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LOAN-LOSS PROVISIONS AND THIRD-WORLD DEBT

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INTERNATIONAL FINANCE SECTION

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PRINCETON, NEW JERSEY

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LOAN-LOSS PROVISIONS AND THIRD-WORLD DEBT

1 Introduction

The development of the practice by commercial banks of "provisioning" against loans to developing countries can be understood only in the context of the evolving third-world debt problem. The seeds of the debt problem were sown following the first major hike in oil prices in 1973. Developing countries facing large balance-of-payments deficits were attracted to the alternative of financing, which enabled them to adjust more slowly than would otherwise have been necessary. Even some oil-rich countries were encouraged to borrow on the strength of their oil resources. The required financing was provided in large measure through the intermediation of the private international banks; the official sector adopted a relatively muted role.[1]

By 1982 there were signs that these loans were running into problems. When Mexico announced that it would be unable to meet its debt obligations, the debt "crisis" became a matter of wide public debate and concern. Although commentators have proposed a series of reforms, in practical terms the crisis has been managed largely by a combination of adjustment in the debtor countries and rescheduling of loans.

Initially, there were some indications that this approach, applied in a flexible fashion, would prove adequate, and there were even suggestions in the press in late 1984 and early 1985 that the crisis was over. Such optimism was short-lived and, in retrospect, depended crucially on the ability of the United States to sustain the rapid economic growth it had achieved in 1984. By the mid-1980s there were many signs that the global debt problem was in fact getting worse rather than better, and there were some signs that the debtor countries might begin to adopt a more aggressive posture in their negotiations with creditors. In July 1985, for example, the government of

The recent additional provisioning against loans to developing countries by J. P. Morgan, Chase Manhattan, and Manufacturers Hanover occurred too late to be alluded to in this essay, which was originally drafted in 1987. These events, however, serve to highlight the remarks made here.

[1] The official sector did respond in some ways. For example, the International Monetary Fund established an Oil Facility to assist the countries that were most hurt by the oil price rise.

Peru announced that it would limit its payments of principal and interest to a maximum of 10 percent of the country's export earnings.

Toward the end of 1985, the United States tried to seize the initiative by putting forward the Baker Plan, a set of proposals designed to encourage more lending to heavily indebted developing countries in return for structural adjustment on their part. Unfortunately, the plan had very little discernible impact on the quantity of financial flows. Much of 1986 was dominated by the attempts of creditors to negotiate an acceptable package of policies with Mexico under the auspices of the IMF, and these were eventually successful. In February 1987, however, Brazil suspended interest payments on part of its international debt. It was against this background that Citibank decided to add $3 billion to its existing loan-loss reserves in May 1987, a move that was fairly quickly matched by other money-center banks in the United States and by many international banks elsewhere.

This essay differs from broader reviews of the commercial banks' role in third-world debt (e.g., Sachs and Huizinga, 1987; Sachs, 1989; and Bird, 1989) by concentrating on certain aspects of this spate of commercial-bank provisioning. It is divided into four principal parts. Section 2 examines the nature and extent of provisioning, drawing out differences among countries and explaining the implications of provisioning for banks' balance sheets. Section 3 looks at the factors affecting the decision to provision and tries to differentiate between those of a secular and environmental nature and those of more immediate and bank-specific relevance. Section 4 examines the implications of provisioning for both creditors and debtors. Section 5 asks whether provisioning has been adequate. A concluding section appraises provisioning as a contribution to the resolution of the third-world debt problem.

2 The Factual and Statistical Background of Provisioning

Although the phrases are sometimes used interchangeably, there is an important distinction between writing off or writing down loans and provisioning against them. When writing off or writing down a loan, the creditor institution reduces the book value of the asset on its balance sheet to a level that more accurately reflects its net present value. Banks have generally been reluctant to write down loans and have done so only against claims on a fairly narrow range of countries. Instead, what they have done is to "provision" against certain loans by putting aside reserves in low-earning but risk-free assets in order to cover the possibility that repayments of principal or payments of interest may not be made. Provisioning is therefore the same as building up loan-loss reserves.

These reserves may be "general" or "specific." General reserves repre-

sent the normal business practice of allowing for the statistical probability that a certain proportion of loans will encounter problems. Specific provisions, by contrast, are set aside against loans to a particular country or group of countries where a specific risk has been identified.[2] If for no other reason, the distinction between general and specific provisions is significant because creditors are not allowed tax deductions against general provisions (in the United States, this has been the case only since 1986, when the federal tax law was changed), whereas they may be able to negotiate some tax reductions against specific provisions.

The setting aside of reserves reduces the provisioning institution's earnings and therefore has an adverse effect on profits. While creditors reduce their risk exposure by provisioning, they must pay a price in terms of reduced short-term profits. However, neither writing down a loan nor provisioning against it reduces the debtor's contractual obligations. Such relief is forthcoming only when the lending institution translates the writedown into a reduction in debt-service payments from the debtor. In that case, the bank is forgiving a proportion of the debt.

To provide some factual and statistical background against which to assess the causes and effects of provisioning, the following questions are examined here: (a) How much provisioning or reserving by the banks has occurred, and does the practice vary among banks, across countries, and over time? (b) Do tax and regulatory environments differ in their treatment of provisioning? (c) To what extent does the provisioning by banks that has occurred reflect the discount on less-developed-country (LDC) debt observed in the secondary market?

Major difficulties stand in the way of comprehensive answers to these questions: the lack of data concerning provisioning against LDC loans, the confidentiality of much of the data, and the difficulty of getting clear responses from some countries on issues such as the position and attitudes of the regulators and the tax authorities. Most of the data used in this essay are drawn from IBCA (International Bank Credit Analysis Group, London) sources, although even these data are constrained by the factors just listed.

Table 1 shows the percentages reserved against loans to developing countries at the end of 1986. It also reveals important differences among banks even within the same country. In the United States, moreover, there is a marked contrast between the money-center banks and the regional banks. Furthermore, although many banks do not provide information concerning their reserves against individual countries, what information is available

[2] Most provisioning by commercial banks has been presented publicly as being against a group of, say, thirty-five countries. Actually, the banks arrive at the overall provision by aggregating notional provisions against individual countries.

TABLE 1

BANK RESERVES AGAINST LDC LOANS, BY COUNTRY OF ORIGIN, 1986

Country	Reserves
Belgium	15
Canada	10-15
France	33-45
Germany	35-70 (40)
Japan	5
Netherlands	24-26
Spain	7-68 (10)
Sweden	35-80 (50)
Switzerland	30-60 (40)
U.K.	6-10
U.S.	5

NOTE: Figures in parentheses are approximate average where there is a considerable range among banks.

SOURCE: IBCA Banking Analysis, London.

suggests that there may be quite wide divergences. Thus, for a bank with an overall provision of, say, 25 percent, the reserve against one Latin American country may be as low as 5 percent, while that against another may be as high as 35 percent.[3]

What Table 1 does not show is the absolute exposures of the banks, by country of origin, to the highly indebted countries, or their exposures relative to bank capital or to their overall portfolio of loans. Data on absolute exposures reveal the dominance of the U.S. banks, with over 32 percent of worldwide bank exposure to Latin American countries in 1986. Exposures were also large for banks in Japan (12.6 percent) and the United Kingdom (12.3 percent), smaller for banks in France (8.8 percent), Germany (7.7 percent), and Canada (7.1 percent), and much smaller for banks in Switzerland (2.8 percent) and Italy (1.4 percent). But note that the total of portfolios of the U.S. commercial banks was also much larger than that of banks in other countries.

[3] These figures are derived from data on the practices of Dutch banks in 1986, as reported to IBCA Banking Analysis, but similar divergences seem to exist among other banks.

To some extent, the varying levels of provisioning may reflect the traditionally different attitudes of bankers throughout the world to the optimum point of any return/risk tradeoff. German bankers, for example, frequently criticize the rapid expansion of U.S. bank loans to developing countries during the 1970s precisely because of the risks involved and because of their own more prudent approach to lending.

How important are differences in the tax and regulatory environments in explaining international differences in provisioning? Before we can offer some answers to this question in section 3, we need to identify the differences in the regulatory and tax environments across countries.[4]

In the United States, most large banks are regulated by the Federal Reserve Board or by the Office of the Comptroller of the Currency. The Federal Deposit Insurance Corporation (FDIC) also has a hand in determining provisioning regulations, as well as rules relating to capital adequacy. The regulators' attitudes to provisioning are coordinated through the Inter-Agency Country Exposure Review Committee (ICERC), the agency that sets standards for bank treatment of loans to countries that are not servicing their debts. Under existing regulations, U.S. banks must hold reserves equal to at least 5.5 percent of total assets, and capital equal to at least 6.0 percent of total assets. There are no further regulations relating to general provisions, but the regulatory bodies can require banks to make specific provisions against individual countries in the form of allocated-transfer risk reserves (ATRRs). In the first year after such a requirement is imposed, the ATRR must cover 10 percent of the loans, rising to 15 percent in subsequent years. Such reserves are tax deductible, but they have not been much used.[5] While U.S. banks can no longer claim any portion of general provisions against taxes, such provisions do count as part of the banks' primary-capital base and therefore do not damage the banks' position with respect to the regulations relating to capital adequacy. Furthermore, U.S. banks can claim a tax allowance for actual "writedowns" against general provisions. In principle, by offering more lenient tax treatment regulators can encourage banks to offer some form of debt relief to debtor countries.

In Germany, the tax laws are particularly favorable to provisioning and permit reserves to be deducted from taxable profits. Furthermore, the

[4] The Cooke Committee representing central banks has made proposals to impose more international uniformity on the measurement and standards of capital adequacy. By 1992 it is envisaged that banks would have equity capital equal to 4 percent of their total assets.

[5] The ICERC may classify debts as substandard, value-impaired, or a loss. For a debt to be classified as value-impaired, the debtor must fulfill more than one of four conditions: it has not paid interest for six months, it is failing to comply with an IMF-supported program, it has failed to meet its rescheduling terms for a year, and there is little prospect for an orderly restoration of debt service in the near future.

financial authorities have actively encouraged German banks to be prudent in the valuation of their claims on developing countries.

French regulations are slightly less liberal; provisions against sovereign debt are tax deductible only if the debtor country is on a list of forty-one countries compiled by France's Banking Commission. For such countries, provisions are deductible from taxable profits up to 100 percent of the face value of the loan.

By contrast, in Japan banks may not deduct more than 20 percent of their provisions from taxable profits. Moreover, regulations permit them to hold reserves against no more than 5 percent of their total loans.

In the United Kingdom, regulators have traditionally encouraged the banks to appraise the adequacy of their provisions with respect to their LDC loans, without setting formal minimum or maximum values. However, in August 1987 the Bank of England sent a letter to all U.K. banks with exposures in developing countries encouraging them to reconsider the adequacy of their provisions with a view to increasing them "where appropriate" to reflect "the deterioration in the prospects of their recoverability." Stressing the need for objective analysis, the Bank developed a framework, or matrix, designed to measure the extent to which the chances of full recovery had deteriorated, and therefore the extent to which provisions were justified. This was to be used as a basis for discussion between the Bank and each individual institution. The matrix was similar in many respects to those used by commercial banks in assessing country risk. Specific provisions in the United Kingdom do not count as capital, and general provisions are not tax-deductible. The tax status of specific provisions is unclear. There is certainly no presumption that they may be automatically offset against tax. Much would seem to depend on the particular negotiations between an individual bank and the tax district handling its affairs.

The large increases made by the banks to their loan-loss reserves in mid-1987 had a number of effects. In the case of the U.S. banks, as shown in Table 2, the additional provisions raised their reserves to about 25 percent of their LDC exposures, although there was considerable variation among individual banks. At the same time, the additional provisions had an adverse effect on their earnings and on the ratio between their equity and assets. Although the provisioning generally increased the ratio between primary capital and assets, it uniformly reduced the equity component of primary capital.

For the United Kingdom, the IBCA calculated that an increase in the provisions of U.K. banks to a uniform level of 30 percent would shift two of the five banks examined from profit to loss.

While this discussion describes the effects of the additional provisioning on the balance sheets of the banks, it is also important to examine the timing

TABLE 2

ADDITIONAL PROVISIONS AGAINST LDC DEBT BY THE MAJOR U.S. BANKS, AND THEIR EFFECTS, MID-1987

(dollar figures in millions)

	LDC Exposure	Additional Provision	Second-Quarter Earnings	1987 Earnings	Reserves			Reserves/ Loans	Reserves/ LDC Exposure	Non-LDC Reserves/ NPLs [a]	Common Equity/ Assets [b]	Total Equity/ Assets
					Total	LDC	Other					
Citibank	$15,590	$3,000	$(2,500)	$(1,000)	$4,900	$3,500	$1,400	3.7%	22.5%	41.2%	3.30%	4.01%
BankAmerica [c]	10,000	1,100	(1,000)	(750)	3,300	1,800	1,500	4.5	18.0	37.2	2.44	3.13
Manufacturers Hanover	8,400	1,700	(1,400)	(1,050)	2,700	1,850	850	4.8	22.0	39.8	2.74	3.62
Chase Manhattan	8,700	1,600	(1,400)	(850)	2,700	2,000	700	4.1	23.0	36.1	3.45	4.09
J. P. Morgan [d]												
Chemical New York [e]	5,900	1,100	(1,100)	(710)	2,074	1,380	694	4.1	24.8	47.9	3.27	3.79
Bankers Trust	4,000	700	(570)	(175)	1,300	1,000	300	4.5	25.0	34.1	4.36	4.36
First Chicago	2,800	800	(700)	(435)	1,370	935	435	5.4	33.4	53.1	3.89	4.74
Security Pacific	1,850	500	(175)	150	1,300	650	650	2.9	35.1	54.3	4.19	4.68
Wells Fargo [d]	1,900											
First Interstate	1,600	750	(455)	(200)	1,200	530	670	3.5	33.1	65.6	4.45	4.46

[a] NPLs = nonperforming loans. Totals are for year-end 1986 and thus do not include the Brazilian loans placed on nonaccrual status in the first quarter.

[b] Adjusted ratios assume that the holding companies pay the same dividends in 1987 as in 1986 and that asset totals at year-end are the same as at year-end 1986.

[c] BankAmerica indicated that its reserve was for 25% of its $10 billion LDC exposure, but that ratio is achieved only after adding back about $800 million of ATRRs and prior chargeoffs of LDC loans.

[d] Reserve increase announced after this table was completed.

[e] Adjustments made to reflect acquisition of Texas Commerce in May 1987.

NOTE: Several of the banks stated that their LDC reserves were 25% of LDC exposure, but this was accomplished by adding back the ATRR to reserves. This reserve is not added back here, and thus the ratios are slightly lower.

SOURCE: IBCA Banking Analysis, London.

of the decisions to increase reserves. As noted earlier, the initiator was Citibank, which added to its reserves on May 19, 1987. After a lapse of one week, Norwest and Chase Manhattan followed suit. Then, during little more than the first two weeks of June, another fifteen major U.S. banks responded by raising their provisions. A similar lagged response was seen in other parts of the world: the U.K. banks began to set aside extra provisions in mid-June.

3 Factors Influencing Provisioning

A range of factors impinges on the decision to set aside provisions. Some factors may be fairly general, affecting most banks similarly; others may be more specific to a group of banks, perhaps in a particular country, or indeed to one particular bank. The difficulty lies not so much in compiling a list of factors that might influence provisioning as in classifying these factors and assigning them relative weights. The quantity and quality of the data do not permit sophisticated empirical investigation. The empiricism here is therefore fairly casual: conclusions on the factors' relative importance are largely drawn from discussions with people involved in the actual provisioning decisions.

We begin by assuming that the banks set out to maximize expected profit. In so doing, they have to consider both return and risk, utility being a positive function of return and a negative function of risk. Bank decisions in general and decisions relating to loan-loss provisioning in particular can then be interpreted as attempts to move toward a preferred combination of return and risk.

One component of risk for bank managers is the possibility of a takeover. Decisionmakers within banks will therefore be concerned about the competitive position of their firm in the banking industry as reflected by the price of its shares on the stock market. Managerial theories of the firm that stress such factors are thus relevant here.

The time dimension is also important when analyzing the objectives of the banks. Do banks want to maximize profit in the short or the long run? It is reasonable to assume that they want a fairly stable profit performance, and they may be prepared to trade off some current profit or return to reduce risk and secure future profits.

Against this analytical background, the remainder of this section distinguishes between environmental factors—broad secular influences that created an environment in which provisioning was more likely to occur, and bank-specific factors—influences that may provide more immediate explanations of why the banks provisioned when they did. After identifying a number of factors that may have affected the decisions of banks to set aside extra loan-loss reserves, we take a brief look at two specific cases: (a) Citi-

bank's decision to add $3 billion to its loan-loss reserves on May 19, 1987, and the related decisions of other U.S. money-center banks and (b) National Westminster Bank's decision to add £466 million to its sovereign debt provisions on June 16, 1987 and, again, the related decisions of the other U.K. clearing banks.

Environmental Factors

The economic performance of the debtor countries. Over the years, and particularly in the light of their experience since 1982, commercial banks have had to reassess the economic performance of the highly indebted developing countries to which they have made loans, and therefore to reassess the risk attached to such loans. Banks have become increasingly sensitive to risk, some might even argue overly sensitive, having perhaps paid too little attention to risk and too much attention to nominal return during the earlier phases of lending. Provisioning is a manifestation of their reassessment of the risks associated with a given portfolio of loans. As perceived risks rise, provisioning against these risks will tend to rise as well.

The economic performances of the highly indebted countries are unlikely to be perfectly positively correlated, even though all debtor countries will be similarly affected by such world economic developments as rising interest rates and increasing protectionism. This imperfect correlation will encourage banks to examine each country individually and to form views on each country's creditworthiness and the extent to which they should provision against their loans to that country. (This is so even though publicly the banks usually provision against a group of countries rather than against individual countries.) In view of this case-by-case approach by the banks, it may be misleading to look at data for a group of countries. Yet even these data give ample evidence that the economic performance of the major debtor countries has been deteriorating over recent years. Although some debtor nations have notably strengthened their current-account balances, they have frequently done so against a background of stagnating growth and falling levels of trade. Perhaps the most worrisome sign has been the falling investment ratio in many highly indebted countries. (Gross investment in the Baker Plan group of fifteen heavily indebted countries fell from 24 percent of GNP in 1982 to 17 percent in 1986. And falling import volumes suggest that fewer capital goods are being imported.) While banks may regard some measure of short-run domestic demand deflation as an appropriate component of economic adjustment, they also recognize that in the long run the ability of countries to service their debts depends on sustained economic growth. Given the central significance of investment in generating economic growth, falling investment ratios must cause creditors concern about the long-run ability of countries to cope with their debt.

At the same time that the economic performance of the highly indebted

countries was showing signs of deterioration, various debt indicators suggested that the debt position itself was getting worse. The most frequently consulted ratios, such as a country's debt-service ratio and its ratio of interest payments to exports, showed substantial deterioration. Moreover, the banks can hardly deny that the change from positive to negative net transfers may prove unsustainable under current economic growth rates and living standards in the indebted countries. The switch to negative net transfers raises the perceived benefits to these countries of debt repudiation relative to the perceived costs and brings closer the threat of default.

Provisioning can thus be viewed as an entirely appropriate response by the banks to a worsening situation. A discrete decision to provision might, of course, be a response either to a stochastic shock that weakens both the economic and the debt positions of the highly indebted countries or to a gradual and prolonged weakening of their positions. As underlying economic conditions in the debtor countries change, of course, provisioning activity can be expected to change. Thus, a decision to set aside provisions of a certain amount at a particular moment does not mean that these provisions will be seen as appropriate in the future.

Since the debtor countries' economic performance can be fairly objectively monitored and is largely outside the control of the banks, it might appear that all banks would make similar provisions. This need not be the case. Banks will have different exposures in different countries, will be more or less risk-averse, and will interpret the same data differently; their perceptions of risk will vary as a result. Moreover, as we shall see, other factors influence provisioning as well, and the differences among the banks in relation to these factors may account for the variations in the extent of provisioning.

As the economic performance of the highly indebted countries has deteriorated since 1982, recommendations for solutions of the debt crisis have gone through a series of stages. At different times, they have emphasized economic adjustment in the debtor countries, rescheduling of existing debt on more and less stringent terms, and the injection of new money. An approach encompassing all these components was built into the Baker Plan of 1985.

The hope that these policies together would solve, or at least alleviate, the debt problem has not been realized. Indeed, some banks view the approach as growing less successful as time has gone on. They perceive a "weakening" of IMF conditionality in recent years. Provisioning represents a response by the banks to their frustration over the inability of the international economic system as a whole to resolve the debt problem. No longer believing that the problem will be resolved within a reasonable time span, the banks are using provisioning to legitimize the situation as it is. Provi-