British Policy and the Cancellation of Commercial Debts

Thomas Lines*

Introduction

One important influence on the debtor/creditor relationship has been widely ignored in the extensive literature spawned by the international debt crisis. In arranging its affairs each commercial bank has to follow certain rules and conventions — some laid down by statute, others determined by accountants or other professionals, and yet others the product of custom. To find a way out of the debt impasse it is worth examining these rules and procedures in order to understand how they operate, whose interests they mainly serve (they are rarely if ever neutral), and how they might be amended or reformed to the benefit of debtor nations.

In particular, it will be worth seeking changes which will advance the full or partial cancellation of debts. Both historical precedent and international equity suggest that some form of debt cancellation is not only the likely but the best solution to the debt crisis. More than six years after the crisis erupted in 1982, the concept of 'debt reduction' has at last come on to the creditors' agenda, with US Treasury Secretary Nicholas Brady for the first time proposing International Monetary Fund and World Bank support for it in his major policy announcement of March 1989. This final recognition of the intractability of the Third World debt problem marked a major change of emphasis on the creditor side.

It has often been remarked that the arrangements which have addressed the debt crisis hitherto serve the interests of creditors far more than the debtor nations of the Third World. Susan George (1988) goes so far as to call the process a 'financial low-intensity conflict' pursued by dominant forces in the capitalist world to ensure the submission of developing countries to their objectives. The main

* Lecturer in International Business, Edinburgh University.

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battleground of this unequal struggle has lain in the periodic renegotiations of debts at the Paris Club for money owed to other governments and in bank steering committees (the 'London Club') for commercial bank debts. These have pursued a divide-and-rule strategy in which the creditors meet together to discuss the sums owed by each individual debtor separately.

George's concept carries the implication that the creditors do not want to see an end to this conflict: the gradual economic attrition which the need to service debts imposes on indebted nations suits the creditors. However one views this voluntaristic interpretation, the economic means chosen to tackle the crisis since 1982 have done little to resolve it. The pattern has been for creditors to grant extensions on repayment periods and to provide additional 'new money' enabling immediate payments to be met. In the long run this has merely piled up the debts ever higher, further aggravating the eventual problem of repayment.

Creditor governments first officially acknowledged the principle of debt reduction at their Toronto summit meeting in June 1988, when they agreed a limited programme permitting interest concessions and some write-offs on debts owed to governments by the poorest nations. This move was initiated by a promise made by the Chancellor of the Exchequer, Nigel Lawson, in 1987 to write off debts owed by African countries to the British Government. By the time of the Toronto summit it was reported that the UK had cancelled £1 bn of aid loans in this way.[1]

These official moves reflected changes already occurring among the creditor banks, which have recently used various techniques to reduce their exposure to Third World indebtedness. John Reed, chairman of the largest US bank, Citicorp, gave the lead in 1987 when he said that Citicorp's US$3 bn of new provisions against foreign loans aimed in part to enable it to 'reliquefy' its loan portfolio.[2] In the year to 30 June 1988, Citicorp reduced its loan exposure to developing countries by $1.88 bn to $9.45 bn.[3] But voluntary debt reductions by the banks have been of limited importance when compared with the size of the debt overhang. According to one report early in 1989, debt reduction techniques had resulted in $26 bn of debt relief since the crisis began, including $15 bn in 1988. But the total amount of long- and short-term debt owed by developing countries amounted to $1,200 bn (of which $450 bn was owed by Latin America).[4]

This article looks at what the British authorities – mainly but not only the government — might do were they minded to look ahead and encourage the cancellation of Third World commercial debts. Governments like Britain's recognize a wide responsibility towards the world economy. Since they have been implicated in the Third World's private debts ever since they began to grow in the 1970s, it is appropriate that they should take the initiative in finding ways to eliminate them. The British Government is in a critical position because of London's place as the largest banking centre, the importance of the major British banks, and the country's close political alliance with the United States.

Because of its emphasis on the debts owed to commercial banks rather than to other governments or supranational agencies, the article will relate to those Third World countries which have the highest debts in absolute terms, resulting from their greater creditworthiness as formerly perceived by the banks and the greater size of their economies. These countries are mostly in Latin America and classified as of 'middle income' rather than the very poorest nations in Africa and elsewhere. It must not be forgotten, however, that the latter have been just as deeply affected by the debt crisis and solutions to it are even more urgent in their case.

The structure of the article is as follows. The next section gives some background information on the involvement in the debt crisis of five major British banks. The following section discusses the rules and procedures which affect the banks, under five headings: prudential regulation, lender-of-last-resort facilities, accounting conventions, the role of auditors, and tax arrangements. The concluding section summarizes the recommendations made, and then discusses the political context in which they will have to be achieved.

Sovereign lending and the banks

US banks are the most exposed among the leading industrial countries to Third World debt problems, while West German, Swiss and Italian banks tend to be in the safest position. The hardest hit major US bank has been Manufacturers Hanover of New York, with Third World debt exposure reported in 1988 as equivalent to 329% of its equity; the equivalent figure for both Deutsche Bank and the Swiss Bank Corporation was 17%.[5]

In late 1987 the Bank of Boston and American Express Bank became the first commercial banks to announce that they were writing off part of their Third World loans.[6] But no bank has yet shown any willingness to follow the governments at the Western economic summit in Toronto in actually *cancelling* outstanding loans. Even the two US banks insisted that although they were writing the debts concerned off their balance sheets, they still expected them to be serviced in full. This may have been more for public relations reasons than because either bank seriously expects repayment, but the ostensible refusal to contemplate debt cancellation remains.

Until 1987, the nine US 'money centre' banks and the UK banks stood out among major banks as having failed to set aside substantial provisions against troubled Third World loans. Until they had acquired extra capital they felt unable to absorb the balance-sheet losses involved. But after Citicorp's provisioning exercise in 1987, most banks felt obliged to follow suit, even at the cost of a serious worsening of their financial positions. This greatly sharpened the financial divisions among the major creditor banks, with some of the more prosperous such as Bank of Boston readily assuming losses of a sort which others could not bear. In Europe Deutsche Bank chairman Alfred Herrhausen publicly hinted at a moratorium for some Third World debtors while Sir Kit McMahon, chairman of the Midland Bank, was warning *against* any increase above current levels of provisions.[7] Two badly affected UK banks, the Midland and Standard Chartered, had to sell off subsidiary banks to raise enough funds to pay for the new provisions.

The new provisions also did nothing to alleviate the plight of the debtor countries. They are still paying interest at secularly high rates based on the original nominal value of their loans. Where banks have set aside 30% provisions, repayments are in effect 43% higher than is justified by the banks' own valuation of the debts. Measured as a rate of return on the loans' realizable secondary market value, actual rates are at least two or three times the market interest rate. (This is on top of the steep rise in market rates themselves during the 1980s).

The four major English 'clearing' banks (in order of size: Barclays, National Westminster, Midland and Lloyds) plus the smaller international bank Standard Chartered will now be examined. Other British banks are both smaller and less deeply involved in the debt crisis. The UK banks fall into two groups. Among them are the most seriously affected outside the United States, with Standard Chartered,

Lloyds and the Midland exposed at the end of 1988 to the extent of 197%, 132% and 137% of their shareholders' funds (paid-up share capital plus reserves) respectively (see Table 1). Other UK banks are in a relatively comfortable position, with Barclays' and the National Westminster's exposures amounting to 42% and 46% of equity respectively. In nominal value terms, the total loan exposure of the five major UK-based banks to Third World and East European countries with liquidity problems amounted to £15.4 bn or US$27.9 bn at the exchange rate of £1 = $1.81 ruling on 31 December 1988.

TABLE 1
British banks' foreign debt exposure at end-1988 (£m. unless stated)

	Barc.	Nat.West.	Midland	Lloyds	Std. Ch.
A. Shareholders' funds	5,711	5,933	3.039	2,875	1,161
B. Problem exposure	2,627	2,500	4,176	3,793	2,292
C. B as % of A	46.0	42.1	137.4	131.9	197.4
D. Number of countries exposed to	29	33[a]	N.A.	33	27
of which:					
Brazil	344	N.A.	1,172	1,001	332
Mexico	515	N.A.	1,000	664	288
Argentina	315	N.A.	700	464	0
These three as % of B	44.7	N.A.	68.8	56.1	27.1
South Africa	516	N.A.	N.A.	N.A.	546
Nigeria	N.A.	N.A.	N.A.	N.A.	336
E. Loan-loss provisions	854	861	1,363	1,274	620
F. Provisions as % of exposure	32.5	35	32.6	33.6	27.1
G. Risk asset ratio (%)	9.3	9.8	11.8	10.1	10.4

[a] 1987 figure (none given for 1988).
Source: 1988 annual reports. Risk asset ratios apply to 31 December 1988 and are calculated according to the new Bank for International Settlements guidelines.

Generally, the major UK banks appear relatively well placed to weather the losses that would arise from writing off bad foreign loans. According to *The Banker*'s annual survey of leading international banks, at the end of 1987 Barclays and National Westminster were the two most highly capitalized banks in the world although ranked only 14th and 15th by volume of assets (see Table 2). Barclays had twice the capital and reserves backing the world's biggest bank, Dai-Ichi Kangyo of Tokyo, although Barclays' assets less contra

accounts were 39% smaller. Put another way, the two British banks had by some way the highest capital/asset ratios among the world's top 25 banks (Citicorp was next). Among the rest of the top 50 banks, only three from Switzerland and one from the Netherlands had similar ratios to those of England's big four. (Standard Chartered was less well off in this respect but significantly improved its position during 1988).

TABLE 2
International comparisons of British banks

	Asset ranking on *The Banker* table	Assets less contra accounts ($bn)	Capital and reserves ($bn)	Capital assets ratio (%)	Number of employees
Dai-Ichi Kangyo Bank	1	271	6.4	1.79	19,293
Citicorp	8	198	8.8	4.44	90,000
Mitsubishi Trust & Banking	13	166	3.9	2.34	6,164
Barclays	14	164	12.7	7.75	100,000
National Westminster	15	163	9.1	5.61	102,000
Tokai Bank	16	162	4.1	2.56	12,795
Midland	39	91	4.8	5.34	58,778
Lloyds	42	84	4.5	5.32	76,186
Standard Chartered	74	56	1.3	2.41	55,000

Source: The Banker, July 1988. Most figures relate to 31 December 1987. Capital assets ratios are calculated according to *The Banker*'s own definitions.

Another measure suggests that the major British banks must have relatively high cost structures, which could presumably be cut back in the event of financial constraints arising from write-offs. National Westminster and Barclays are recorded as having by some way the largest workforces of any banks in the capitalist world, the next highest again being Citicorp. The big Japanese banks, which had far fewer employees, no doubt have different asset and liability structures and offer different services from their British rivals. But it is hard to escape the conclusion that Thatcherite belt-tightening has barely touched the banking sector in its land of origin.

However, the Midland Bank — which has the highest cost ratio of the five leading British banks — has announced a plan to lose 2,000 jobs during 1989. This is part of a radical restructuring of routine operations which the press suggested could go a long way further,

with the average number of staff at the bank's branches falling from 25 to less than 10 by the mid-1990s.[8]

What can be done?

There are five technical areas which the British authorities might exploit to encourage banks to write off or cancel their troubled sovereign loans. These are

i) prudential regulations governing British banks;
ii) the 'lender of last resort' function of the Bank of England;
iii) accounting rules followed by the banks;
iv) the role of auditors in ensuring the reliability of banks' accounts;
v) tax incentives to nudge banks in the direction desired.

Let us look at these in turn.

Prudential regulations

The first aim of prudential regulations is to prevent banks from lending greater amounts, or less carefully, than their capital base will justify. It is too late for them to play this role in the present debt crisis as the doubtful loans have already been advanced. Before 1982 the regulations were too lax, while signals from other parts of government encouraged the commercial 'recycling' of international surpluses to developing countries.

But a second purpose of regulations is to limit any damage to the banks (and through them the rest of the economy) once loans have turned sour. The rules aim above all to prevent consequent failures of banks, and in the event of failure to protect customers' deposits and stop the failure from spreading more widely.

From our point of view, two aspects of supervision are of cardinal importance. The first is capital adequacy, which seeks to ensure that banks have enough equity and other capital resources to provide a substantial cushion in case of loan losses. It is widely argued that when the debt crisis broke in 1982 capital adequacy requirements had not been strictly enough enforced over many years, leaving many international banks vulnerable. The second aspect lies in ensuring that banks set aside sufficient provisions against the danger of loans not being repaid. Provisions are laid aside in this way against a

specific loan or the loans of a specific country to defray the losses which banks would suffer later if the loans were to go into default and have to be written off.

In 1987 Parliament passed a new Banking Act which transformed the methods of official regulation of British banks. The Act came into force in October 1987 and large loan exposures were covered by it from 1 January 1988. The new system is more formal, subjecting both the banks and the Bank of England as regulatory authority to more precise rules and obligations than previously. The reform was largely prompted by the widely perceived failure of regulation in the collapse of Johnson Matthey Bank in 1984, but the dangers associated with the Third World debts greatly contributed to the climate of opinion. The more formal rules should help to forestall future British bank collapses but it is not certain how they would cope in the case of major losses to the banks from Third World debt defaults or write-offs.

The Act for the first time brought the accounts of all banks under detailed scrutiny of the Bank of England. Under the previous regime (introduced in 1979) the more prestigious banks were subject only to informal supervision, with lesser institutions being required to make formal reports and comply with precise financial measurements. The 1987 Act laid down the following requirements on banks:

- to maintain adequate risk-reporting systems for management;
- to hold sufficient paid-up capital and reserves to safeguard depositors, bearing in mind the risks of operations;
- to hold adequate liquid assets;
- to provide for the possible depreciation or diminution in value of assets;
- to report any transactions amounting to more than 10% of capital or bringing the total outstanding to one borrower to more than 25% of capital.

The Act established a Deposit Protection Scheme and required auditors for the first time to consult with the Bank of England about the banks they audit.

In view of the growing internationalization of banking, in 1988 the leading industrial countries also agreed at the Bank for International Settlements in Basel to assimilate their national banking regulations. This followed two previous BIS 'Concordats' since the mid-1970s which distributed the lender-of-last-resort responsibilities for banks with branches and subsidiaries in more than one country. The Concordats laid down that international banks would have to be

regulated on a consolidated basis by the authorities of the country in which they were based.

The most important aspect of the 1988 accord lies in the common method it established for measuring banks' capital adequacy. The simplest means is to measure total capital as a percentage of assets. But this makes no distinction either between the different kinds of capital held by banks or between the different levels of risk attached to their loans. The BIS rules seek to overcome this problem. They divide capital into two 'tiers' of share and loan capital, while assets are given various weightings according to risk. Thus, sovereign loans are given a high rating, requiring relatively large volumes of capital, while house mortgage loans, which British banks have greatly expanded in recent years, have a lower risk rating and require less capital. Under the new rules, each bank has to meet a risk/asset ratio of at least 8%: that is, the two tiers of capital between them must amount to at least 8% of risk-weighted total assets. British banks generally satisfy these requirements amply (see Table 1 above), by contrast with those of some countries such as France and Japan.

The European Community is also drawing up guidelines for the removal of national barriers in banking as part of the planned European Single Market. The most important part of this proposal would be the creation of an EC banking licence permitting banks registered in one country to set up in all other members of the Community. Capital adequacy requirements will follow the BIS guidelines.

Both the BIS and EC changes will mature in 1992, but the Bank of England is insisting on British banks meeting the capital adequacy requirements immediately. However, it may be that substantial changes in the new regulatory arrangements would be useful. There is a danger that the international convergence of banking regulations will not leave the UK authorities with a sufficiently free hand to modify national regulations — even though the Bank of England has pressed for such convergence more than any other body. But bank regulations need time both to be changed and for the effects of change to percolate through the system. If, as this article contends, a more urgent policy is required from the British Government, other means of implementing it will have to be found.

Bad debt provisions can serve this purpose by allowing losses to be marked up in an orderly way before they occur. In the present crisis they could be manipulated more quickly than the regulations themselves to ease the process of writing down. Whether write-offs

are to be a deliberate policy of the creditors or forced on the banks by debtor defaults, the proportion of debts provided for in loan-loss reserves should be encouraged to rise further.

As part of the Banking Act reform, the Bank of England in 1987 drew up a 'matrix' to guide banks in establishing provisions against problem foreign loans. This matrix gives weights to 15 factors which indicate a country's ability and willingness to service its loans, such as its history of debt reschedulings, existence of arrears, the proportion of export revenues required to meet interest obligations, commodity dependence in exports, and the secondary market price of the loans. These factors are then added to determine what proportion of the bank's exposure to the country's loans should be set aside in provisions against it. The Bank of England could progressively tighten its matrix so that banks have gradually to set aside more against a given volume of doubtful sovereign loans.

Lender of last resort

Liquidity, capital adequacy and loan-loss provision rules seek to prevent banks from failing. But once a bank has failed it is widely considered important to preserve the value of the deposits which customers have placed in it. This is for reasons of equity, since a bank's depositors (unlike its shareholders) cannot be considered responsible for any policies that led it to go under, and also for the economic reason that if a failing bank brought its customers' funds down with it, this might broaden a purely banking crisis into a general economic one. (It is argued that this happened in the 1930s in the United States.) Since all banking and credit operations are based on confidence, it is also argued that major failures must be prevented in order to retain confidence in the system as a whole.

Central banks therefore serve as 'lenders of last resort', operating at the everyday level through national money markets, where banks temporarily short of funds can borrow overnight to prevent a liquidity problem arising. When a serious liquidity difficulty does occur, similar facilities can be provided on a larger scale, occasionally leading the central bank to call on commercial banks to contribute to a 'lifeboat' fund to save banks that might otherwise capsize. (This is how Britain's 'secondary banking crisis' was treated in 1973–5) (Moran, 1986).

In many cases, whatever the stated policy of the authorities, a

central bank's last-resort lending to an important bank will effectively amount to a takeover. In this way even Mrs Thatcher's private-enterprise government found itself (via the Bank of England) nationalizing Johnson Matthey Bank on its collapse in 1984. But few jurisdictions will consider this worthwhile with smaller banks. In some countries (including Britain under the 1987 Act) the authorities have set up special insurance funds into which banks have to pay premiums against their deposits. Depositors can draw on these funds in the event of a failure.

The desire to prevent banking failures from leading to financial and economic collapse is praiseworthy. But the lender-of-last-resort function appears to go considerably further than this, in seeking to prevent the failure of major banks at all. In present circumstances it is not clear that such protection from the market is desirable. There are three grounds for questioning lender-of-last-resort facilities when confronting actual banking failures:

1. The problem of 'moral hazard', which suggests that those who used resources irresponsibly or inefficiently should have to face the consequences of their actions rather than being bailed out by more successful fellows. In the context of the debt crisis, this argument is often used to criticize the writing off or even rescheduling of sovereign debts, since it is said that this provides benefits to those borrowers who have been least careful and responsible in the use of their loans. Curiously, the argument is almost never raised where saving the *banks* from the consequences of past errors is concerned. Yet it is open to question whether the community should use public money to save ill-managed banks in this way. Other types of enterprise do not enjoy similar immunity and in the 1980s one would find few defenders of the idea that they should. The 'moral hazard' question concerns other banks directly when they are asked to contribute to a general 'lifeboat' operation. In a competitive economy, it is doubtful that the funds of successful banks should be called upon to succour their less prudent fellows in this way.

2. Many financial commentators would argue that UK and US banking markets are overcrowded. The stock market gives low values to banking shares, and the proposed conversion of building societies into banks has been criticized for further congesting the sector.[9] This situation is surely untenable in the long run and may be best dealt with by surgery now. In any industry a simple (if brutal) way to deal with surplus capacity is to permit insolvent companies to go under.

3. The familiar counter to the second argument is that it would cost jobs at the insolvent bank itself, lead (short of an adequate insurance scheme) to losses on the part of innocent depositors, and have other serious knock-on effects on the national economy. But in the context of the debt crisis that may in fact be just what is required. For keeping in business badly run and possibly insolvent banks has helped to ensure that most of the costs of the crisis were borne by the indebted nations. Bankruptcy of some of the banks to which debts are owed would destroy not only surplus capacity within the industry but some of the debts themselves. This is probably the most effective form of debt reduction that could be devised, the Brady Plan notwithstanding. This is not to argue against imposing and strengthening capital adequacy and other rules in an attempt to prevent bank failures. But regrettably the debt crisis cannot be resolved without causing harm to one or another party to it. Permitting the failure of insolvent banks would go some way to spreading the inevitable costs around.

Accounting rules

The debt crisis perfectly illustrates the social uses to which accounting procedures can be put, defending the positions of a certain group within the world economy. This is largely the result of special procedures which banks are allowed to employ in drawing up their accounts. As far as possible such procedures should be abandoned, leading banks to follow the same general accounting rules that other forms of enterprise have to obey. The most important of these is the 'lower of cost or market' rule, by which stocks and assets are assessed at either their cost price or their current market valuation, whichever is lower at the time.

In Britain (as in other countries) banks have enjoyed a long history of privileges in supplying information to the public. For example, until the 1960s they regularly manipulated their declared profits by exploiting undeclared 'hidden reserves'. (The more old-fashioned of the merchant banks, as well as some continental European banks, still do this.) Existing accounting conventions permit the following:

i) unlike other companies, banks can value major assets in their accounts at cost, even where everyone — including the banks themselves — knows that the realizable market value of those assets is well below cost;

ii) use of this convention ensures that indebted countries continue to pay interest on bank loans at very high levels;

iii) at the same time, the banks are permitted to mark up income from interest payments even where those payments have not actually been made. This further weakens the bargaining position of the debtors.

Loan assets valuation. The banks' privileges were enshrined in the Companies Act of 1985, which defined banking companies as a 'special category' of firm. If a bank opts for this status, the 1985 Act exempts it from declaring its assets (i.e. mainly its outstanding loans) according to the same rules as apply to industrial companies.[10] In declaring the value of their fixed assets, the latter have to take provisions, write-offs, depreciation and current value into account. But if a bank under special category lends £1 m. it can keep that asset on its balance sheet at the same value until its maturity date, even if the bank sets provisions against it as a doubtful loan and whatever the open market valuation of the loan might be.

There is a rationale for this. An industrial firm's assets are used for the production of goods which are sold on the market for what they can fetch. Although the assets are required to generate the firm's earnings, those earnings are only indirectly related to the assets' value. Moreover, physical assets wear out over time or become outdated and eventually have to be replaced, so a regular depreciation charge against them is prudent. A bank's revenue, on the other hand, is *directly* related to its loan assets by the interest rate. The assets are created only by being themselves placed on the market, and the interest rate — which is their price — determines the bank's revenue. A loan, however, does not deteriorate, become outdated or have to be replaced as a piece of machinery does: as long as interest is paid on it, it retains its original value until it matures and is then repaid. The need to depreciate such assets or declare them at a realizable market value is not immediately evident.

However, for regulatory purposes the Bank of England already requires certain financial assets of banks to be 'marked to market' — that is, valued at a current market value rather than the original face value. This is true, for example, of certain off-balance-sheet items such as interest-rate swaps.[11] Standard UK accounting practice also has banks value certain securities at the lower of cost and market value, rather than on just a cost basis. This has the curious outcome that similar securities can be assigned different values depending on

whether they are held as long-term assets (and valued on a cost-only basis) or for dealing purposes (and marked to market).[12]

The Bank of England's requirement that the banks should set aside provisions against doubtful foreign loans also amounts to a devaluation of them. Even where the provisions are placed against general risks rather than specific loans, in total those loans are effectively written down from their face value. Although this does not refer to market value, in accounting terms it is not far from requiring that loan assets should be marked to market. In the *politics* of banking, however, the two are a long way apart, since provisions do not imply any abandonment by the bank of its ultimate claim to the full value of the loans concerned.

A market has developed in outstanding Third World loans since about 1984, and although it was long marked by thin trading and consequently volatile prices, it has recently acquired a more solid and reliable base. By 1989 secondary market valuations of Third World sovereign debts rarely amounted to as much as 40% of the nominal value, and for loans of some countries such as Bolivia, Nicaragua and Peru they were well under 10%. To meet realizable market prices the book values of the major loans would therefore have to be written down by at least 60%.

With Third World loans now so strongly devalued by the market and — implicitly, because of provisions — by the banks themselves, the privilege permitting the major banks not to mark those assets to market has led to a serious distortion in their balance sheets. It has helped them to stay afloat under the pressure of the debt crisis, which was their main aim. But this has been achieved by the use of accounting mirrors — the pretence that loans are worth more than everyone knows they are worth. The quid pro quo is that the debtor countries, in remaining liable for the full interest charges, have borne virtually the whole cost of adjustment to the crisis although the banks were fully as responsible as they were for its appearance.

Pressure should be applied on the British Government (as on all creditor governments) to end this accounting privilege, just as in the past hidden reserves were abandoned. As far as possible, banks should join other companies in having to declare their assets at current market value. This is *not*, however, always possible or advisable. If it became a universal rule, it could lead to many borrowers refusing to honour their payments schedules *in order* to get the valuation of the loans — and by that token the interest schedules

themselves — reduced. This is another variant of moral hazard and should naturally be avoided.

But where, as in the international debt crisis, the market valuation of a certain type of loan has been reduced without a shadow of doubt, such a valuation procedure should be adopted. In making such a reform, a difficult problem would be to decide under what circumstances and when the change in valuation procedures should occur. In the case of the present debt crisis, however, the time for such a change is certainly overdue.

This proposal leaves scope for various definitions of current market value. Three main possibilities are apparent:

1. It could be determined judgmentally. This could be left to the banks themselves or their auditors (either of which is unsatisfactory because of their vested interests), or the Bank of England could lay down some guidelines or itself make decisions for individual banks.

2. Secondary market prices could be followed. The price ruling for a particular country's loans could be applied in the accounts to all loans outstanding to that country, regardless of whether the bank in question had traded in them — and if it had, whether it was at that or another price. Alternatively, the new valuation could be introduced only after the bank had traded in a country's loans, and its own latest price (paid or received) for them would be used. This might cover only sales for cash on the open market, or in addition discounted debt-equity and other swaps, exit bonds or discounted sales back to the indebted country.

This form of valuation would have the advantage of following a market value which the bank itself had accepted, but it would have severe practical drawbacks. Firstly, a procedure would have to be found to choose a value when various loans of a country had been sold or swapped at various discounts. Should the latest price be followed (even if it is unrepresentative)? A weighted formula could alternatively be adopted, subject to revision at every date of reporting either company accounts or prudential returns for the Bank of England. Secondly, there is the danger that British banks would draw back from using the secondary market or other debt reduction techniques at all, if selling or swapping just one of a country's loans would inevitably entail writing down all loans out to that country.

3. The valuation could be based on an official formula, perhaps similar to the matrix already employed by the Bank of England for calculating sovereign debt provisions.

Some simple calculations show that the financial consequences for

the five main British banks would not be disastrous. Profits would be reduced over a number of years due to lower interest receipts, while in the year of write-down two banks would nevertheless earn substantial profits while three would make losses. Table 3 shows the estimated impact of the proposal, based on writing debts down beyond the present level of provisions to an average discount of 65% and an assumed average interest rate of 11.5% per annum.

The worst outcomes would be at the Midland and Standard Chartered banks. In the first year the Midland's already depleted reserves of £1bn would fall by a third — a serious reverse but not insuperable. The problem at Standard Chartered appears more severe. First-year losses of £423 m would be equivalent to almost one-half of shareholders' reserves. This would have to be covered by raising new capital or somehow reducing assets. In 1988 Standard Chartered sold United Bank of Arizona and Union Bank of California for about £540 m.[13] It may be necessary to make further disposals to cover the first-year losses. Standard Chartered has subsidiaries and associates in 32 (mostly developing) countries, including the wholly-owned London bullion-dealing group Mocatta & Goldsmid. It would be interesting if in response to the debt crisis Standard Chartered were to sell some of these Third World subsidiaries to local interests. A danger is that the bank might not achieve very good prices for such distress sales.

TABLE 3
Impact on British banks of revaluing sovereign loans at market prices (£m.)

	Barc.	Nat. West	Midland	Lloyds	Std. Ch.
A. Problem exposure	2,627	2,500	4,176	3,793	2,292
B. Annual interest @ 11.5%	302	288	480	436	264
C. Discount to 65% of B	196	187	312	284	171
D. Extra write-off required	854	750	1,353	1,191	869
E. D after 35% tax relief	555	488	880	774	565
F. Pre-tax profit (1988)	1,391	1,407	693	952	313
G. First year pre-tax profit (loss) (F-E-C)	639.6	733	(499)	(106)	(423)
H. Reserves at end-1988	4,597	5,155	1,447	2,062	928

Source: 1988 annual reports. The interest rate is based on dollar LIBOR rates plus a margin of just over 1%, the valuation discount of 65% is based on secondary loan market rates, while tax relief is measured at the UK corporation tax rate of 35%, all as in March 1989.

The government should also be pressed urgently to alter the law to make banks comply with another provision of the 1985 Companies Act. This states that a company's report should record in a note or annex:[14]

> If in the opinion of the directors any of the current assets have not a value, on realisation in the ordinary course of the company's business, at least equal to the amount at which they are stated.

Among their other privileges under the Act, banking companies are exempt from this.[15] But the substantial provisions already set aside show that bank directors indeed no longer see their Third World loan assets as having a realizable value equal to the original — and still declared — valuations. This is nowhere noted in the annual reports and accounts.

Banks' financial statements should, like all others, be made to comply with this general provision of the Companies Act, and it would be hard to justify a delay in this. It would not require any devaluation of the banks' assets but would introduce greater honesty and clarity into their public documents.

Accrual of interest income. The choice of a cost-only basis for valuing loan assets is at variance with the convention used in another fundamental area of banking finance, that of interest income. The convention here is that interest on loans can be marked up as income *even when it has not been received.* If a debtor declares a moratorium on interest payments or goes into arrears, the interest due is still counted as income and becomes added to the loan principal; when payment resumes, interest is recalculated on the basis of the new, higher principal.

Accrual of interest income is based on the opposite accounting principle to that used for valuing loan assets. R. H. Parker quotes the US accounting theorist H. R. Hatfield who 'pointed out that it is inconsistent to deny that profit can exist without a sale and at the same time to recognize accrued interest as income' (Parker, 1969). If we substitute for 'profit' the word 'loss' we can see that banks currently are pursuing just this inconsistent line. They value their loan assets on a cost-only basis, implying that they can lose value only when they are sold, yet they insist on marking up interest income even where it has not been received. This combination is particularly damaging for debtors. The cost-only rule of asset valuation means their interest payments remain based on the original nominal value of their loans (and actual payments are much higher than foreseen

owing to the rise in interest rates over the last ten years). Interest accrual then further increases the principal if at any time the debtor becomes incapable of meeting repayments or takes steps to press for a better deal.

We saw how the banks' hand is strengthened by their ability to insist on continuing payment according to the nominal value of loans because of the cost-only rule. Paradoxically, the accrual convention of interest receipts also strengthens their position because it allows them a breathing space to exert pressure on recalcitrant debtors before the impact of defaults and moratoria hits them. Without this convention, an indebted nation's threat of default would have a much more immediate and frightening impact. More limited moratoria on interest payments would also require an immediate response from the banks, corresponding with the immediate loss of accounting income.

In the United States, accounting standards were reformed in this respect under the International Lending Supervision Act (ILSA) of 1983. The Act imposed a new system of mandatory debt write-offs and provisions for foreign debts that were not being fully repaid. The greatest impact came from the requirement that any foreign loans on which principal or interest payments fell more than 90 days overdue would be declared 'non-performing', in which case interest which was due but unpaid could not accrue. Banks have to write down such non-performing loans or set specific provisions against them.

This could have a serious impact on a US bank's profits, particularly in the case of highly indebted nations such as Brazil or Venezuela. Many banks have used the tightness of this regulation to justify refusing concessions in loan renegotiations, particularly where they would require changes in interest payment procedures such as capping interest rates at a certain level or capitalizing interest, either of which would lead to write-downs under these rules. According to Lomax, the non-performing loans requirement came to form 'the hinge on which the entire debt crisis negotiations swung' (Lomax, 1986).

The existing combination of cost-only asset valuation with interest accrual ought to be abandoned forthwith. It is internally inconsistent and adds to the means by which with time the debt crisis grows inexorably worse for debtor nations. If loan assets were valued on a realizable value basis, interest accrual would matter less because the debt obligations of Third World nations would be much reduced already. For the sake of consistency, interest accrual should remain the rule if assets are to be reassessed along the lines proposed.

However, if the change in asset valuation is not made, income should be permitted to accrue to banks' accounts only when interest is actually paid. This should be carried out under a (preferably tighter) variant of the US ILSA rules, with the exception that agreed changes to the payment basis for interest (due to interest capping, capitalization, etc.) would not require write-downs or provisions.

The role of auditors

Criticisms can be levelled at the banks' auditors. They are obliged to ensure that the accounts provide a true and fair view of a bank's financial situation and comply with legislative requirements under the Companies and Banking Acts. Whatever its historical origins in defending the interests of shareholders, in the modern world the audit is carried out at least as much to ensure that the general public is protected and informed. Since the 1987 Banking Act, this has become undeniably the case with bank audits. In this, they perform a public function. Yet auditors earn their fees from the firms they audit, which faces them with a clear conflict of interest. An auditor might quite humanly think twice before qualifying the accounts of a big bank whose collapse would have broad economic repercussions, and from which in addition he earns part of his keep.

Arguments about the role of auditing are neither new nor confined to banking and finance. In 1976 the journal *Accountancy* carried a brief debate about the proposed establishment of a State Auditing Board to oversee and eventually take over British company audits. Proponents of the idea argued: 'In many cases, management regard the statutory audit as little more than a formality and of little practical value' (Lyall and Perks, 1976). Elsewhere cases are cited of companies dismissing auditors who took their responsibilities so seriously as to qualify the firm's accounts. In the United States, Abraham J. Briloff pointed to the alleged complicity of auditors in accepting what he regarded as dubious accounting practices by the Lockheed aircraft company during its ill-fated TriStar programme in the mid-1970s. Costs were 'averaged' over the life of the project, leaving what Briloff (1984) called a 'half-billion [dollar] blob' on the accounts when in 1975 high costs had already been incurred while revenue had yet to build up.

If Lockheed's auditors could be criticized for passing this unusual procedure, so should those of some of the major banks for accepting

accounts which accord little with actuality. Even if all the procedures used in preparing the banks' accounts comply with accepted standards of the accountancy profession and the law — and there is no reason to suppose they do not — that does not condone passing accounts which patently do not provide a true picture.

In the long term, the private, contractual basis of auditing ought itself to be brought into question. The basic function of auditors should become the public one of ensuring that companies behave responsibly in the public interest, rather than, as now, the private function of safeguarding shareholders' interests. Representing a public function, auditors should then be paid out of public funds. That would be a major change for the whole of private business — not just the banks — and would be bound to provoke bitter controversy and resistance. In the meantime, auditors should be forcefully reminded by the Bank of England and the Department of Trade and Industry that there are precedents for rejecting the accounts of important banks — however long ago! One was in January 1929 during a crisis in the Lancashire cotton industry, when the Manchester-based bank Williams Deacon's was in severe difficulties and its auditors refused to sign its accounts (Sayers, 1976).

Taxation

An effective source of government pressure on the banks is through tax incentives — not just to encourage them to set aside provisions against doubtful loans but to write off and indeed cancel the loans, in part or in whole. After several months of uncertainty, the UK tax authorities eventually granted tax credits against the £4.1 bn increase in loan-loss provisions of the five major banks during 1987. This matched practice in many other countries (but not the United States or Japan).

These provisions did nothing to help the position of indebted countries as the principal value of the loans involved was not reduced. Interest payments were still set against their full nominal value. Yet the tax credit amounted to a public subsidy of British banks amounting to £1.4 bn. This is about as large as the government's annual foreign aid budget. It is hard to justify this when the banks were doing no more than presenting their accounts in somewhat more realistic fashion. Any future tax concessions should be conditional on

the banks that receive them making adjustments that will provide benefits for the debtors.

The present tax allowances could be replaced with a 100% allowance against any full or partial writing off of troubled sovereign loans. A bank which was contemplating setting aside provisions worth, say, 30% of some outstanding loans would be encouraged instead formally to write off the same portion of these loans.

However, even this is inadequate. If we look at the handful of US banks which have made such write-offs, we see that they have not permitted the debtor countries to benefit from this change any more than from provisions. The Bank of Boston, the twelfth largest US bank, in 1987 wrote off in full $200 m of its $1 bn of loans to Third World countries.[16] This means the bank could now forgive 20% of such debts without any further effect on its balance sheet. But it has *not* forgiven them: the bank made it clear that it still considered the principal and interest payments to be due on these loans. This left it in the logically absurd position of calling part of its assets valueless and yet expecting to earn a financial return on them!

There may be little to stop the banks from behaving in this way — as long as their accounts make it clear that that is what they are doing. But the government should give them no incentive to indulge in such doublethink. Therefore tax allowances, apart from being withheld from mere provisioning exercises, should be permitted only for those write-offs or write-downs in which the bank concerned makes it clear that the debt has been *cancelled*. This is in addition to the requirement already made that the Bank of England should encourage larger provisions to be set aside. And it should be explicitly enacted by Parliament and not left to the tax authorities to decide, in the interests of clarity, openness and political accountability.

Tax allowances which have already been granted against existing provisions pose a problem. It would be rather dishonest (though by no means unprecedented) to claw back these allowances retrospectively, even on the valid argument that they were inappropriate and should never have been granted. On the other hand, they have covered about a third of all the pertinent loans at issue from British banks, making any later allowances against debt cancellation correspondingly less effective.

There are various possible solutions to this dilemma. The most straightforward would be to leave the existing allowances as paid but make it clear that in following years tax allowances will be advanced only against such parts of Third World debts as are actually

cancelled. Alternatively, it could be argued that the allowances were only appropriate as a short-term aid in 1987, when the new provisions had a serious impact on the banks' profits. (Two of them — Midland and Lloyds — returned the first losses on their annual accounts of any major banks this century.) The banks could then have a special tax levied on such existing provisions as were not replaced by the full or partial cancellation of loans to which they applied. This would amount to dressing up a retrospective clawback under another name.

A third possibility would be to argue that the banks are making comfortable profits in general and should be subject to a superprofits levy on their corporation tax. The UK Government imposed such a special levy in the tax year 1981–2 due to the windfall profits accruing to banks from high interest rates at the time. This is comparable to the special petroleum levy which the Thatcher Government also once raised and to the excess profits or resource rent taxes levied by some developing countries on mining projects at times of high mineral prices. In 1989 British interest rates are again high (in real terms they have remained so throughout the 1980s) and, as Table 4 shows, the banks are at least as profitable as in 1981 when the levy was imposed.

This tax would have the advantage of limiting the impact on more seriously affected banks such as Standard Chartered, while ensuring that profitable banks do not get indiscriminate public subsidies.

TABLE 4
British banks' profits and taxation, 1981 and 1988
£ million unless otherwise stated

	Barc.	Nat.West.	Midland	Lloyds	Std.Ch.
A. Tax charge (1981)	105	57	39	123	N.A.
B. Special tax levy (1981)	94	97	65	59	N.A.
C. B as % of A	90	170	167	48	N.A.
D. Pre-tax profits as % of net interest income:					
1981	33.1	39.0	21.5	37.4	N.A.
1988	46.9	47.7	40.3	49.4	40.7
E. Pre-tax profits as % of total income (1988)	29.3	29.5	24.2	31.4	26.5
F. Total tax as % of pre-tax profits:					
1981	35.1	31.2	44.8	47.2	N.A.
1988	35.8	32.9	39.4	35.1	30.4

Sources: *The Banker*, April 1982, and the banks' 1988 annual reports. *The Banker* did not give figures for total income in 1981 but non-interest earnings increased substantially between 1981 and 1988.

While none of the three alternatives is entirely satisfactory, the third seems best — partly because it also has wider application.

Recommendations and their political implications

Seven specific policy recommendations appear in this article:
(1) The Bank of England should progressively tighten the matrix it uses for assessing recommended loan-loss provisions, with the aim of ensuring higher levels of provisions for a given volume of problem loans.
(2) The effective guarantee against bankruptcy provided to major banks by lender-of-last-resort practices should be called into question and probably abandoned.
(3) Where possible, banks should value loan assets according to their realizable market value, not the initial sum lent. Sovereign loan interest payments should be based on such (reduced) valuations.
(4) Banks should have to specify in their reports and accounts where assets have not been declared at a realizable market value.
(5) If recommendation 3 is not carried out immediately, banks should be able to mark up income from loans as accrued only when interest has actually been paid. Where interest is not paid, provisions or write-off would then be required after a short interval.
(6) In the long term, auditors should be made responsible to and remunerated by the public, not the companies they audit. In the short term, the Bank of England and the DTI should make auditors aware of their responsibility to qualify or reject accounts which are seriously misleading, e.g. in their valuation of loan assets.
(7) Tax allowances should be provided only where debts are actually cancelled, not for provisioning exercises or for write-offs which do not involve forgiveness.

This article is concerned with how the British Government might encourage the full or partial cancellation of Third World commercial debts. It has ignored the numerous 'Big Solutions' to the debt crisis which various parties have advanced. Some of these, such as the proposal that some sort of international bankruptcy arrangement should be introduced to enable insolvent countries to reduce their liabilities, are well worth consideration. Others, such as the proposal by American Express chairman James D. Robinson to introduce a multinational debt relief agency, have been widely aired in the most influential financial and political circles. But all such schemes,

whether good or bad, have foundered on the rock of US refusal to break away from the case-by-case approach to debt restructuring. They have also induced a 'debt initiative fatigue' to match the often cited 'debt fatigue'.

Instead, the aim of the article has been to look at more limited unilateral steps which the British authorities could take to ease the burden of commercial debts on the developing world. Of course, while limited or simple in nature, they are not all limited in their likely consequences.

It has so far avoided the thorny political question of *how* the government might be persuaded to accept such a policy. For the present British Government identifies strongly with the banks and other financial interests. And while British public opinion in recent years has shown strong concern over specific problems of hardship in the Third World (e.g. over famines and floods in Ethiopia or Sudan), the overriding problem of foreign indebtedness has failed to fire its imagination, remaining obstinately on the financial pages of the newspapers. There is therefore only a limited lobby of opinion which might press the government to make such changes.

But some powerful political arguments can be mobilized in their favour, irrespective of the issues of principle which this article has addressed. First among these is Nigel Lawson's willingness to press for debt relief for poor African countries. Logical consistency demands that he should seek the same where sovereign commercial bank debts are concerned, for the issue is essentially the same. The same also applies to debts owed to international agencies — most critically, the IMF.

Where conditional short-term credits were granted because of a mistaken view that a long-term structural problem was in fact short-term and conjunctural, it is quite reasonable to cancel them later. Such a mistaken view was taken by the IMF in the years after 1982, when it made a grave error in interpreting the debt crisis as a liquidity problem which would be amenable to conventional deflation and devaluation measures in order to put balances of payments back on track. This misinterpretation, whether wilful or not, has proved extremely damaging in its consequences for indebted economies throughout Latin America, Africa and parts of Asia and Europe. It is only right that the IMF should have to pay for this mistake. The industrial nations which lie behind it must accept this and be prepared to pay the financial penalty necessitated to keep the IMF afloat in these circumstances.

Technically, the cancellation of such credits (which is the same as transforming them into grants) should pose no insuperable problems. It is in line with the decision of the Toronto summit about official loans to the poorest countries. The main difficulties would be the immense political ones of persuading sufficient influential member nations of the IMF — and principally the United States — to take such a radical step. There should be no illusions over what a radical step it would be. Admitting that the IMF's interpretation of the debt crisis since 1982 has been fundamentally flawed would remove the main prop from the whole debt management system in use since then. It might be seen as an invitation to wholesale default by the debtor countries, and would therefore have to be enacted with the utmost care. (While defaults can be seen as a likely outcome of the crisis in the early 1990s if there are not major changes in creditors' debt management policies now, this article does not advocate default.)

The Chancellor of the Exchequer should also consider other sectors of the British economy than finance, which evidently does have an interest in ensuring a continued flow of interest payments from the indebted nations. Quite apart from any diplomatic advantage it might create in Britain's relations with developing countries, writing off Third World debts should work to the advantage of domestic industry. For every penny released from debt service by a Third World nation can be used to import capital equipment and other manufactured goods from the developed world. This may be a less important incentive in a relatively weak manufacturing nation like Britain, but for the country's manufacturers and their workers it would nonetheless provide a real benefit.

Notes

1. Robert Martin, 'Summit moves to help poorest', *Glasgow Herald*, 21 June 1988.
2. Anatole Kaletsky, 'Banks face the facts at last', *Financial Times*, 21 May 1987.
3. Stephen Fidler, 'Debt fatigue in Latin America', *Financial Times*, 31 August 1988.
4. Stephen Fidler, 'Debt reduction: the coming game', *Financial Times*, 12 January 1989.
5. David Lascelles, 'Bankers stand by principle that loans must be repaid', *Financial Times*, 15 March 1988, citing Citicorp Scrimgeour Vickers and Citicorp 1988 Annual Report as sources.
6. A. Kaletsky, 'Boston Bank writes off $200m Third World debt', and Roderick

Oram, 'American Express arm writes off loans to Latin America', *Financial Times*, 16 December 1987 and 13 January 1988 respectively.

7. Andrew Fisher and Haig Simonian, 'First among equals', *Financial Times*, 9 May 1988; and Stephen Fidler, 'Loans cover "unlikely to rise"' *Financial Times*, and Mark Milner, 'Third world debt warning', *The Guardian*, both of 14 April 1988.

8. David Barchard, 'Midland to cut 2,000 jobs in streamlining operation' and 'Cracks appear in the retail banking facade', *Financial Times*, 29 March and 3 April 1989. The ratios (%) of total costs to income at the five banks in 1988 were, in ascending order: Lloyds 65.1, Standard Chartered 65.9, Barclays 66.4, National Westminster 67.3, Midland 70.8.

9. 'Lex Column: The crowded world of banking' *Financial Times*, 6 March 1989.

10. Companies Act, 1985, Schedule 9, Para. 27 (2) (a). See also Para. 5 (1).

11. See Bank of England (1987a and b).

12. Auditing Practices Committee (1988) p. 30.

13. David Lascelles, 'Standard Chartered to sell Union Bank offshoot', *Financial Times*, 17 February 1988.

14. Companies Act, 1985, Schedule 9, Para. 13 (12).

15. Ibid., Para. 27 (2) (a).

16. Kaletsky, op. cit.; Oram, op. cit.; see Note 6.

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