise capital. While this is especially true of capital-short banks, it is true to varying degrees for all banks regardless of their current capitalisation. Both regulators and the market place are already placing pressure on banks to meet the 1990 year-end guidelines. For instance in the United States the Federal Reserve is expected to make satisfaction of the 8 per cent requirement a prerequisite for approving proposed mergers and acquisitions. Market analysts have begun to evaluate the capitalisation of banks according to the 1992 criteria. The ability of banks to meet these criteria is, for these analysts, an important indicator of competitiveness. It should be remembered that the Basle guidelines establish a *minimum* or floor capital requirement. National regulators may establish capital requirements that exceed the minimum established by the Basle guidelines. In the United States the staff at the Federal Reserve has recommended that organisations that wish to expand have strong capital positions 'substantially above the minimum levels'.

Faced with the task of improving their capitalisation, banks have three choices, they can raise capital, sell-off assets, or (as a result of the new system of risk weights) change the composition of their investments. The first two options are likely to be the most expensive. Raising capital means

diluting the ownership of existing shareholders. This is expensive to existing shareholders where shares are selling for below their book value as they are in the case of many highly exposed banks. Diluting ownership may also be perceived as dangerous by existing managers in that it may provide an opening for a hostile takeover. Selling off assets means reducing the size of the bank. This can be painful for two reasons. First those assets which are marketable are probably those which are potentially most valuable to the bank. Second, reducing assets may involve laying-off people which is likely to have high costs in terms of labour relations and general morale. Given these costs management may consider that a less costly approach to raising its bank's ratio of regulatory capital to assets is to change the composition of its asset portfolio in such a way that its risk-weighted assets have been reduced, although the size of the unweighted asset portfolio may remain unchanged.

A bank can increase its capitalisation without raising new capital in equity markets or shrinking assets if it changes the composition of its investments towards assets which carry lower capital coefficients as defined by the Basle guidelines. Banks should be able to improve their capitalisation inexpensively by selling off the lowest yielding of their high risk assets and buying the highest yielding of the low risk assets. It may even be possible to construct operations which raise capital at a negative cost.

While the guidelines will motivate changes in portfolio composition for the purposes of raising capital, they will also impact the investment decisions of banks that easily meet the 1992 capital guidelines. The value of an asset is determined not only by its maturity, interest rate and underlying credit risk but also by its capital requirement. The guidelines encourage banks to move into the higher yielding of low-risk weight assets and away from the lower yielding of the high-risk weight assets regardless of their current capitalisation.

### *Impact on Pricing of Assets*

By changing the willingness of banks to hold particular assets at given yields (that is, by changing the bank industry demand curve for various assets), the new capital adequacy rules will alter the relative yield relationships between general classes of assets. The magnitude of the impact will depend upon the size of the risk weight differential and the share of the instrument currently held by the banking sector. Bouchet and Hay [1989] think it likely that the new capital guidelines will have a significant impact upon the yield relationships between United States government agency securities, tax-exempt securities, business loans, consumer credit loans and, of course, *loans to LDCs*.

If it is assumed that an equilibrium will happen when a certain adjustment in relative spreads has taken place and further assume that the spreads on low risk-assets will not change significantly, then this adjustment will take place through an increase in the spread of high risk-weight assets and a corresponding contraction of bank credit that carries a high

risk-weight. In general it should be expected that the required spread on high risk-weight assets will increase.

It is important to note that this does not mean that banks will necessarily avoid high risk assets. Rather the guidelines encourage banks to avoid low yield assets with high risk-weights and encourage banks to hold high risk-weight assets with the highest yields (that is, riskier assets).

#### *Impact on LDCs with Voluntary Access*

The above analysis suggests that the cost of funds for LDCs that rely to a large extent upon bank finance will rise. Lenders will in general require a higher spread over their cost of funds to compensate them for their relatively higher risk weight. LDC loans currently require a 100 per cent 'risk-weight'. The guidelines do, perhaps, encourage some forms of trade finance since they give a 20 per cent risk weight to loans with a residual maturity of up to one year guaranteed by banks incorporated in countries outside the OECD.

#### *Impact on LDCs Without Voluntary Market Access*

The new capital guidelines might be expected to discourage involuntary lending and to remove some of the current disincentives for voluntary debt reduction. The guidelines increase the capital requirement for LDC loans. For banks that currently include significant amounts of country risk reserves in capital (for example, United States and French banks), the new guidelines might be expected to increase the capital cost of holding LDC loans, and, therefore, to increase the cost of banks increasing their exposure to LDCs. Yet, one must still compare the cost and benefits of lending new money to the next most likely alternative. If the alternative is for banks to recognise a large capital loss either as a result of participating in voluntary debt reduction or allowing arrears to build up, the new capital guidelines may (for the short-term) encourage the new money process. Given the pressure the guidelines place on banks to improve their capitalisation, some banks may continue to have an incentive to make new loans to avoid the potentially costly recognition of capital loss. As the highly exposed banks improve their capitalisation with respect to the new capital requirements, these guidelines might be expected to discourage new lending. It would seem that in the short run (for example, until year-end 1990), the new capital guidelines will encourage defensive lending. In the longer term, the guidelines should discourage such strategies, as well as remove some of the current disincentive to participation in voluntary debt reduction.

#### IV. POLICIES FOR PROVISIONING

In the United Kingdom provisions against country risk are specific provisions; they are mandatory in accordance with a country scoring system developed by the Bank of England initially in 1987, and modified in January 1990, which is widely known as 'the matrix'. The January 1990 matrix suggested a prudent level of provisioning of around 50 per cent

against LDC exposure for regulatory purposes; this implies a significant increase over 1987 levels. The Bank of England (the regulatory body in the UK) sees the 'matrix' as 'a framework which aims to measure the extent to which the prospects for recovery in full of claims on any country have deteriorated . . . , that will provide a basis for establishing adequate provisions for prudential purposes'. The Bank of England clearly establishes that any provisions against country risk will not count towards an institution's capital base, a point which makes an important break with previous policy. (For details of January 1990 matrix, see Appendix 1; for estimated figures of provisioning by British banks for the major Latin American debtors, see Appendix 2).

Where provisioning against short-term trade credits is concerned, the Bank of England has no clear rules, but defines desirable levels of provisioning on a case-by-case basis. This is a far more flexible approach than that of some other European countries. For example, in Switzerland banks have to reserve automatically against trade financing loans, which discourages banks from providing crucial short-term financial flows that are fairly secure. Therefore, trade credit constitutes an essential lubricant in the process of international trade. Having to reserve against trade loans discourages banks from providing essential short-term financial flows even if they are secure. Given the dramatic decrease in new lending to the developing countries over recent years, trade credit should be isolated from the international debt problem. It would be preferable if trade credits did not have to be provisioned against, unless there was strong evidence that the country was unwilling or unable to service them.

#### V. RECENT CHANGES OF REGULATORY TREATMENT

In this section, we will examine the regulatory treatment of the 1989 Mexican deal, which seems to show some new flexibility, particularly in items such as the use of FASB15 by the US authorities, for the first time, for a developing country restructuring (see below).

In the United Kingdom, the Bank of England had to determine how banks should treat the different impact on their exposure under the two conversion instruments of Mexico's debt. The regulatory treatment of the bonds was decided as follows: the discount bonds are carried on bank books at face value. The difference between the original and the new face value of the assets is charged to provisions. An additional charge to income would only be required if the loss exceeds provisions. The discount bonds lead to an upfront tax relief. The Bank of England has indicated that no additional provisions would be required against the bonds 'at this time' as the terms are presumed to reflect an acceptable risk.

In the case of par bonds, no additional provisions are needed provided original reserve levels were considered adequate, but those reserve must be maintained as the potential loss has not yet been realised. Tax relief is equal to the net present value of the difference between the banks' funding cost and the reduced interest rate. The tax savings is given upfront but is gradually written back to income as the collateral grows because tax

TABLE 3  
REGULATORY TREATMENT FOR MEXICAN DEAL: A SUMMARY

	<u>Par Bond</u>	<u>Discount Bond</u>
<b>United Kingdom</b>	*100% Mexican Risk  *No additional provision	*TAR loss equal to discount *Accounting loss charged to provision *No immediate additional provision
<b>United States</b>	*Accounting regulatory loss need not be recognised (FASB15)  *Tax loss need be recognised  *Exposure reduced by current value of collateral	*Accounting loss not recognised (FASB15) *Tax loss need be recognised *Exposure reduced by current value of collateral *Regulatory capital loss need be recognised for tax purpose
<b>Canada</b>	*Reserve proportional to exposure (=loan minus collateral)  *Booked at face value  *Provision reversed as collateral grows	*Reserve proportional to exposure (= loan minus collateral) *Booked at face value Provision reversed as collateral grows *Tax deduction proportional to loss and face value

Source: Bouchet [1990].

deduction is only provided for 'doubtful claims'. Rather controversially, additional provisions are required against new money in the United Kingdom; this clearly discourages banks lending new money, one of the options offered in the deal.

In the United States money-centre banks have increased their provisions from an average of 28 per cent in 1988 to about 56 per cent in early 1990. The two lower reserve levels are Citibank with 38 per cent and Manufacturers Hannover with only 35 per cent. Morgan is already at 100 per cent and Bankers Trust at 84 per cent. Mandated reserves for a dozen 'basket cases' were also increased at the time of the October 1989 ICERC meeting.

Regarding Mexico's debt exchange, US banks faced the risk that discount bonds would have led to an upfront capital loss to the extent that they had included the loan-loss reserves in regulatory capital. In July 1989, the SEC issued a letter to the US Treasury stipulating that both par and discount bonds could be treated as FASB15 restructuring. This treatment provides that *no loss needs to be recognised upon acceptance of either bond* so long as the total future undiscounted cash receipts specified by the new terms of the loan, including receipts of principal interest, equal or exceed the book value of the loan. This reduces the pressure on the capital of the banks until the full 'Cooke Committee's' rules on capital requirements are implemented in 1992. In addition, banks may show a reduction in their LDC exposure equivalent to the current value of the collateral. Regarding new money credits, Gerald Corrigan, a member of the Federal Reserve Board suggested that no additional provisions were required in the context of officially sponsored financing programs. Thus, changes in regulations in the US seem both to facilitate debt reduction (through FASB15) and new money (through lenient provisioning).

For tax purposes, the bonds must be recorded at fair value if they are traded within ten days of the exchange. If not, bonds are recorded at their issue price, which is the lesser of a) the face amount of the new instrument or b) the present value of the instrument using the applicable Federal interest rate.

In France, one can observe two phenomena: one is the heavy concentration of claims in Africa compared to US or other European banks; the other, is the remarkable stability of claims after accounting for exchange rate variation.

The Banque de France issued specific recommendations regarding the accounting treatment of the Mexico bonds in October and November of 1989. Both par and discount bonds give rise to a 'disposition of the asset' and, as such, old claims are no longer on the banks' balance sheet. The par exchange does not lead to any accounting loss. The new bonds can be registered at the banks' discretion in the 'transaction' of in the 'investment' portfolio. The former treatment is applicable only to those securities which are negotiable on a liquid market. Mexico's bonds do not require additional provisions so long as there is no country-risk deterioration. Regarding the tax treatment of discount bonds, the Treasury recommended that banks gradually recapture their excess pro-

visions (above the 35 per cent reduction in the face value of the bonds) over the life of the new instruments so as to account for the increase in value of collateral. Remaining provisions on the bonds are applied the tax regime of securities and are tax deductible up to 15 per cent. New money credits do not require provisions if the overall reserve level of the lending bank is in line with the average level of the banking community as recommended by the Commission Bancaire.

In Japan, the Ministry of Finance asked commercial banks to increase provisions against sovereign risk to 25 per cent of exposure on a specified group of debtor countries (see Table 1). The reserves are still included in regulatory capital, except for one per cent that is tax deductible. The Banking and International Bureaus of the Ministry of Finance issued administrative guidance in October 1989, with respect to the tax and accounting treatment of the Mexican bonds. The bonds should be recorded at their acquisition price for both tax and accounting purposes. That acquisition price will be the first traded price on the Luxembourg exchange, where the bonds are to be registered. In addition to the loss recognition on the exchange, banks must revalue the bonds annually in accordance with normal accounting method for listed securities.

Recent events in Japan (for example, stock market slump, fall in the yen and rise in interest rates) may require Japanese banks to increase capital/asset ratio, thus discouraging their participation in new money operations.

In Canada, banks are required to maintain a minimum reserve level of 45 per cent. In practice, Canadian banks have boosted reserve levels in the range of 70–75 per cent. The Office of the Superintendent of Financial Institutions (OSFI) of the Ministry of Finance issued a draft of income tax regulations with respect to Mexico's debt exchange on January 1990. The revised treatment stipulates that both bonds are to be recorded at face value with any writedown to account for the difference between new and original face value. Both bonds are still in the basket of country risk for provisions purposes. The face value of the bonds minus the current value of the collateral is to be treated as Mexican exposure. Effectively, provisions have to be calculated on the face value of the original debt less the current value of the collateral. Any writedown recorded on the debt exchange should be credited against the amount of provisions.

The tax deductible reserves are restricted to 45 per cent of the loan principal. Since the tax treatment is based on loan principal and not on exposure, it means that the collateral does not reduce the level of reserves for tax purposes.

## VI. CONCLUSIONS

Regulatory and fiscal changes in creditor countries fit well as *part* of a strategy in which industrial governments induce, encourage and nudge private banks towards some debt/debt service relief. These measures can be and have been complementary to other actors by industrial governments to encourage debt relief.

A priority area for change – in Europe and Canada – is to modify tax treatment of provisions and debt/debt service relief, so as to provide incentives for both. It is proposed that the European and the Canadian government modify their tax treatment in the following manner: Tax concessions could continue to be granted when loan-loss provisions are made. However, they would only be maintained if within a limited period of time (for example, three years), the commercial bank accepted debt or debt service relief to the amount of provisioning being accepted for tax concessions.

If a deal was agreed within the context of the Brady Plan for a particular country within the period of 3 years, the bank would naturally only maintain the relief if it participates in the debt or debt service reduction exercise (or makes equivalent contribution), and the tax relief would be maintained only for the proportion of the effective debt/debt service reduction. It is encouraging that the British Chancellor has taken a very small, but very positive, step to provide temporary tax incentives for disposal of debt, which favours indebted countries.

Beside the above suggestion to encourage debt relief, it is proposed that tax treatment on international lending is explicitly and transparently defined, as far as possible, *ex-ante*, and not negotiated *ex-post*. This would imply not only that desired incentives are created as suggested above, but that the actors involved are aware of them. It would seem appropriate for action to be taken either by individual European governments or by European institutions, such as the EEC Commission, to change tax regulations.

As regards treatment of loan-loss provisions, it is important that for all countries, these provisions are excluded from capital, as this would also encourage debt/debt service relief. In particular, it is important that no exceptions are accepted to the Basle agreement, which defines by 1992 a uniform maximum level of loan loss reserves to be included in capital. In the longer run, the Basle Agreement would seem likely to remove some disincentives for voluntary debt reduction, on the other hand, the Basle Agreement will in the longer run discourage new lending by banks to LDCs, and make it more expensive. This would seem to make the need for debt reduction even clearer. However, it should be stressed that the effects of the Basle Agreement seem to be smaller than had been expected.

As regards provisioning it would seem desirable that in European – as well as in other creditor nations – no provisions be required against trade credits, unless special reasons indicated such a need. Trade credit is an essential lubricant for international trade, and its effective functioning should be isolated as much as possible from the international debt problem.

A recent positive change is that for the first time ever, the US SEC has accepted that the disposal of LDC debt (for Mexican par and discounted bonds) can be treated as a FASB15 restructuring, which implies that no loss need to be recognised upon acceptance of either bond, as long as certain conditions are met.

Emphasis has been placed in this study on regulatory and fiscal measures that encourage voluntary debt relief.

As pointed out in the Introduction, fiscal and regulatory changes can be pursued either independently or more probably simultaneously with other 'third party' actions, that nudge banks to agree larger levels of debt relief, in the context of the Brady Plan; other 'third party' measures include for example, industrial governments and/or international financial institutions granting of loans or provision of guarantees for ensuring debt relief. There are other measures which could enforce debt relief, and eliminate free rider problems far more directly than the ones discussed in the preceding paragraph. One such measure that would seem to be easily applied if the G-7 governments wished to do so – would be to use Article VIII 2 (b) of the IMF Articles of Agreement for the IMF to approve exchange controls for debtor countries, that have agreed an IMF adjustment programme with debt/debtor service reduction included in it, to limit remittance of interest income to the level approved by the IMF. Such a measure would provide clear signals for debtor governments that compliance with special adjustment programmes will deliver the necessary debt/debt service reduction, to make the adjustment programme work, and to allow for economic growth. This would make such a measure attractive to debtor and creditor governments, as well as to the international financial institutions.

## NOTES

1. See E. G. Corrigan 'Supervisory Attitudes Towards Instruments for Debt and Debt Service Reduction', in Faber and Griffith-Jones [1990].
2. Information obtained through interview.
3. See Inland Revenue Press Release, 20 March 1990, *New Scheme of Tax Relief for Doubtful Sovereign Debt*, enclosed here as Appendix 1.
4. *Financial Times*, 22 March 1990, S. Fidler, *Incentive on Bank Third World Debt Welcomed*.
5. See 'Controversial BBA Letter Says Bank Tax Changes Unfair', *International Bank Accountant*, Vol. 1, No. 7, 11 May 1990, *American Banker*, Bethesda, Maryland, USA.
6. Information obtained through interview.

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## APPENDIX 1

### THE NEW BANK OF ENGLAND MATRIX (JANUARY 1990)

#### I. INTRODUCTION

In August 1987 the Bank of England wrote to all UK incorporated institutions authorised under the Banking Act which had exposures to countries experiencing debt repayment and servicing difficulties to encourage them to reconsider the adequacy of their provisions against exposures to such countries. The Bank of England developed a framework for objective analysis for measuring the extent of the difficulties of each country (known as the matrix); this framework has been used during the last two years as a basis for discussions between the Bank and each institution so that an appropriate level of country debt provisions for supervisory purposes can be determined.

In January 1990 the Bank of England reviewed the structure of the matrix and the factors contributing to the assessment of repayment difficulties. The Bank has also looked again at the level of provisions indicated by the matrix, bearing in mind the widespread market perception that the situation among debtor countries has on balance deteriorated. The result of this review is reflected in a number of technical changes in the matrix and *in a significant increase in the average level of provisions produced by its application.*

Besides the increase in the average level of provisioning, there are two significant changes. The first concerns the source of the minimum default of 10 from category A and B factors. Previously, evidence of *actual* default was required before the question of provisioning arose; provisioning could not be triggered by category C (economic) factors alone. The Bank now believes it right that indicators which provide evidence about the *likelihood* of debt repayment

difficulties in the future, even without actual default, should be capable of triggering provisioning; therefore, while the minimum score of 10 remains, it now applies regardless of the source.

Secondly, in order to avoid sudden changes in future provisioning requirements the Bank believes that a smoothing technique should be introduced based on a moving average.

## II. THE NEW BANK OF ENGLAND MATRIX

There are three stages in the process of deciding an appropriate level of provision:

- (i) to identify countries with current or potential repayment difficulties;
- (ii) to identify the nature of those difficulties and the extent of the country's problem; and
- (iii) to determine, at this point, what proportion of exposures to that country is unlikely to be repaid in full.

A number of factors or criteria can be identified to help make this decision. These factors can be incorporated in a matrix and weighted to reflect their relative significance for determining the appropriate level of provision in respect of an exposure.

The Bank of England groups them into three categories, namely:

- A Factors which evidence a borrower's inability or unwillingness to meet its obligations, whether at the due date or thereafter;
- B Factors which show a borrower's current difficulties in meeting its obligations; and
- C Factors which provide evidence of the likelihood of repayment difficulties either persisting or arising in the future.

The matrix includes a total of 16 factors under these three categories. They can be applied to any country and to any type of exposure taken either in aggregate or by type of exposure. The Bank of England's aim has been to identify a range of observable factors which point to the likelihood of a partial or total failure to repay. For this reason differing levels of maximum score are attributed to the different factors, reflecting their perceived relative weight in the aggregate assessment of repayment difficulties.

The factors and the weights attaching to them are set out in the matrix attached. Only one factor (16) is to be weighted within a range according to individual judgement.

It is suggested that a minimum score of 10 is required before the appropriateness of provisioning needs to be considered.

### *Method of Scoring*

The total score for a country is the sum of the individual scores for each factor. Changes in the circumstances of individual countries should be taken account of by updating country scores whenever provisioning levels are redetermined.

In order to avoid excessive volatility in the scores, the Bank considers it appropriate to take a moving average over fifteen months, starting from January 1990, as the basis for determining the level of provisions.

### *Setting the Level of Provisions*

Once the moving average has been determined, the Bank of England instructs that levels of provision should be established within broad bands, shown below:

<i>Score</i>	<i>Provision</i> January 1990
10-24	5-13%
25-39	14-23%
40-54	24-37%
55-69	38-58%
70-84	59-75%
85-99	76-89%
100-119	90-96%
120-145	97-100%

If one compares the January 1990 matrix (attached) with the one issued by the Bank of England in August 1987, the main difference is that the scores set up in the later matrix tend to be significantly higher, particularly for countries which are very 'uncreditworthy'. For example, factor 14 (accounting for the secondary market price) now ranges from 2-12 points; in the August 1987 matrix the range was from 2-4. As a result, it becomes easier for countries to get higher scores, and thus for higher provisioning to be required against their debts.

#### *Scope of Application*

There are two alternatives:

- (i) to apply the factors and resulting provisioning percentage against all claims on a country;
- (ii) to apply the factors and resulting provision percentage separately to different classes of asset.

The Bank of England's view is that, for supervisory purposes, the percentage provision should be applied to a bank's *total* exposure to, (including risk transfers to and excluding risk transfers from, a particular country), unless it can be satisfied that a particular claim or class of claims will be repaid in full.

This latter decision is somewhat controversial, as it would have seemed preferable to separate trade credit (so essential to sustain trade flows) and *only* to refuse provisioning *if* it was not being serviced regularly. (See discussion in text.)

The matrix itself is attached reflecting the new scores. It has been reported that the new matrix will imply Bank of England support for levels of provisioning averaging around 50 per cent, as compared to the levels of 30 to 35% provisioning set in the earlier 1987 matrix. The British Inland Revenue (the UK tax authority) will accept the Bank of England's new guidelines as *one* of the factors, when calculating allowances against tax.

APPENDIX 2 TABLE A 2  
 COMPARISON BETWEEN THE APPROPRIATE PROVISIONING BAND UNDER  
 NEW AND OLD BANK OF ENGLAND MATRIX, FOR MAJOR LATIN  
 AMERICAN DEBTORS

	<u>Current (1990) recommended provisioning band %</u>	<u>Previous (1987-1989) recommended provisioning band %</u>
Argentina	76-89	16-25
Bolivia	90-96	61-100
Brazil	59-75	26-40
Chile	14-23	16-25
Costa Rica	76-89	26-40
Ecuador	76-89	26-40
Mexico	24-37	16-25
Peru	90-96	41-60
Venezuela	38-58	16-25

Source: IBCA [1989], London.



APPENDIX TABLE A1 (cont.)

\*C'Factors [Columns 8 - 16]

Totals

(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)		
Interest Service Ratio	Visible Import Cover	Debt/GDP Ratio	Debt/Exports Goods & Services Ratio	Not Meeting IMF Targets/ Unwilling To Go To IMF	Unfilled Financing Gap Over Next 12 Months Excluding Agreed Announcements During Restructuring Negotiations	Market Price	Highly Dependent On a Single Source Of Income: Commodity Export, Single Commodity Based Export, Service Earning.	Other Factors	TOTAL SCORE (Max 145)	PROVISIONING RANGE
>15%→3 >25%→5 >35%→7 >45%→10	<4Mths→3 <2Mths→5 <1Mth→7 <0.5M→10	>50%→3 >75%→5 >100%→7 >150%→10	>200%→3 >300%→5 >400%→7 >600%→10	3	2	<70-2 <50-4 <30-8 <10-12	2	0 to 5	TOTAL	
3 - 10	3 - 10	3 - 10	3 - 10	3	2	2 - 12	2			

## **Dudley Seers Prize**

The Editorial Board of The Journal of Development Studies is pleased to announce that two prizes honouring the memory of Dudley Seers will be awarded annually for the best articles published during that year in the Journal. The value of each prize will be £500. The first awards will be made in late 1991 for papers published in Volume 27 of the Journal (October 1990–July 1991). All the articles published in the relevant volume will be eligible for the prize, excluding Notes and Communications. Special weight will be given to both analytical originality and work of an interdisciplinary nature. At least one of the prizes will normally be awarded for contributions which are not wholly or primarily within the discipline of economics.

The judges will be drawn from amongst the members of the Editorial Board, and details of the awards made will be published in the Journal.