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EUROPEAN BANKING REGULATIONS AND THIRD WORLD DEBT: THE TECHNICAL, POLITICAL AND INSTITUTIONAL ISSUES

by

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EUROPEAN BANKING REGULATIONS AND THIRD WORLD DEBT: THE TECHNICAL, POLITICAL AND INSTITUTIONAL ISSUES

1. INTRODUCTION

For some time, debtor governments concerned with the need for greater flexibility in debt management, including scope for debt reduction, have believed in the urgent need for creditor governments to review their banking and fiscal regulations to facilitate debt/debt service reduction. Studies examining the debt problem, which stress the needs of the debtor economies, took a similar line. In a previous study, it was concluded that:

> Innovations in debt management required changes in banking and taxation regulations in some or all creditor countries that would smooth (over the years) or make less costly to creditor banks the partial writing down and writing off of debt, and/or some sort of interest relief. Existing regulations have become too great an obstacle to innovative solutions to the debt crisis; it has often been almost forgotten that regulations are only man-made and can be modified if they do not suit current needs! (Griffith-Jones 1988)

In June 1989, the main Latin American debtor governments, represented in the Group of Eight, formally presented such a position to the main industrial countries; summarising the position, the Brazilian Finance Minister, Mr Mailson da Nobrega, said: 'We are ready to propose to the Group of Seven that they adopt concrete and rapid actions such as fiscal and banking regulations which help the commercial banks commit themselves to the debt reduction policies' (**Financial Times**, 19 June 1989).

The view that supervisory tax, accounting and other regulations and conventions should be modified so as to facilitate debt/interest reduction and other options, has been also argued by independent observers (see M. Williamson 1988 for an enthusiastic and thoughtful example of such a position) and supported by staff members of institutions such as the World Bank.1/

This position received official US government endorsement when US Treasury Secretary Brady launched his plan in March 1989 in a speech in which he argued that 'creditor governments should also consider how to reduce regulatory, accounting or tax impediments to aid reduction, where these exist'.

Up until late June 1989, however, no major regulatory or fiscal reforms were being promoted in the US, Europe or Japan.2/ Indeed surprisingly, a decision taken by US tax authorities briefly after the Brady Plan was announced , shifted the country's tax incentives in a way that reportedly could potentially diminish banks' incentives for debt/interest reduction.3/ This may in part reflect the normal time lag between political changes, policy formulation and implementation, particularly relevant in the context of such a complex technical issue, which furthermore involves important differences between countries. However, it may reflect also 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 (e.g. debtor governments and some parts of the creditor governments) and those in charge of banking regulation supervision and taxation. This tension of objectives emerged particularly clearly in a series of interviews with European bank regulators4/ several of whom argued that:

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1. See, in particular, World Bank **World Debt Tables** 1988-9 Washington D.C.; for a careful analysis of these issues, see M. Bouchet and J. Hay 'The Rise of Market-Based "Menu" Approach and its "limitations", paper presented to World Bank Symposium, January 1989.

2. For a good journalistic account, see S. Sparks, 'Wrangling Over Regulations', **Latin Finance**, May 1989.

3. For example, D. Wessel and R. Guenther 'IRS ruling limits the tax advantages banks get on foreign loans write-offs', **Wall Street Journal**, 4 May 1987.

4. Though extremely grateful for the detailed information and analysis received, at the request of some of those interviewed, I will not provide their names.

(1) the main concern of bank regulators and supervisors is not to pursue the objective of the Brady Plan, to facilitate debt and interest reduction, but to safeguard the interest of the depositors by defending the solvency of banking institutions;

(2) particularly as regards possible changes in fiscal aspects, modifications suggested (see below) to encourage debt/interest reduction are seen by regulators as undesirable, not necessarily in the context of Third World debt itself, but because it could set a precedent for other (domestic) debtors.

The latter argument seems weakened by the fact that special regulatory treatment has for example been given already to a specific category of loans, without this having a contagion effect; as a result of specific legislation passed by the US Congress in 1987, certain banks (with assets under $100 mn) were allowed to amortise losses on qualifying agricultural loans for a period of seven years. Interestingly, a report5/ by the US Federal Deposit Insurance Corporation, Federal Reserve Board and the Office of the Comptroller of the Currency, argues that this special treatment for agricultural loans, and other special regulatory treatments afforded small agricultural banks are 'not viewed as a relevant precedent to the international debt situation, because the banks are small ones, and do not fund themselves in the world-wide financial markets'. Paradoxically, specific changes in regulatory treatment for domestic debtors to enable debt reduction for them are not allowed to be used as a precedent for changes in Third World debt; on the other hand, changes in regulatory or fiscal treatment to further Third World debt reduction are rejected by regulators on the grounds that they could potentially set a precedent for domestic debtors. A hypothesis could be advanced that up till now there seems to be greater willingness to modify banking and fiscal regulations if this will favour domestic debtors, and that the precedent argument is used rather

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5. Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve Board 'Study on Accounting and Regulatory Policies Affecting Debt Restructuring', January 1989. This report was prepared by the US Federal Bank regulating agencies at the requirement of the US Congress (Section 3122 of the Omnibus Trade and Competitiveness Act of 1988) on regulatory obstacles to negotiated reductions in debt service to banks by borrowing countries.

incoherently in both cases to limit any changes to only those benefiting domestic debtors.

In the case of the US Federal bank regulatory agencies, according to their own Report quoted above, not only is it undesirable to change regulatory and accounting policies, but it is also unnecessary as a means to enhance debt reduction options; the Report, issued just before the Brady Plan was announced, concludes that 'Current regulatory and accounting policies have not prevented banks, that were otherwise inclined to do so, from participating in a wide range of negotiated debt reduction transactions with borrowing countries'. The view of US regulators in particular seems to have started to change as a result of the Brady Plan (I am grateful to Edwin Clock, US Deputy Comptroller of the Currency for providing clear examples of recent increased flexibility by US regulatory suthorities). However, the prudent attitude of regulators and their legitimately different objectives are likely to remain a source of tension in using changes in banking and fiscal regulations to attain debt reduction, particularly in Europe.

To resolve these institutional tensions and to attempt to define changes that conciliate legitimately different objectives of different groups of policy-makers in creditor countries, it would be valuable to integrate more closely the discussions between regulators, relevant fiscal authorities, and accountants with policy-makers involved in the designing of the new debt management strategy, within countries and internationally. It is noteworthy that for example in the European case, there does not exist as yet even a published study on how the regulatory authorities themselves view the need for changes so as to increase incentives for debt reduction, similar to the US one quoted above. In this sense, perhaps a valuable first step would be for the production of such a report, preferably at European level, or alternatively by the major European creditor countries. Such a report would also clarify the extent to which differences in the approach to regulatory and fiscal matters between the US and Europe are significant for the debt management strategy and point a way towards how, where relevant, changes could be made.

More generally, the decisions on tax, accounting and regulatory matters seem to be taken in a fairly isolated way. Closer interchange of ideas and co-ordination within industrial countries to define consistent and transparent policies would seem very useful. As a second step, greater co-ordination internationally on aspects such as taxation and accounting standards for banks would be valuable; in this sense, the example set by the Cooke Committee, which has made slow but very important progress on co-ordination between supervisory authorities, could be replicated for accounting and particularly for tax matters. An important area for consideration for such an international commission would be that of tax treatment of loan loss reserves,and their possible use to encourage debt/debt service reduction options (see below). Though ideally such a co-ordination forum should include representatives of all major creditor countries, a possible first step could be a European forum, for example in the context of the EEC. This would seem relatively easy to achieve in the context of rapid moves towards European banking and financial interpretation, in the context of 1992.

Before beginning the description and evaluation of European banking regulations and policy recommendations, some caveats need to be made.

Changes in regulatory, accounting and fiscal rules are only one of the possible mechanisms to encourage 'officially supported, market based debt reduction', which is how one perceptive observer has characterised the Brady Plan (Islam 1989). Even within the context of the Brady Plan, regulatory and fiscal changes would be just one element of government action to encourage debt reduction; others will include the supply of funding or guarantees by the IMF, the World Bank and the Japanese Government. To a certain extent, the effectiveness of regulatory and fiscal changes should be compared to other more direct policy instruments.

More broadly, fears have been expressed that the measures and incentives provided by the Brady Plan may not lead to sufficient debt reduction, mainly due to the incentives for banks to free ride. 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) that would be based on an 'officially mediated, collective bargaining approach for achieving substantial debt relief'. In this approach, the volume of debt reduction and the discount would be determined by bargaining and negotiation, rather than by market auction; secondly, such an approach would require a substantial majority of banks to agree to participate in advance, rather than giving individual banks freedom to choose whether to enter into debt/debt service reduction schemes. 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 indirectly force creditor banks to accept levels of interest payments that are lower than the market ones, and consistent with debtor countries' adjustment and growth programmes, agreed with the IMF. 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 (see Debevoise 1984). Such an approach would deal neatly and effectively with the 'free rider' problem of recalcitrant banks unwilling to participate in debt/debt service reduction.

Such an approach would have the advantage (for industrial governments 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. Though it is not obvious that the G-7 governments are prepared to pursue such a course of action at present, 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 in their financing packages, de facto recognising the possibility of countries' arrears to banks not interfering with IMF disbursements. Finally, if and when debtors were to take unilateral action to stop servicing the debt or limit debt service payments , the role of regulatory and fiscal rules becomes far more passive and responsive to changing circumstances.

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 seems to imply. Should the context change, with greater emphasis on negotiated or unilateral debt/debt service reduction rather than purely market based ones, then regulatory and fiscal issues would lose much of their significance as mechanisms for encouraging banks to take 'voluntary' action.

2. EUROPEAN AND US BANKING REGULATIONS COMPARED

European regulations have important differences from US regulations. This is particularly true for the continent of Europe, where the regulatory and taxing 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 (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. within the whole range of regulatory issues, in its potential impact on debt/debt service reduction.

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 late 1988 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, 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 - December 1988

Country	Tax deductibility	Reserve Level
France	Yes, up to 60%	52% (a)
Germany	Yes	58%
Switzerland	Yes	60% (b)
UK	Up to matrix levels (since 1987)	35% (c)
Canada	Yes, up to 45%	45%
US money centres	No	30%
U.S regionals	No	55%
Japan	Only 1%	15%

(a) The biggest banks are reported to have 55-60%
(b) June 1988
(c) By September 1989, UK provisions reached around 50%

Source: Bouchet and Hay 1989; interview material.

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 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 matrix in August 1987, the British 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 will be of some 80 per cent of the specific provision against sovereign risk. Apparently for 1988, the Inland Revenue is moving towards recognising, for tax purposes, nearer to 100 per cent of provisions recommended in the 'matrix'.6/ One of the problems in the UK is that the Inland Revenue's position has no legal authority, and that regional tax authorities have different interpretations; tax treatment is developed in negotiation between the Inland Revenue and the parties; the establishment of the Bank of England 'matrix' has significantly clarified the position, but still not made the tax position completely clear, due to existing tradition in the Inland Revenue.

On the continent of Europe, the link between taxation and provisioning seems more straightforward than in the UK. For example, in the Netherlands7/, tax authorities accept as tax deductible the level of provisions previous agreed between the Central Bank and the commercial banks in regular meetings, held twice a year; as a result of these discussions, the banks are informed by the Central Bank about the levels of provisioning they should adopt; automatically, the tax authorities accept that level as deductible.

In the German case, banking practice has shown that reserves percentages of up to 40-50 per cent have been acceptable for tax purposes for debtor countries facing balance of payments problems, debt restructuring situations and access on internal payments.8/ It would seem that even higher levels of provisions would be acceptable to tax authorities.

As is well known, in the US tax policy with respect to provisioning is the most 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 was 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.

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6. Information obtained through interview.

7. Information obtained through interview.

8. It is interesting that the admissibility of specific provisioning against foreign lending has been only partially tested in the courts in Germany. Only in the case of Poland is there a court decision (made in September 1983) confirming that a 50% write down for this country is acceptable to the authorities.

As regards the tax advantages given to European banks to encourage their provisioning, there are two schools of thought which I outline below.

(1) Regulators in European countries and banking analysts believe that the tax incentives provided to banks have performed a positive role in the international debt crisis management strategy, mainly because (together with other factors) it strengthened the banks against risk of insolvency in case of Third World default or debt service limitation. When pressed on the issue of debt/debt service reduction, they argue that the existence of large provisions makes feasible debt/debt service reduction.

In this context, in the British case regulators and bank analysts are rapidly moving to the position9/ that UK banks' provisions are too low, that they should be increased and that both regulators and tax authorities should 'nudge' banks towards such an increase (indeed British banks have increased their provisions in late 1989). This represents quite an important change, as in earlier years the UK authorities seemed less keen to encourage provisions. As larger provisions are adopted by British banks, then their ability to make debt/debt service concessions is increased.

(2) There is a second school of thought, which convincingly argues that in fact the structure of the incentives in Europe discourages debt/debt service reduction. Bouchet and Hay (1989) thus emphasise that:

> where banks are able to deduct loan loss reserves from taxes there is little or no tax benefit to recognizing losses upon restructuring debt. Where loan loss provisions are not tax deductible, banks may have an incentive to accept instruments that involve the recognition of loss in order to receive the corresponding tax deductions.

Furthermore, they argue that:

> one way to structure a policy environment that encourages market-based debt reduction would be not to allow banks to recognize tax losses for provisioning or for secondary market

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9. Interview material.

transactions which do not result in a realistic restructuring of a debtor country's obligations (and, thus some benefit for the debtor country).

Thus, it is suggested, banks should be 'only allowed tax benefits if they sell their claims for cash or reduce the debtor's contractual obligations'. Bouchet and Hay also point to the fact that such a policy could avoid tax concessions being granted for debt swaps amongst banks - they estimate that the US Treasury lost US$2 bn in 1988 alone, of tax income, without any benefit having been passed on to the debtor countries.

There are some minor problems with the latter approach. Firstly, it is good (for prudential reasons) for banks to have high levels of provisions against doubtful loans, and therefore it is appropriate that supervisory and tax authorities encourage such a policy. Though Bouchet and Hay make this point, it is not fully integrated into their policy prescription. Secondly, supervisory authorities will argue that it is impossible to treat Third World debtors differently from domestic debtors where tax is concerned; in the latter also, provisions are made when fears arise of non-payment. As we have seen above in the US case, regulators have waived provisions in the case of banks heavily exposed to US farmers. There is no reason why special treatment could not be given for Third World debtors, provided the criteria for this were made explicit. Furthermore, in the UK case some flexibility towards bank taxation is indicated by the special tax applied on banks' windfall profits applied in 1981.

Finally, the policy proposed by Bouchet and Hay would have been easiest to apply in earlier years, when tax incentives were being given to bank provisioning.

A specific tax proposal to encourage debt reduction

In this sense, it would seem best to define a tax policy whereby tax incentives would be given for provisioning; however, when a certain level of debt/debt service reduction was agreed as desirable between a country and the IMF/World Bank, banks could only maintain their tax concessions if they participated in the debt/debt service reduction exercise (or in equivalent contributions). Such a policy would have several advantages: (1) provisioning would still be encouraged by taxation policy; (2) at the same time debt reduction would also be encouraged, as tax concessions could only be maintained if banks participated in debt reduction schemes10/; (3) debt reduction would be conditional on adjustment programmes agreed with the IMF (a condition which would make it attractive to the industrial governments).

Such a change in taxation policy would perhaps require some legislative changes in the main creditor countries. This could possibly be the main obstacle, particularly in countries (like some of the European ones) that are unwilling to use public incentives to encourage debt reduction. It is, however, noteworthy that in the US, legislation has been proposed11/ by Walter Fauntroy, Chairman of the House sub-committee on international development, finance, trade and monetary policy, that would require commercial banks which refuse to participate in IMF/World Bank-sanctioned debt reduction agreements, to establish special reserves against the banks' outstanding loans to the relevant country; if this proposal were approved, commercial banks that refused to participate would be banned from taking a tax deduction when the outstanding loans are declared partially or wholly uncollectable. This legislation further requires the appropriate US agencies to enter into multilateral negotiations to seek the adoption of similar guide-lines for non-US bank institutions.

Though the proposal in the US House of Representatives is somewhat different from the one made above in the European context (as it addresses the need in the US to increase reserves, as well as to encourage debt reduction), it seems to pursue a similar objective to the one presented above, in that it wishes to use tax incentives for encouraging debt reduction and increased provisioning.

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10. Devlin (1989) explains the reluctance of some banks to sell Bolivian debt in early 1988 as due to the fact that they were **fully reserved** against Bolivian risk and would gain little immediate accounting benefit from a formal recognition of loss; on the other hand, Devlin points to the fact the other banks, **with inadequate reserves**, wanted to avoid the losses implied by participation in a buyback. In the scheme presented above, banks would be encouraged to increase reserves but their tax incentives would only be maintained if debt losses were taken, so they would have had a fiscal incentive to sell Bolivian debt.

11. 'Incentives play for banks' debt reduction deals', **Financial Times**, June 29,1989

Implementation of the proposed tax changes may possibly not require changes in European tax laws; indeed, the proposal that tax concessions should - after a period - continue to be granted only if debt/debt service reduction takes place, by a particular bank joining internationally agreed schemes, is consistent with basic taxation and accounting principles. An expert on bank, tax and accounting matters (Wainman 1959) argues that 'for tax purposes a loan loss provision must relate to the expected ultimate irrecoverability, or past irrecoverability, of principal...tax authorities may be suspicious of "prudential" provisioning rather than that wholly based on strict estimates of irrecoverability'. Thus, if a bank would refuse to participate in debt/debt service reduction at the time this was being agreed by most banks and recommended by the IMF, its claim - for tax purposes - of irrecoverability would be seriously eroded, and the case for continued tax relief on the provisions against these loans would be so weakened that a logical case could be made by the tax authorities to reduce those tax concessions, possibly without recourse to new legislation.

If such a line were to be taken by tax authorities, it would be particularly valuable if the position were made clear and public, to provide signals to the banks. Lack of knowledge and clarity about the future reaction of tax authorities to changes in debt management policies may inhibit the search for innovative solutions, as bankers are less willing to be innovative if they are unsure of the implications of their actions.12/

3. CAPITAL REQUIREMENTS AND LOAN-LOSS RESERVES

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 reduction. 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 (Rodriguez 1989).

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12. Based on interview material and personal experience in negotiating debt donations for UNICEF.

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 are 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 regulators13/ 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; as an expert in bank accounting put it, 'the bank directors can be seen to be acknowledging (for general reserves) that whilst the main function of all banks' capital is always to meet potential losses, this part of the bank's capital is slightly more earmarked'.

Furthermore, it had been reported that France had partly adopted this approach due to its need to strengthen the financial position of the banking system in the context of a gradual privatisation of the banks. However, the Mitterand government shelved plans for privatising the large state banks (such as BNP and Credit Lyonnais) when it announced in 1988 that there would be no further privatisations during his second term of government; this announcement, plus the French government's decisions to boost the capital of one of the large state-owned banks, Credit Lyonnais, to meet international standards of capital requirement

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13. Interviews both in the Banque de France and the Bank of England; see also D Wainman, op. cit.

ahead of time14/, would 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 (see Bouchet and Hay 1988), may not have such negative effects on possible debt/debt service reduction as some observers have feared.

Furthermore, it is interesting that French bank supervisors do not seem aware of any disincentive effect which their treatment of loan loss reserves, as part of capital, may have on debt reduction.

They 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.15/

Examined from the criteria of debt/debt service reduction, it would seem desirable that no exceptions to the Basle agreement remained after 1992, as regards inclusion of loan-loss reserves in capital, as this would harmonise incentives in this aspect for debt/debt service reduction. Furthermore, this approach would seem clearer and more correct in accounting terms; as David Wainman (1989) points out:

> A bank must in all cases provide against bad and doubtful lending, in the latter case to the extent of its dubiety. Such provisions directly reduce profits ('above the line') and therefore reduce also retentions and shareholders' funds.

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14. See 'Credit Lyonnais to boost capital', **International Financing Review**, Issue 775, May 13 1989.

15. Some difference may still remain in the application of the Basle agreement. For example, the French banking and regulatory authorities are reported to have indicated their wish to use the part of the Basle agreement allowing loan-loss reserves after 1992 to be included in capital 'temporarily and exceptionally' up to over 2.0% of risk weighted assets.

4. INTEREST CAPITALISATION vs NEW MONEY

The specialised literature on debt (Bouchet and Hay 1989; Williamson, M. 1988; Williamson, J. 1989) has stressed correctly that US regulatory and accounting policies discourage the use of interest capitalisation, because under normal circumstances in the US capitalised interest would not be eligible for accrual into reported profits but would be counted as part of taxable income; this is in contrast with 'new money' which finances interest payments, in which case those interest payments are included as part of income.

It would seems that this artificial distinction between 'new money' and capitalised interest does not exist in European regulations. European regulators argue that the best option would be not to accept the capitalised interest as income, and therefore not to tax it.16/

In Europe regulators expressed willingness to be flexible and not to provide disincentives as regards different options for debt/debt service reduction, including in particular interest capitalisation. In the U K regulators also expressed their aim to provide a neutral regulatory environment (a level playing field), so as to 'facilitate rational choices for banks'. They pointed to the conceptual difficulties in defining appropriate rational accounting and regulatory treatment for actions such as interest capitalisation, interest relief or debt relief for which there are no real precedents. A feeling emerged from the interviews that regulators and regulations in Europe would not discourage interest capitalisation, though they would also not actively promote it.

In the UK, treatment of interest arrears (which gives an indication of how agreed interest capitalisation would be treated) is somewhat more flexible than in the US (Wainman 1989). Thus, in the US, a convention recently reinforced by a US Practice Bulletin 'Income Recognition on Loans to Financially Troubled Countries' suggests that after payment has restarted, some history of repayment performance is required, as well as fully current payments on interest and principal, and 'normalisation' of relations with the IMF before the borrower is removed from non-accrual status. In the UK, there is less insistence

16. This is also the optimum solution adopted by J. Williamson for US treatment of interest capitalisation.

on seeing continuity in a debtor's meeting its obligations, before accrual of interest is recognised.

5. POLICIES FOR PROVISIONING

I have discussed above the tax implications of loan-loss reserve provisioning. In this section, I will refer to the regulatory policies on provisioning itself.

Most emphasis will be placed on British regulations, given their more precise nature, and given the interest that such regulations have provoked internationally, with some other creditor countries reportedly even studying the possibility of implementing a similar system.

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 in 1987, which is widely known as 'the matrix'; in the UK, the 'matrix' marked an important break with earlier provisioning policies. 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 Bank of England's previous policy.

The Inland Revenue has stated its view that the matrix is relevant material for determining the extent to which provisions against sovereign debts are deductible for tax purposes; as discussed above, it has been reported that for 1988 up to 100 per cent of the specific provisions against sovereign risk may be allowed against tax. One of the problems with tax treatment of international lending (provisioning and alternative debt management) has been lack of clarity and transparency by tax authorities. The introduction of the 'matrix' has made an important contribution towards improving transparency on tax matters, though full transparency is far from being achieved. (For details of matrix, see Appendix 1).

As regards the provisioning treatment of Mexico's bond swap transaction of March 1988, the Bank of England ruled that the adequacy of provision against Mexican debt not exchanged (whether tendered or not) would continue to be assessed in reference to the matrix. In this aspect, therefore, the Bank of England proved far more flexible than the US regulatory authorities, which ruled that treatment of debts tendered would be similar for regulatory purposes, whether the tender was accepted or not, thus providing a disincentive to banks to participate in the tender.

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 the 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; however, it would be preferable in Britain and elsewhere 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.

In the case of Germany, there is far less influence from the regulatory authorities over the level of provisioning. Credit risks relating to sovereign debts are regarded as specific rather than general risks. There is in Germany no binding guideline which prescribes for which developing country provisions must be set up, or the percentage write-downs which are considered necessary. It is up to each bank's management and their auditors to decide what is adequate. However, Bouchet and Hay (1989) report that if the bank's profitability is sufficient, it is expected that provisions will be built up each year for country risks, so that over the years sufficient amounts are accumulated to absorb major credit losses if a sovereign debtor defaults. As discussed above, these provisions are strongly encouraged by their tax treatment.

In the case of France, great priority is given by the regulatory authorities (located at the Commission Bancaire, of the Bank of France) to levels of provisioning that are close to the average of all the banks, for a basket of sovereign risks on countries with serious liquidity problems. French regulators point to the fact that basically they trust the average judgement of the banks, a concept which they call 'the wisdom of the financial centre.' French regulators see their use of the average rate of provisioning, as a point of reference, as having two main advantages: firstly, it reflects the judgement of bankers which they value; secondly, it implies an upward bias to provisioning levels, which French regulators consider essential. It is reported (by Bouchet and Hay, 1988) that the Commission Bancaire can be quite aggressive in recommending that banks increase their provisions against country risk if a bank is not keeping up with its peers. During 1988, the average rate of loan loss provisions is expected to have increased significantly, to a level of about 52 per cent. The highest levels of provisioning are expected to be in the two large state banks (BNP and Credit Lyonnais). Two out of the three largest French banks are state-owned; though these two banks are run on commercial principles, the fact they are state-owned could possibly increase their flexibility for debt/debt service reduction, particularly if appropriate encouragement/incentives are provided by the government.

6. CONCLUSIONS AND POLICY RECOMMENDATIONS

Changes in regulatory, fiscal and accounting policies in creditor nations are particularly relevant in the context of the Brady Plan, which stresses officially supported, market based, voluntary debt reduction. In this context, regulatory and fiscal changes fit well as part of a strategy in which industrial governments induce, encourage and nudge private banks towards some debt/debt service reduction. If the Brady Plan would be seen not to work, and a directly negotiated or unilateral approach were to become dominant, then regulatory and fiscal changes would possibly become less crucial to the outcome, playing more of a supporting and passive role, rather than the encouraging and active role required by the framework of the Brady Plan.

In the context of the Brady Plan it seems particularly essential to integrate far more clearly than has been done until now, discussions between regulators, fiscal authorities and policy-makers designing the new debt management strategy, to make more consistent their policy objectives and measures. This should be done both nationally and internationally.

At a European level, it would be very desirable for a report to be produced by regulators and tax authorities to evaluate effects of current regulatory practices on debt management and evaluate possible changes.

Furthermore, it would seem valuable if closer co-ordination took place at an international level amongst taxation and accounting authorities, on international debt matters, along lines similar to the highly effective Cooke Committee on Banking Supervision. A priority issue for such a committee could be to examine the most appropriate form of tax treatment of loan-loss reserves, that would satisfy the objectives and needs of tax and regulatory authorities, and encourage debt/debt service reduction.

In this area, a relevant proposal for Europe and Canada, is that tax concessions continue to be granted when loan-loss provisions are made; however when debt/debt service reductions are accepted as desirable for particular debtor countries, by the IMF and World Bank, **banks should only retain their tax concession if they participate in the debt/debt service reduction scheme.** This would both encourage provisioning and discourage free-riding.

European action in this field could be complementary to legislation currently being discussed in the US Congress (see above). Tax policy seems the most crucial element to change within regulations, broadly defined, if voluntary debt reduction is to be encouraged.

Beside the above suggestion to encourage debt reduction, it is suggested 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.

As regards treatment of loan-loss provisions, it is important that for all countries they are excluded from capital, as this would also encourage debt/debt service reduction. 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.

As regards interest capitalisation vs new money, it is essential to provide neutral incentives for either option to be followed. The optimum solution (for both the US and Europe) would be that capitalised interest would not be included in income, and not be taxed. The main constraint for neutral treatment is in the US regulation. Europe, where the regulations are more ambiguous, could take the lead in this matter.

As regards provisioning, the high levels of provisioning established or required in most European countries are in themselves a positive development, as they cushion the banks from possible losses and provide new flexibility for debt management. What is required are the tax and other incentives to transfer some of these loan-loss provisions into debt/debt service reduction. In the UK the use of more precise criteria for provisioning (via the'matrix') seems a positive step, which gives a fairly broad and objective basis for evaluating desirable levels of provisioning. Finally, 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.

Emphasis has been placed on measures that encourage voluntary debt reduction. There are other measures which could enforce debt reduction, and eliminate free rider problems more directly. 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 debt/debt service reduction.

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Appendix 1

Description of Bank of England Matrix

A number of factors or criteria are identified in the Matrix to help decide the appropriate level of provision. These factors can be weighted to reflect their relative significance for assessing the recoverability of a loan. They fall 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;

C Factors which help to assess the likelihood that these difficulties will not be overcome.

The matrix includes a total of 15 factors under the 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 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 different weights have been attached to the factors to reflect their relative seriousness.

Category C factors alone are not thought to point to irrecoverability and the need for provisioning, which can only be triggered by a factor or factors taken from Category A or Category B. It is suggested that a minimum score of 10 from categories A and B is required before the question of provisioning arises. Nonetheless it is recognised that economic and other factors of the kind incorporated in the matrix are important in assessing the borrower's position.

The scoring system will provide a country ranking which can be used to establish the relative ranking in the size of provision. Because the methodology cannot produce precise results, levels of provision are established within broad bands against bands of scores.

Score	Provision
10-24 (of which 10 from Categories A and B)	5- 15%
25-40 (of which 10 from Categories A and B)	16- 25%
41-55	26- 40%
56-70	41- 60%
71-83	61-100%

Scope of application

There are two alternatives:

(i) to apply the factors and resulting provision percentage against all claims on a country;

(ii) to apply the factors and resulting provision percentage separately to different classes of asset.

The Bank's view is that, for supervisory purposes, the percentage provision should be applied to a bank's total exposure, including risk transfers to a particular country, unless it can be satisfied that a particular claim or class of claims is recoverable in full.

'A' FACTORS

(1) Moratorium in Effect

Unilateral action by a country to limit its debt servicing payments, either totally or partially, to creditor. Score 3 if moratorium has been currently in effect for up to 3 months, score 6 for between 3-12 months. Any moratorium over 12 months scores 10.

(2) Country Re-scheduled at any time since January 1983

Country that has re-scheduled either commercial or official debt since January 1983 or is currently in re-scheduling negotiations. Score 10.

(3) Second or more Rescheduling of Principal Amounts rescheduled since January 1983

Country that has rescheduled either commercial or official debt since January 1983 or is currently in rescheduling negotiations. Score 10.

'B' FACTORS

(4) Arrears Interest or Principal to IFI's over Threshold to Stop Disbursement

Country that is currently in arrears on either interest and/or principal to the International Financial Institutions (IMF, World Bank, Regional Development Banks) over the threshold to be declared ineligible (in the case of the IMF) or to stop disbursement (in the case of the World Bank and Regional Development Banks). Score 10.

(5) Arrears Principal on Original and Rescheduled Loans Other External Creditors

Any current arrears on principal on loans (both original and re-scheduled) from external creditors other than those in category (4). Score 4 for arrears of currently up to 3 months and 8 for arrears in excess of this period.

(6) Arrears interest

Any current arrears on interest on loans (both original and re-scheduled) from other external creditors. Score 4 for arrears of currently up to 3 months and 8 for arrears in excess of this period.

'C' FACTORS

Economic and Miscellaneous Factors (Columns 7-15)

(7) Interest Service Ratio

This is defined as interest payable divided by the value of exports of goods and services (in 1986) and rounded to one decimal place. An interest service ratio between 15.0% and 24.9% scores 2, one of 25.0% or more scores 4.

(8) Visible Import Cover

This is defined as the number of months' import cover (i.e. the annual value of imports divided by 12 and then divided into reserves) the result rounded to one tenth of a month. Reserves should include gold valued at 75% of the market price at end-1986 ($293 per oz). Import cover of 1.9 months or less scores 4. Cover between 2.0 and 3.9 months scores 2.

(9) Debt/GDP ratio

This is defined as total external debt divided by Gross Domestic Product for 1986 expressed as a percentage, and the result rounded to the nearest one tenth of a percentage point. Ratios between 50.0% and 74.9% score 2; ratios 75.0% and over score 4.

(10) Debt/Exports ratio

This is defined as the total external debt divided by the value of exports of goods and services for 1986 expressed as a percentage, the result rounded to the nearest percentage point. A debt export ratio in the range 300% to 499% scores 2. A debt exports ration of 500% or more scores 4.

(11) Not meeting IMF Targets/Unwilling to Go to IMF

A country should score 3 under this criterion if it is in breach of IMF targets (i.e. performance criteria for any programme, e.g. SBA or SAF) or is unable or unwilling to go the IMF.

(12) Unfilled Financing Gap Next 12 months

Country has an unfilled external financing gap between its prospective payments outflows and its prospective inflows after taking into account all presently available sources of finance. Score 2.

(13) Market price

Secondary market 'bid' price for the country's debt (as a percentage of face value): between 50.00% and 79.90% score 2, below 50.00% score 4.

(14) Over-dependence on single crop/commodity

Score 2 if 30.0% or more of the value of a country's exports of goods and services in 1986 comprised a single primary commodity.

(15) Other Factors

Score any number from 0 to 5 depending on your assessment of other conditions in the country (whether economic or political) which affect its ability to repay indebtedness both now and in the future.

*   *   *