

Abbott, George C.

Article — Digitized Version
Loan loss provisioning

Intereconomics

Suggested Citation: Abbott, George C. (1989) : Loan loss provisioning, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 24, Iss. 5, pp. 233-240, <https://doi.org/10.1007/BF02928640>

This Version is available at:
<https://hdl.handle.net/10419/140204>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

the dynamic effects of trade in services have remained "underexploited" so far; by importing services that they cannot yet provide cheaply themselves and developing their physical and human capital a number of countries can modify their export structure and develop a competitive range of services. For example, today Singapore has a comparative advantage on account of its good communications infrastructure and well qualified workforce. This dynamic element is not confined to newly industrialising countries; India and Thailand have become important suppliers of technical services. Moreover, the developing countries retain their traditional comparative advantage of lower labour costs in certain service industries, such as tourism. Finally, new fields with comparative advantages are opening up for developing countries, such as more sophisticated services in which a shift in their direction is discernible. Examples of services imported by industrial countries include type setting in Korea, data recording in the Philippines, Korea and Barbados and computer software from India and Pakistan.

²⁹ J. N. Bhagwati: Trade in services: Developing country concerns, in: "economic impact", No. 62 (1988/1), pp. 58-64, here p. 58 (abridged version of a paper published in: The World Bank Economic Review, Vol. 1, No. 4, September 1987).

The detailed discussion of procedural questions between the "Group of Ten" – mainly Brazil and India in this instance – and the United States before the opening of the talks in Punta del Este long overlaid fundamental differences of approach on the issue; the United States and more recently the EC as well want to grant concessions on their merchandise imports in exchange for more liberal conditions for their exports of services. By contrast, the developing countries insist that the industrial countries should resolve the old problems of merchandise trade by means of "standstill" and "rollback" arrangements under existing GATT obligations, which they have not wholly fulfilled up to now. Hence in their view there is no justification for wanting to link concessions on merchandise trade and trade in services.²⁹

For the majority of developing countries multilateral negotiations are an appropriate path, since this approach provides the most effective protection for the economically weak. To minimise disappointment over the outcome of the Uruguay Round, no more than freer trade in the services sector should be expected; it would be unrealistic to envisage the complete removal of restraints.

George C. Abbott*

Loan Loss Provisioning

Before the background of the debt crisis loan loss provisioning has been gaining in importance, as one of the measures adopted by banks to reduce their exposure in highly indebted countries and to strengthen their balance sheets. Prof. Abbott examines the concept and forms of provisioning, and discusses the recent establishment of international guidelines and their likely effects on the debt crisis.

By the nature of their operations, banks are discreet, prudent and cautious institutions. They do not throw around their clients' money or engage in imprudent lending on a massive scale. Yet, in retrospect, this is precisely what they did in the 1970s and early 1980s. There was also a lot of imprudent borrowing on the part of the developing countries, but this aspect of the debt crisis is well-covered in the literature, and for purposes of this paper, can be taken as read. Of more

immediate concern is the way the banks reverted to form once the crisis broke, and the effect which their actions have had on the course of the crisis.

Basically, the banks reacted to the debt crisis in two ways. Firstly, they reduced the amount of lending to debtor countries, and secondly, they sought to call in outstanding loans. The purpose of these mutually reinforcing actions was to reduce their exposure in problem debtor countries. In 1982, for example, the claims to capital ratio of the 9 US money centre banks in

* University of Glasgow, UK.

the most heavily indebted countries amounted to almost 200 per cent. By 1986, it had been reduced to 120 per cent. Admittedly, these were the most highly exposed banks, but their actions were typical of banks in general, which cut back sharply on lending to developing countries and adopted a variety of measures, a "menu of options", to use the current phraseology, to reduce their exposure and strengthen their balance sheets. The banks are now, in fact, considerably stronger than when the crisis broke in 1982.

This paper deals with loan loss provisioning, one of the measures by which the banks transformed their bargaining position over the course of the debt crisis. It defines the concept and forms of provisioning and reviews the various policies, practices and procedures of the major creditor countries, and compares the effects which different national supervisory requirements, tax regulations and accounting procedures have on provisioning. It also discusses the recent establishment of international guidelines (the so-called Basle Accord) and the effects which these are likely to have on the debt crisis and banking operations in the problem debtor countries.

Concept and Forms

Loan loss provisioning is the process by which banks set aside resources or increase their reserves against the possibility of some loans not being repaid. It is thus a *sine qua non* of prudent banking practices and procedures. However, the emergence and scale of the debt crisis have added a new dimension and urgency to provisioning. It is no longer a purely precautionary move in anticipation of possible losses. It has now become an essential and integral part of the banks' overall strategy for coping with the crisis.

Loan loss provisions are debited against profits for the year in which they are made. They are held in a special reserve account, which is debited as and when the expected losses materialise. If, on the other hand, the loans prove sound, these reserves are re-credited to the bank's balance sheet through its profit and loss account. Provisioning therefore plays a crucial role in determining the tax liability, profitability and the capital adequacy of banks. In 1987, for example, several British banks reported massive pre-tax losses for the first time in their history as a result of having to increase their level of provisioning against overseas lending. Others had to raise equity capital and/or sell assets in order to strengthen their balance sheets. These measures had serious knock-on effects on the market value of their shares.

Basically, there are two types of provisions: specific (allocated) and general (unallocated). The former covers losses which are identified as likely to materialise in the foreseeable future and for which provisions are allocated. The latter is really a precautionary measure where a general deterioration of the loan performance is anticipated. The distinction between the two categories affects, *inter alia*, the amount of tax relief which the banks can claim against loan loss provisions. In some countries, (the UK and the USA) general provisions are not fully or automatically tax-deductible, but have to be negotiated on a case-by-case basis. They are therefore costly to banks and a major disincentive to new lending. In most cases, loans to developing countries are covered by general provisions, on the grounds that: "First, it was not (and is still not) clear under what conditions losses can be realised, other than by disposal, on a loan made to a sovereign debtor. And second, banks have been concerned that knowledge of the existence of specific provisions might induce an element of moral hazard, encouraging the debtor country to consider that its obligation was in some measure reduced."¹

Policies, Practices and Procedures

Provisioning is essentially a function of exposure and the perception of risks associated with lending. In terms of international banking, the major risk is that borrowers may default on their debts. In the case of developing countries, there is the further possibility that a particular country may not have the necessary foreign exchange to service its international obligations, although individual debtors within the country may not themselves be in financial difficulties. Banks have, therefore, to diversify their exposure not only between individual debtors but also among individual borrowing countries. Consequently, there is considerable variation in terms of the policies, practices and procedures for provisioning among the major creditor countries.

Some banks not only increase their general provisions (i.e. strengthen their capital base as well as increase reserves) but also make specific provisions against individual debtors or debtor countries. Others provision against a group or "basket" of countries which have had, or are likely to have, debt service problems. Both methods obviously have their advantages and are

¹ World Bank: World Debt Tables 1987/88, External Debt of Developing Countries, Vol. 1, Analysis and Summary Tables, Appendix II, pp. XXIV-XXV, Washington, D.C., 1988.

² Cf. Peat, Marwick, Mitchell & Co.: Allowances for Sovereign Risks: an International Survey, 2nd ed., Frankfurt 1986.

adapted to suit particular circumstances. Specific provisioning gives banks greater flexibility in their operations and allows different categories of loans to be treated according to the record of the debtor. On the other hand, a "basket" approach spreads the risks over the members of the basket. However, if the risks in any one country increase, then this is reflected in terms of the overall risks of the basket of countries and results in higher provisioning for the group, irrespective of developments in individual members. A "basket" approach could thus well prove counterproductive.

These are essentially extreme positions. The provisioning practices of most creditor countries fall somewhere between them. The trouble is that some banks provide details of their practices and requirements. Others do not. The picture of what actually pertains in terms of the different accounting procedures and practices as well as tax regulations and requirements is thus far from clear or complete. In a survey undertaken in 1986, Peat and Marwick found that although there was some move towards uniformity, there was still considerable variation among reporting countries in respect of national provisioning practices and the way sovereign borrowers were categorised.²

Canada, for example, did not estimate directly the risks attached to individual countries. Instead it adopted the "basket" approach and listed a total of 32 countries for which loan loss provisioning should be made. The United States named 7 countries with rates varying from 15 per cent to 80 per cent. The Netherlands had a list of 25 countries with minimum rates of allowances between 5 per cent and 100 per cent. Some countries (Spain, Sweden and Switzerland) grouped debtor countries into risk categories, while others like Japan and the USA took account of various risk parameters, such as the

number of reschedulings and non-performing loans, in assessing risks to sovereign borrowers. Table 1 gives a summary of the different practices.

Tightening of Requirements

Since this survey was published, several creditor countries have tightened their procedures and requirements for provisioning. In Canada, where provisioning is mandatory, the number of countries in the "basket" has been increased to 34, with reserve requirements ranging between 30 per cent and 40 per cent. In the United States, provisioning is mandatory only in cases of claims which have been declared "value-impaired" by the Interagency Exposure and Review Committee. An asset is considered "value-impaired" when

- ☐ interest payments are six months overdue,
- ☐ there are no immediate prospects for compliance with IMF programmes,
- ☐ the country has not met rescheduling terms for over a year, and
- ☐ an orderly restoration of debt service in the near future is unlikely.

In 1988, Bolivia, Costa Rica, Liberia, Nicaragua, Peru, Poland, Sudan and Zaire fell into this category. The level of reserves held by big banks for problem debtor countries ranges between 25 per cent and 35 per cent.

In Switzerland, another country in which provisioning is mandatory, the supervisory authorities issued a set of guidelines in 1986 which, *inter alia*, required banks to raise the average level of provisioning against 100 developing countries to 50 per cent. Most big banks in fact, have reserved up to 60 per cent. In Japan, all banks must meet the government's guidelines of maintaining a minimum of 5 per cent reserves against loans to 38 countries. On the other hand, there are no formal rules on provisioning in France and West Germany. The supervisory authorities take a very liberal approach to provisioning, and the capital adequacy of banks is judged on a case-by-case basis and precedent. However, most big banks have established reserves against loans to developing countries. In France, these average about 45 per cent for a basket of 40 countries, while in Germany they exceed 50 per cent.

In July 1987, the Bank of England issued guidelines to British banks for determining the appropriate level of provisioning they should hold against loans to developing countries. These guidelines, or matrix, incorporate a checklist of factors against which each

Table 1
Countries which Identify Problem
Sovereign Borrowers

Each Country	Group of Countries	Risk Parameters	Rate of Allowance (in %)
Canada	—	—	10 - 15
—	—	Japan	1 - 5
Netherlands	—	—	5 -100
—	Spain	Spain	1.5-100
—	Sweden	Sweden	30 -100
—	Switzerland	Switzerland	10 - 50
USA	—	USA	15 - 80

Source: Peat, Marwick, Mitchell & Co.: Allowances for Sovereign Risks: An International Survey, 2nd ed., Frankfurt 1986, as reproduced in: Financial Times, London, 24th June 1986, p. 24.

bank can rank the repayment performance of individual debtor countries. The negative criteria are cumulative, i.e. a country which fails to meet all of them would score the maximum of 83. The matrix of debt recoverability along with the "unofficial" bands for converting to the appropriate provisioning requirements are shown in Table 2.

The advantage of this particular approach is that it allows banks a considerable amount of flexibility in determining the performance of debtor countries and the appropriate level of provisioning. It is possible, for example, for debtor countries to be assessed differently by individual banks. On the other hand, banks complain that it does not give sufficient weight to the positive factors such as whether a debtor country is repaying principal or if it has a good debt-equity swap scheme in operation. In 1988, the average level of provisioning against Latin American debtors ranged between 35 per cent and 40 per cent.

Divergences

There are also glaring divergences in respect of capital adequacy regulations and practices. Although the supervisory authorities determine the minimum capital asset ratios which banks must maintain, the factors (and their relative weighting) which determine this ratio create enormous problems of definition, measurement and international comparability. For example, how should primary capital be defined, and what should it include? In the USA, loan loss provisioning is included as part of primary capital in order to maintain the mandatory 6 per cent capital-asset ratio. In the United Kingdom, banks must disclose their reserve position, and loan loss provisions, whether general or specific, are not considered part of primary capital. Canada, Germany and Switzerland also do not include loan loss reserves against developing country debts as part of primary capital.³

Also, how should hidden reserves and various forms of "off-balance sheet" operations which entail hidden risks be treated? One obvious point of the difficulty of international comparability is the case of Japan which has a low loan loss reserve ratio but massive hidden reserves, 70 per cent of which are treated as good capital. This enables it to accept lower rates of return on equity than other creditor countries. The question of interest capitalisation also needs to be resolved. Among other things, interest capitalisation creates perpetual debt. Should it, therefore, be regarded as an integral

part of primary capital in preference to equity? The French argue that it should. Other anomalies exist.

It is not possible, in a short article, to capture and compare the full range and diversity of supervisory, accounting and tax regulations governing loan loss provisioning in creditor countries. Table 3, which was compiled before 1987 when the real rush of provisioning took place, does not really represent the current "state of play". It does, nevertheless, provide a useful comparison of the principal statutory requirements and country practices affecting commercial creditors. Although the table is self-explanatory, a couple of points are worth underlining. Firstly, Japan and the USA, the countries with the lowest loan loss reserves had the most comprehensive set of regulations. Conversely, the countries with the highest reserve ratios (Germany and France) had the most relaxed regimes. Secondly, the supervisory authorities in Britain had always adopted a gradual and minimalist approach to provisioning, preferring to leave individual banks to set appropriate levels of provisioning and to regulate and monitor loan

Table 2
Bank of England Matrix of Debt Recoverability

Factor	Score
Moratorium in effect	3
0-3 months	6
3-12 months	10
over 12 months	10
Rescheduled since 1983	5
Rescheduled twice or more	10
In arrears to IMF/World Bank	5
In arrears on principal to other creditors	10
0-3 months	4
over 3 months	8
In arrears on interest to other creditors	4
0-3 months	8
over 3 months	8
Interest/export ratio since 1986	2
over 157/16	2
Import cover end 1986	2
below 4 months	4
below 2 months	2
Debt/GDP ratio since 1986	2
over 50 %	4
over 75 %	2
Debt/export 1986	4
over 300 %	4
over 500 %	4
IMF targets unmet/unwilling to go to IMF	3
Unfilled financing gap	2
Secondary market price	2
below 80	4
below 50	4
Overdependence on single export	2
Other factors	0-5

Unofficial¹ Bands for Provisioning Requirement

Score	Provisioning Requirements
10-24	5-15 per cent
25-40	16-25 per cent
41-55	26-40 per cent
56-70	41-60 per cent
71-83 (max.)	61-100 per cent

Source: Financial Times, London, 12th August 1987.
Note: ¹ Unconfirmed by the Bank of England.

³ Cf. Maxwell Watson et al.: IMF Occasional Paper 43, International Capital Markets: Developments and Prospects, Washington, D.C., Feb. 1986, pp. 27-29.

performance. The publication of the Bank of England guidelines in 1987 strengthened and systematised the whole process of provisioning.

International Levels of Provisioning

The level of provisioning is influenced by a variety of factors, including the supervisory requirements of individual creditor countries, the scale of banks' exposure, the tax position regarding the liability of reserves and the level of banks' profitability. Historically, though, the level of provisioning has tended to be higher in continental Europe where banks are allowed to offset provisioning for unrealised losses against current tax liability. In Japan and the USA, only a specified proportion is allowed for tax liability purposes, when actual losses have been sustained. Given the diversity of factors involved, it is not possible to draw direct comparisons between levels of provisioning among the principal creditor countries. Nevertheless, Table 4 gives a broad picture of the level of loan loss reserves as a percentage of exposure in developing countries between 1985 and 1988.

Although it is only partially reflected in the Table, provisioning levels in the principal creditor countries have increased since 1982, when the debt crisis erupted. What the figures do clearly show though, is that since 1987 there has been a dramatic increase in

provisioning levels. Two interrelated events accounted for this change. One was the decision by Brazil in February 1987 to suspend indefinitely payment of capital and interest on some \$60 billion commercial bank loans. The other was the decision by Citicorp in May 1987 to provision \$3 billion against potential losses on its loans to developing countries.

At the time, Citicorp's decision was billed as a straightforward precautionary move to allow for the possibility that some of its loans to these countries were unlikely to be repaid. However, it had much wider repercussions. Among other things, it triggered off a spate of similar precautionary moves by other banks both in the United States and other major creditor countries. The most significant increases in provisioning occurred in the USA, where the 9 largest banking groups increased their total provisions by almost \$11 billion over their 1986 level.

As the figures in Table 4 show, loan loss reserves as a proportion of developing country debt exposure in 1986 ranged between 2 per cent and 5 per cent. In 1988, the proportion rose to 30 per cent for large banks and between 50 per cent and 60 per cent for regional banks. In Japan, the pre-1987 level of provisioning was officially limited to 5 per cent, out of which only one per cent of exposure to a basket of 38 countries was tax-deductible. The ceiling has now been raised to 10 per cent which is

Table 3
International Differences in Supervisory, Accounting and Tax Regulations Affecting Commercial Creditors

	USA	UK	Japan	Canada	Germany	France	Switzerland
Rules Issued by Supervisory Authority on LLPs ¹							
a) No Rules Issued		x			x	x	
b) Rules Published			x	x			
c) Rules Communicated Confidentially	x						x
Identification of Countries by Supervisory Authority							
a) None		x			x	x	
b) Specific	x		x				
c) By Groups							x
d) With Risk Parameters	x		x				
Identification of Provisions Required or Recommended							
a) Specific	x		x				x
b) General			x	x			
Monitoring of Compliance with Regulatory Requirement							
a) Inspection	x			x		x	
b) Use of Reporting Requirements	x		x	x			x
c) Use of Auditors				x	x		x
Requirement for Foreign Loans to be Disclosed in Public Financial Statement	x			x			
Disclosure of LLPs Required	x	x	x	x		x	
Disclosure of Allowance for Possible Loan Loss							
a) Specific and General Allowance Less Gross Loans	x	x			x		
b) Specific and General Allowance Shown with Liabilities			x				x
c) Specific Allowance Less Gross Loans or General Allowance Shown with Liabilities							x
d) Other				x			

Source: Peat, Marwick, Mitchell & Co.: Allowances for Sovereign Risks, op. cit.

Note: ¹ LLPs: Loan Loss Provisions

still low by comparison with other major creditor countries. This disparity is, however, offset by the size of hidden reserves which is considerably larger than in other creditor countries.⁴

Even allowing for the upward revision of provisioning levels induced by Citicorp's decision, there is still a wide disparity among creditor countries. The highest levels of provisioning occur in continental Europe (France, Germany, Switzerland) due mainly to the fact that these countries have been provisioning against developing country loans over a much longer period, and also to the liberal approach of the authorities to each bank's provisioning policies. In Germany and France, provisioning is done on a case-by-case basis and is tax-deductible. In the United States, on the other hand, only "value-impaired" loans are tax-deductible. The authorities place more emphasis on capital adequacy and general reserves than on provisioning against individual debtor countries. Another reason for the disparity is that the depreciation of the dollar since 1985 has raised the value of provisioning levels in domestic currencies in relation to dollar-denominated claims.

Prior to 1987, British banks adopted a rather relaxed approach to provisioning for Third World debts, partly in the hope that these debts would be repaid eventually. Consequently, the level of provisioning was woefully inadequate and low by international standards.

⁴ Japanese banks also established a factoring company in the Cayman Islands in 1987 which purchases Japanese loans to Mexico at a discount. Any losses sustained in the transactions were tax-deductible.

Table 4
Loan Loss Reserves as Percentage
of LDC Exposure, 1985-1988

	1985	1986	1987	1988
United States	...	2-5	...	...
Large Banks	...	...	25	30
Regional Banks	...	...	30-35	50-60
United Kingdom	5	5-15	25-30	25-33
Germany	...	30-50	35-70	35-70
Japan	...	5	5	10 ^a
Canada	8	10-15	30-40	35-40
France	min 16	30	min 30	min 30
Switzerland	...	20-30	30-50	min 35

Sources: Burn Fry Limited; Business Week, 20th March 1987 and 21st May 1988; The Economist, 21st March 1987, 27th February 1988 and 31st January 1987; Euromoney, June 1988; Financial Times, 12th August 1987, 15th March 1988 and 23rd May 1988; IMF: International Capital Markets, World Economic and Financial Surveys, January 1988; Neue Zürcher Zeitung, 29th-30th May 1988; Prudential Bache Securities: Banking Industry Outlook; World Bank: World Debt Tables 1987/88.

Note: ^a The Ministry of Finance is considering raising the provisions allowed for bad loans to LDCs from 5 to 10 per cent. According to the Neue Zürcher Zeitung (29th-30th May, 1988), this increase has been approved by the Ministry of Finance.

However, the position changed abruptly in 1987; a bad year for banks worldwide – profits fell sharply in most continental European countries (France, Germany, Switzerland, Italy, The Netherlands) and, in the USA, J. P. Morgan, one of the most prestigious banking houses, lost its Triple A rating. In the UK, Barclays and Lloyds, two of the leading clearing banks, sustained massive losses, something which had never happened before. Midland raised £700 million by way of a capital rights issue and a further £383 million from the acquisition of its Hong Kong and Shanghai subsidiary. These helped to strengthen its balance sheet against losses of over £500 million on developing country debts and the crash of October 1987. Table 5 shows the level of provisioning and exposure of the main clearing banks in 1987 and 1988.

The amount of funds which these banks reserved against developing countries' debt in 1987 was almost equal to their profits for that year. Although they increased the level of provisioning in 1988, none of them managed to reduce their exposure by more than 5 per cent. In the case of the Midland, it actually increased. They have also continued to sustain losses on their loans to developing countries. In 1988, Lloyds had a pre-tax loss of almost £250 million, and Barclays had a rights issue of £60 million against loan losses to developing countries. This brought its provisions to 48 per cent of debt exposure in 44 countries.

The Basle Accord

The first step towards the international harmonisation of regulations governing the operation of international financial capital markets was adopted by the Governors of the Central Banks of the Group of Ten in July 1988. The Basle Accord, as it is called, grew out of a joint British-American initiative which was intended to establish a common measure of capital adequacy for

Table 5
Provisions and Exposure of UK Clearing Banks,
1987 and 1988
(£ million)

Clearing Banks	Provisions 1987	% of Exposure	Exposure of LDC Debts	
			1987	1988
Barclays ¹	713	29	2,000	1,300
Lloyds	1,066	34	4,300	3,800
Midland	1,016	29	4,100	4,200
Nat West	810	33	3,600	2,500
Standard Chartered	400	NA	1,700	1,600

Source: Various issues of the Financial Times, London.

Note: ¹ Exposure excludes loans to South Africa and short-term loans amounting to £2 billion.

British and American banks operating overseas. It was later developed and formalised in the report of the Cooke Committee.⁵

The Accord has two main objectives, namely

- ☐ to establish new minimum capital adequacy requirements for international banks, and
- ☐ to devise a "fair" regulatory framework with a view "to diminishing an existing source of competitive inequality among international banks".

Effectively, therefore, it will ensure that all banks are subject to the same capital adequacy regulations and that they are competing on more or less equal terms, insofar as capital is concerned the creation of the so-called "level playing fields".

To achieve these objectives, the Accord provides a formula based on the riskiness of assets for measuring a bank's capital adequacy, and lays down a minimum capital requirement of 8 per cent of risk-adjusted assets, of which at least 4 per cent must be held in the form of shareholders equity, thus providing a significant margin of safety for depositors. It applies to Belgium, Canada, France, Italy, Japan, Luxembourg, The Netherlands, Sweden, Switzerland, the UK and the USA. It is due to become fully operational by 1993.

The Accord is divided into four main sections:

- ☐ the definition of capital,
- ☐ the risk weighting system,
- ☐ minimum capital ratios, and
- ☐ transitional arrangements.

As regards the definition of capital, the Accord allows for two categories, or tiers of capital. Tier 1, or Core Capital, consists of equity capital and disclosed reserves, and must constitute at least 50 per cent of a bank's regulatory capital. Supplementary, or Tier 2 Capital includes undisclosed or hidden reserves, asset revaluation reserves and other capital instruments which fall short of "core" capital, including limited amounts of loan loss reserves, hybrid (debt-equity) capital requirements, and subordinated term loans. "Supplementary" capital may equal but cannot exceed "core" capital.

The risk weighting system is virtually the same as that used by the Bank of England in its supervision of British banks. The emphasis is on credit risk and the following five main criteria are used for differentiating risks:

- ☐ maturity,
- ☐ the nature of the counterpart (e.g. bank, central government, etc.),
- ☐ the geographic location of the counterpart (i.e., whether it is OECD or non-OECD),
- ☐ collateral, and
- ☐ the currency denomination of the transaction.

Off-balance sheet items are also included in risk-weighting procedures, but they have to be brought on-balance sheet before being assigned a risk-weighted value. Capital adequacy is then measured by dividing a bank's capital base by the total of its risk-adjusted assets.

Countries like Germany, The Netherlands, Switzerland, the UK and the USA are already within striking distance of reaching the 8 per cent capital-asset ratio by 1992. Others, like Japan and France, will either have to reduce their overseas lending operations or raise additional "core" capital. According to the BIS, Japanese banks will have to raise between \$45 and \$60 billion in "core" capital to meet the target. It does not regard this task as unmanageable. The amounts required in the case of French banks are considerably lower, but distinctly problematic.

The Basle Accord is clearly a step in the right direction, but there is still a long way to go before harmonisation or effective coordination of regulatory and tax procedures and practices of international banking can be achieved. Even if this is achieved by the target date, it is doubtful whether harmonisation will materially affect the course of the crisis or improve the position of debtor countries. Provisioning is, in fact, a very minor part of the Accord's remit and the banks themselves have already reduced their exposure in these problem debtor countries. What it will do, of course, is to standardise practices and provide a basis for consistent and comparable treatment of loan loss provisioning. This should help to avoid a repetition of the unseemly spectacle of banks scrambling over each other to off-load their surplus funds on developing countries.

Effects of Provisioning

The most obvious effect of provisioning has been to strengthen the banks' balance sheets. Although some banks sustained heavy losses, this phase of the crisis is past. Current levels of provisioning in most cases now exceed mandatory requirements by a considerable margin, and banks are in a much stronger position to

⁵ The basic framework of this Accord is contained in the Report of the Basle Committee on Banking Regulations and Supervisory Practices (The Cooke Committee) of the Group of Ten, BIS, Dec. 1987.

resist calls for substantial additional concessions or quick solutions to the debt crisis.

Being better capitalised has major strategic and operational advantages for them. It frees them from the stress and strain of constant negotiations and repeated reschedulings. On the other hand, higher levels of provisioning create serious cash-flow problems for the banks themselves. They also determine to a large extent the size of dividends which banks are able to make. In this respect, therefore, they have an important bearing on shareholders' perception of the prosperity and stability of banks and the market value of their shares, which as recent experience shows, tend generally to fall after a major provisioning exercise.

Further, strengthening their balance sheets has made the banks less willing to provide new money or engage in rescheduling exercises. Providing new loans, particularly for those creditor countries which previously maintained low levels of provisioning tantamounts to a tax on new lending. A system of loan differentiation which allows for differential treatment between old and new loans along with the appropriate tax differential treatment would be one way of getting round this problem. It is doubtful though, whether the creditor countries are prepared to contemplate such a strategy since it raises questions about the status of old loans and the adequacy of existing levels of provisioning. It is more convenient for them to pursue alternative strategies.

On the other hand, increased provisioning has made it more attractive for these creditor countries which previously had low levels of loan loss reserves (Canada, the UK and the USA) to engage in debt-equity swaps, since the losses which they would otherwise have sustained have been substantially reduced or removed. Perhaps, though, more than anything else, what the recent attention to provisioning has revealed is the flexibility and diversity of strategic measures which creditor banks can employ in the management of their developing country loans. To quote the World Bank, "... a bank that has established a high level of reserves that are not considered part of capital has effectively lowered its cost of not participating in new money packages. Being well reserved, that bank can write term loans when arrears build up without impacting regulatory capital. A less-well reserved bank or a bank with reserves that are considered part of its capital may consider the possible cost of participating in a new money package to be less than the costs of having to write term loans or reduce regulatory capital. As a result, the less-well reserved banks may participate, while those with large reserves may try to free ride".⁶

Alternative Options

It is generally agreed that about \$1 billion bank loans to developing countries will never be repaid. One of the things that provisioning does, is to enable banks to write-off such loans, since they have, in fact, already covered themselves against such a possibility. Whether the banks will adopt this option is, of course, open to question. Some clearly feel that countries like Brazil and Mexico can, and should, repay their debts. Consequently, although they have increased provisioning levels against these countries, they depend on other measures from the so-called "menu of options" to see them through the crisis; e.g. debt-equity swaps and repeated reschedulings. Debt conversion in 1988 exceeded \$21 billion, more than the accumulated total for previous years. They have also reduced the scale of lending to problem debtor countries as part of their debt management strategy. Effectively therefore, while they provision against maximum losses, they seek to reduce their exposure to the minimum.

Others are prepared to take what they can get and/or get out. They accordingly trade developing country debts at substantial discounts in the secondary market. Between 1986 and 1988, the average price of developing country loans in the secondary market fell by 35 per cent. In the case of Argentina and Côte d'Ivoire, the fall exceeded 60 per cent and 65 per cent, respectively. In September 1988, these countries' debt was trading at less than 22 US cents of its nominal US dollar value. Other means of off-loading developing country problem debts include exit bonds and buy-backs, both of which have had a marginal impact on the crisis.

However, the wave of provisioning that took place in 1987 did not change the overall liability of the debtor countries or reduce the level of outstanding debts. To that extent, therefore, they remained largely outside the scope of the exercise. Similarly, loan trading operations on the secondary market do not reduce the level of the debt. That remains intact. All it does is to change the ownership of the claims. The significance of these developments is not lost on the debtor countries. Provisioning signals that the loans are risky, while secondary market prices indicate that they are worth considerably less than their nominal value. Yet debtor countries are required to service these loans at face value. Several of them are understandably aggrieved at these practices, which they regard as a contributory factor to the current crisis.

⁶ World Bank: World Debt Tables 1988/89, External Debt of Developing Countries, Vol. 1, Analysis and Summary Tables, Washington, D.C., 1989, p. XXXI.