Some Accounting and Tax Aspects of LDC Debt Provisioning[1]

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Accounting Treatment

A number of accounting issues arise concerning the Mexico proposals in relation to the bonds that will be issued to give effect to the Brady Plan.

Balance Sheet Presentation of Bonds

Although the bonds, if purchased in the secondary market, could well be classified as 'investments', I would favour maintaining them as 'advances'.

On a substance over form approach it is a rescheduled loan.

However, if it is now intended to sell the bonds or otherwise deal in them, then they should be treated as 'dealing investments'.

The fact that the bonds have a market price (in Luxembourg) does not necessarily mean there is a liquid market. Even if they are readily saleable, this does not prevent them being recorded as 'advances' provided there is an intention to hold to maturity. After all, these days 'loans' can be sold.

Recorded Value of the Discount Bond

The discount bond will mature at only 65 per cent of original value, therefore the bond should not be recorded at a value above this.

It should be recorded at the 65 per cent of original value, less any further provision needed to reflect credit risk over the remaining life. The credit risk may be considered to be negligible as the bonds are backed by US Treasury Bonds.

Since the 35 per cent discount has been waived a loss has been 'realised' (i.e. the full 100 per cent will never now be recovered) so this amount should be written off against the provision leaving gross cost at 65 per cent, less further provisions as deemed necessary.

Again, an intention to deal or trade the bonds would suggest using a mark to market approach.

Recorded Value of the Par Bond

In the case of the par bond it could be argued that no adjustments are needed and that the bonds continue to be shown at gross cost less provisions for credit risk. However, I believe a yield adjustment is also needed. Due to the rescheduling arrangements the bonds must inherently have reduced value (reflecting the reduced interest rate). This amount can be isolated by comparing past and present yields. If this is regarded as a 'realised' loss then, as above, this could be reflected by writing off an appropriate amount of bond, but I do not believe this presentation is mandatory (i.e. the value reduction could be held as a provision).

However, regardless of the presentation, the write-off reflecting reduced interest income should not be taken out of the provision for credit risk (i.e. the components of the provision must be separately identified) although credit risk can be assessed on the net value after the write off for reduced yield.

Again, a trading intention would mean the bonds are marked to market.

If the bond is to be held to redemption then, assuming a write down is recognised to reflect the reduced yield of the par bond, it is reasonable to recover that discount on a yield to redemption (actuarial) basis.

However, the provision for credit risk must also be reassessed and adjusted as necessary. If the yield reduction was held by way of provision (as opposed to actual write off) it may result in adjustments within the provision, but no net effect overall.

Bonds held for trading would continue to be marked to market without regard to yield implications.

Future Provisions

Future provisions against capital and uncollected

[1] The information and figures in this article should be regarded as accurate as of 31 January 1990, except in respect of the figures contained in Table 1 and the comments about the Finance Bill 1990 which follow.

The Finance Bill 1990 lays down clearer guidelines concerning tax relief for LDC debt provisions. These proposals allow banks to claim tax relief on provisions up to values which approximate to the current Bank of England matrix levels. Future increases in allowable provisions will be restricted to 5 per cent of the principal sum per year from March 1991 onwards — i.e. the limit for December 1990 financial statements will be the same as December 1989. The same principle will apply to losses which are crystallised by selling debt, unless it is sold back to the debtor country when full relief for any loss will be given immediately.

Although the proposals are not necessarily as generous as banks might have wished, they nevertheless do set down some firm guidelines and also ensure that the banks will get full tax relief even if it does take a few years.

recorded income will be needed in the usual manner but, as indicated above, this is likely to be negligible for the capital element and would also reflect any guarantees of the interest element.

Technically the discount should be amortised even if the market value of the bond is below cost where the bond is to be held to maturity. However, if this is indicative of problems with recoverability then it may involve an equal increase in a provision for credit risk (as discussed above). In practical terms, therefore, the amortisation may not be recognised.

New Money

Any bank making new loans would have to make extra provisions. At a minimum, these extra provisions would have to accord with the Bank of England matrix.

Policy Statement

Ideally the policy adopted should be fully disclosed, i.e.:

- whether bonds are disclosed net or gross;
- whether immediate write off is made;
- whether discount (on par bonds) is being amortised;
- that further provisions are made where necessary.

International Provisioning

As shown in Table 1, the secondary market values of most of the main LDC debt has continued to fall.

In response to this fall, the four major clearers in the UK have made additional provisions against LDC debt over the past year as follows:

	Dec 1988 %	*June 1989* %	*Dec 1990* %
Barclays	38	48	70
Lloyds	34	47	72
Midland	33	50	50
Nat West	35	48	75

These provisions are much higher than can be justified under the new Bank of England matrix (published January 1990). For example, using the matrix, provisions against the major LDC borrowers at 31 December 1989 should be approximately 50 per cent.

Different levels of provisions are applied internationally.

For example, in Canada a matrix system sets mandatory reserves at 40 to 45 per cent. In Switzerland and Germany there are no formal rules but most major banks have provided over 50 per cent. In Japan the Ministry of Finance 'guidance' stipulates an average maximum of 15 per cent against exposure to 39 problem countries. This is to be raised to 25 per cent by 31 March 1990.

In the USA provisioning policy is very mixed, more often than not relating to the strength of the individual bank's balance sheet. Some banks have sold out of LDC debt (First Interstate, Wells Fargo and Security Pacific). Many sound regional banks have provisions in excess of 50 per cent.

J. P. Morgan recently added $2 bn to its reserves for credit losses for LDC debt, increasing provisions from some 40 per cent to 100 per cent. Only trade related short-term lending, which accounts for about 30 per cent of J. P. Morgan's portfolio to LDCs, would not be covered by the reserves.

Manufacturers Hanover Trust, Chase Manhattan and Chemical Bank have raised their provisions against LDC debt to some 36 per cent, 46 per cent and 65 per cent respectively. Citicorp is now the only US money centre bank which maintains its provisions below 30 per cent of its long-term exposure to developing countries.

Table 1 **Secondary Market Prices for Selected LDC Sovereign Debt, 1988-1990**

	Mar 1988	*Sept 1988*	*Mar 1989*	*Sept 1989*	*Mar 1990*
Argentina	28	22	17	17	11
Brazil	47	47	34	30	26
Chile	57	60	59	64	65
Mexico	49	48	40	43	40
Philippines	51	52	41	49	49
Venezuela	53	49	34	41	39
Average for these six countries, weighted by end 1987 external debt	46	45	35	36	33

Tax Treatment in the UK

Introduction

The legislation relating to how LDC provisions are to be treated for tax purposes is contained in Section 74(j) of the Taxes Act 1988:

'No sum shall be deducted in respect of any debts, except bad debts proved to be such, and *doubtful debts to the extent that they are respectively estimated to be*

bad, and in the case of the bankruptcy or insolvency of a debtor the amount which may reasonably be expected to be received on any such debt shall be deemed to be the value thereof.'

The relevant test for LDC risk debt is in italics.

There is limited decided case law.

In Absalom v Talbot 26 TC 166,

Lord Atkin defined 'respectively estimated' as requiring each debt to be separately valued.

In Anderton & Halstead Ltd v Birrell 16 TC 200,

Rowlatt J. decided 'What the statute requires . . . is an estimate to what extent a debt is bad . . . Such an estimate is not a prophecy to be judged as to its truth by after events but a valuation of an asset upon an uncertain future to be judged as to its soundness as an estimate upon the then facts and probabilities'.

In Dinshaw v Bombay Commissioner of Income Tax 13 ATC 284, it was stated that,

Continued trading by a debtor does not of itself prohibit bad debt relief.

Development of the Revenue Position

The Revenue starts from the position that:

(a) sovereign risk debt cannot be bad (i.e. countries do not go 'bust');

(b) secondary market prices are irrelevant in determining provision levels.

The Revenue's Statement of Practice ('SOP') dated 25 January 1983 admits bad debts relief in principle. However, it does not preclude the Revenue from going back to their starting position.

Prior to the introduction of the Bank of England ('the Bank') matrix agreements for bad debt provisions were often based on generally accepted percentages.

In 1987 the Revenue indicated that the introduction of the Bank's matrix would be helpful in agreeing allowable provisions. However, the matrix was regarded by the Revenue as having a prudential element which would give rise to the disallowance of part of any provision. In subsequent discussions during 1988 it became clear that the Revenue were looking for a close correlation between the read across and allowable provisions.

By the beginning of 1989 the Revenue had made an offer which had to be accepted by the seven leading UK banks but which could be extended to other banks. There were three options, all of which involved an agreement of matrix scores to give an agreed read across:

(a) 1987 provisions would be agreed at the lower of the direct read across or the provisions made. A similar basis would be used for 1988 and subsequently; or

(b) Discussions on 1987 allowable provisions would be deferred pending discussions on 1988. This might involve some smoothing between the two years; or

(c) 1987 and 1988 would be agreed on the basis of the 1987 read across or the actual provisions if lower.

In the event provisions for Brazil caused a problem with banks because the matrix produced a lower score in 1988 than 1987. However, under pressure from auditors and the Bank of England, banks maintained provisions for Brazil at the 1987 levels. This apparently led to the Revenue offering a refinement of the direct read across basis. The treatment of Brazil would depend on the 1989 matrix score. If the 1989 score exceeds that of 1988 both 1988 and 1989 will be based on the 1989 score or the actual provision if lower. If the 1989 score is equal or less than the 1988 score then the allowable provision for each period would reflect the score for the period or the actual provision if lower.

Further developments are awaited in the light of the provisioning policy for 1989.